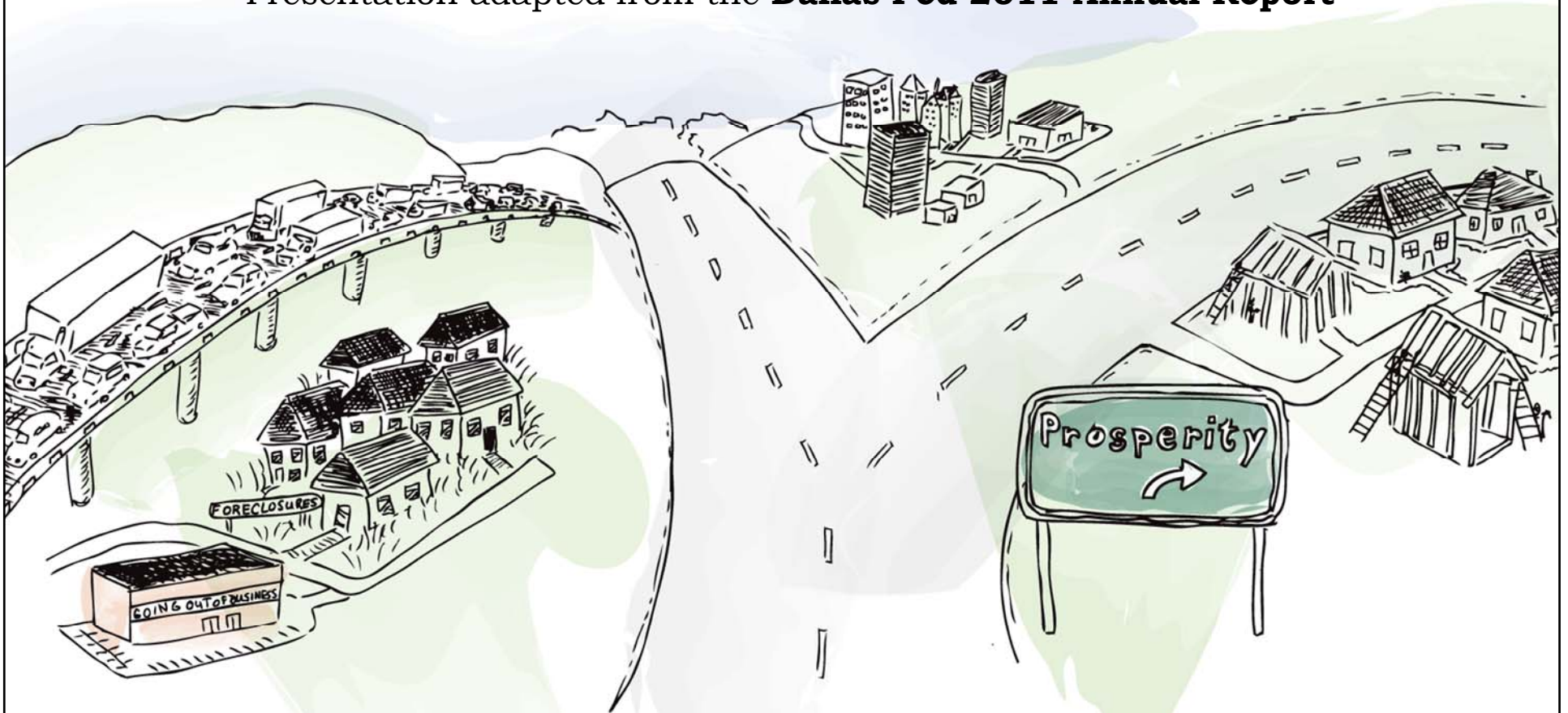




Choosing the Road to Prosperity: Why We Must End Too Big to Fail – Now

Presentation adapted from the **Dallas Fed 2011 Annual Report**



The views herein are those of the Federal Reserve Bank of Dallas and do not necessarily represent the perspective of the Federal Reserve System.



Dallas Fed 2011 Annual Report Media Response

OPINION |

Updated April 4, 2012. 12:23 p.m. ET

THE WALL STREET JOURNAL.

How Huge Banks Threaten the Economy

Article

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By RICHARD W. FISHER AND HARVEY ROSENBLUM

Our nation is at a fork in the road and the destiny of our financial system depends critically on choosing the correct route. One path leads to a continuation of the status quo, where some financial institutions are ordained by government policy to be "too big to fail" (TBTF) and where the rules of market capitalism are undermined and subverted. The other—the path to long-term prosperity—is the one we'll be on when we truly end TBTF.

