Is “Too-Big-to-Fail” Still With Us?
Yes, It’s Hiding in Plain Sight

Dickinson School of Law
Pennsylvania State University
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April 11, 2014

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*Adapted from my testimony: “Ending Too-Big-to-Fail Subsidies: Incentives Really Matter,” before the United States Senate, Subcommittee on Financial Institutions and Consumer Protection; Committee on Banking, Housing and Urban Affairs, Washington, D.C., January 8, 2014
Some Basic Principles

- If you want less of something, tax it
- If you want more, subsidize it
- A subsidy is simply a negative tax
- Regulation is another name for a tax
- The imposition of taxes and subsidies is a role of the U.S. Congress
- If we wish to end “Too-Big-to-Fail,” we definitely should not subsidize it
The Too-Big-to-Fail Subsidy

- Huge: $50-100 Billion annually
- In perpetuity
- Distorts market forces
- Never approved by Congress
- Not illegal, but **economically** inconsistent with U.S. constitutional principles
- Transfer from taxpayers to BHC stakeholders, mainly top management and creditors
Before a Law School Audience

- Need to distinguish between
  - Strictly illegal behaviors
  - Behaviors that are reprehensible, unconscionable or ethically questionable

- We live in a civilized society where we do not necessarily condone all behaviors that are not explicitly prohibited under existing legal statutes
Market Forces Work When

- Proper incentives
- Competition
- Management responsive to shareholder interests
- No companies are either too big (or important) to prosecute

These pre-requisites violated by giant banking institutions
U.S. Banking Industry Concentration

- Concentration intensifies the impact of mistakes
The Banking Bust 2008-2009

Total $$ of 165 failed Institutions: $542 BILLION

TOTAL ASSETS OF (essentially 2) ASSISTED BANKS: $3.22 TRILLION

(failure with a different label)

BANK ASSETS DIRECTLY SUPPORTED ‘08-’09: $3.8 TRILLION

+ COMMERCIAL BANK ASSETS OF 7 OTHER FIRMS FORCED TO TAKE TARP FUNDS: $4.0 TRILLION

TOTAL BANKING ASSETS SUPPORTED: $7.8 TRILLION

~2/3 of the commercial banking industry!
Dodd-Frank Act ("DFA")

- Entrenches, rather than ends, Too-Big-To-Fail
- Unworkable and unenforceable due to length, scope, conflicts, and complexity
  - 849 pages of statutes
  - Over 14,000 pages of proposed regulations, so far
  - Regulations roughly half completed
- Increased government intrusion and weaker market incentives
Dodd-Frank Act ("DFA") cont.

- Next financial crisis will be bigger and be upon us sooner with DFA
  - Last crisis cost $15-30 Trillion (1-2 years of output)
  - DFA reinforces perverse incentives
  - As a nation, we cannot afford to repeat these same avoidable mistakes

- DFA reinforces perception of future bailouts
  - Designates large, complex financial companies as "Systemically Important Financial Institutions" (SIFIs)
  - Provides taxpayer funds for Debtor-In-Possession financing of bankrupt holding companies and subsidiaries
  - Perpetuates quasi-nationalization of largest financial institutions as happened in 2008-09
The Dallas Fed Plan

1. Restrict the safety net (Deposit insurance and Fed lending) only for commercial banking and payments system activities
2. Counterparties acknowledge in writing that no government guarantees support their transactions with nonbank affiliates
3. Government encourages managements of largest banking institutions to streamline and downsize their companies so that any banking affiliate is certified by FDIC as “Too Small to Save”
4. Strengthen Section 23A of FR Act to severely limit asset transfers and sales from nonbank subs to banks subs.

**BOTTOM LINE:** Puts the “market” back in market discipline; recognizes the limits of regulatory discipline
Strengthen Dallas Fed Plan by

- Subsidy Reserve Plan – distribute accumulated subsidy to shareholders only as significant asset sales occur (Professor Cornelius Hurley – Boston Univ.)
- Brown-Vitter TBTF Act requires 15 percent capital-to-asset ratio for largest banking institutions

- Interesting recommendation by Luigi Zingales (U. of Chicago)
  - Big reduction in CDS price would trigger requirement to issue equity within 30 days (like a margin call)
  - Otherwise, BHC taken over by regulator and liquidated
  - Will this work? Breakup at worst time? CDS manipulation?
Summing Up

 Thanks in significant part to “Too-Big-to-Fail,” the U.S. is “broke”
 Our enemies recognize this and treat us like the toothless tiger we have become
 As a nation we simply cannot afford another avoidable financial crisis
 Most of our political leaders talk about ending “Too-Big-to-Fail,” but support policies that subsidize and perpetuate TBTF
 The Dallas Fed Plan, reinforced by Subsidy Reserve Plan and Brown-Vitter, would bring an end to this hypocrisy.
In Conclusion

- There are some things monetary policy can’t fix

END TBTF ASAP
NOW!
References


Brown, Sherrod and David Vitter, Terminating Bailouts for Taxpayer Fairness Act (TBTF Act), S. 798, 2013.


THANK YOU