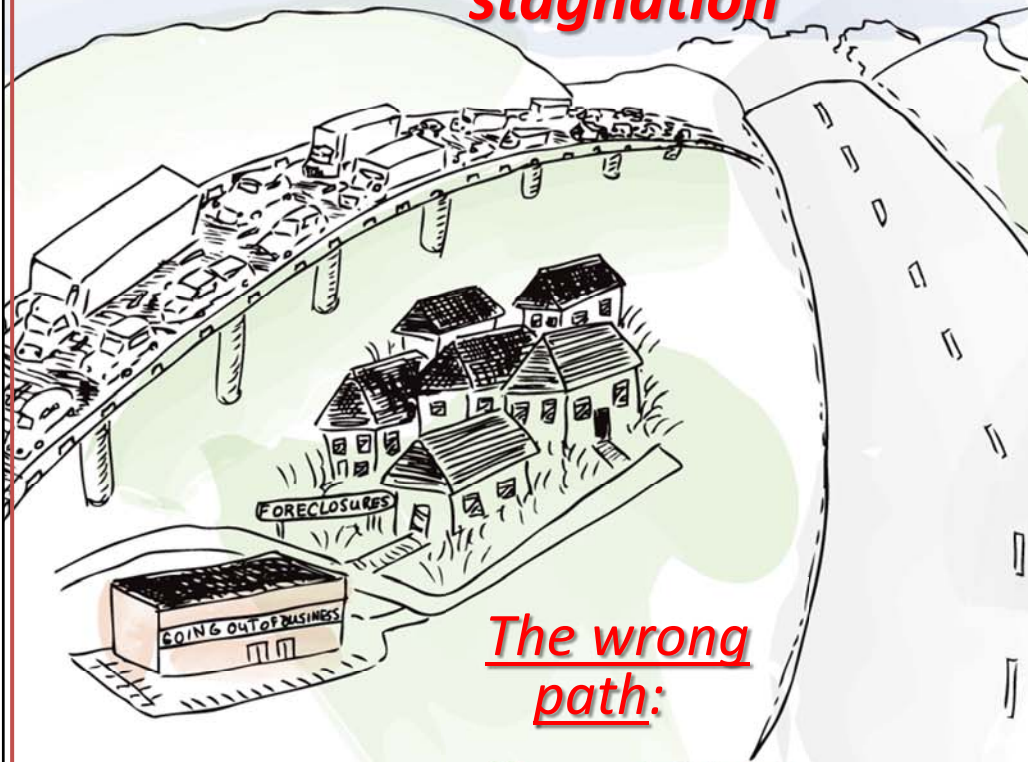
Press Coverage:

- ✓ Forbes
- ✓ Rolling Stone
- ✓ PBS Frontline
- ✓ CNBC
- ✓ The NY Times
- ✓ Wall St. Journal
- ✓ American Banker

- **Predominantly positive feedback**
- **But we left some of the important "next steps" and "how to" out**

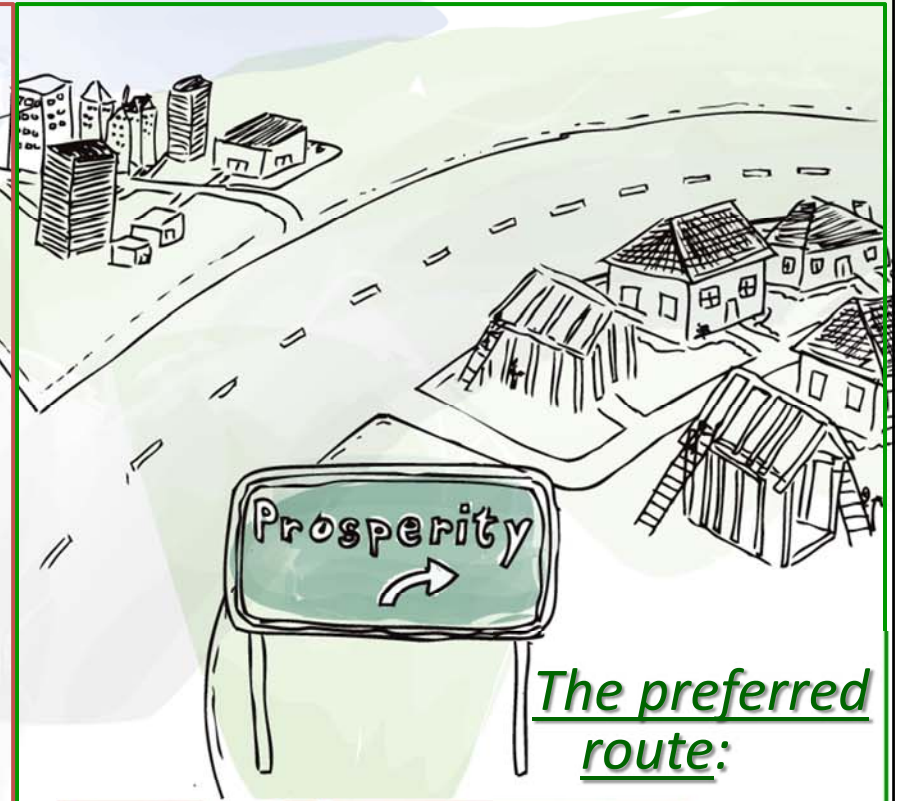
“When you come to a fork in the road, take it...”

**Economic
stagnation**

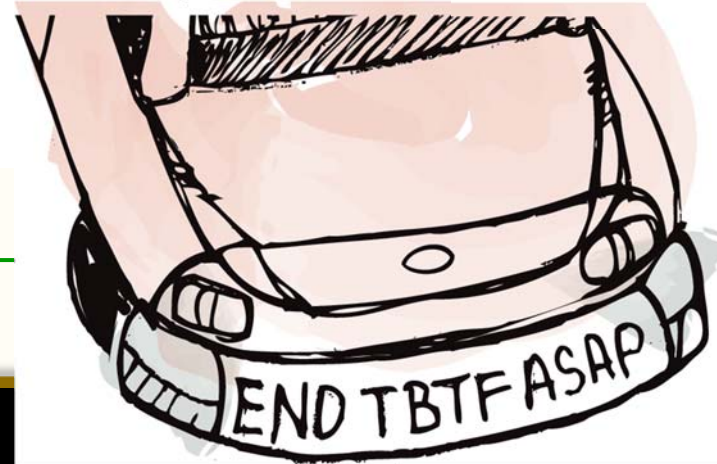


**The wrong
path:**

**Keep TBTF
Status quo**



**The preferred
route:**





What's the Status Quo?

- **A wimpy recovery**
- **After avoiding a possible depression**
- **And we've yet to fully address the financial system dysfunction**



Human Nature Guarantees Financial Crises

It's in our DNA:

- **Complacency**
- **Complicity**
- **Exuberance**
- **Greed**

Conclusion:

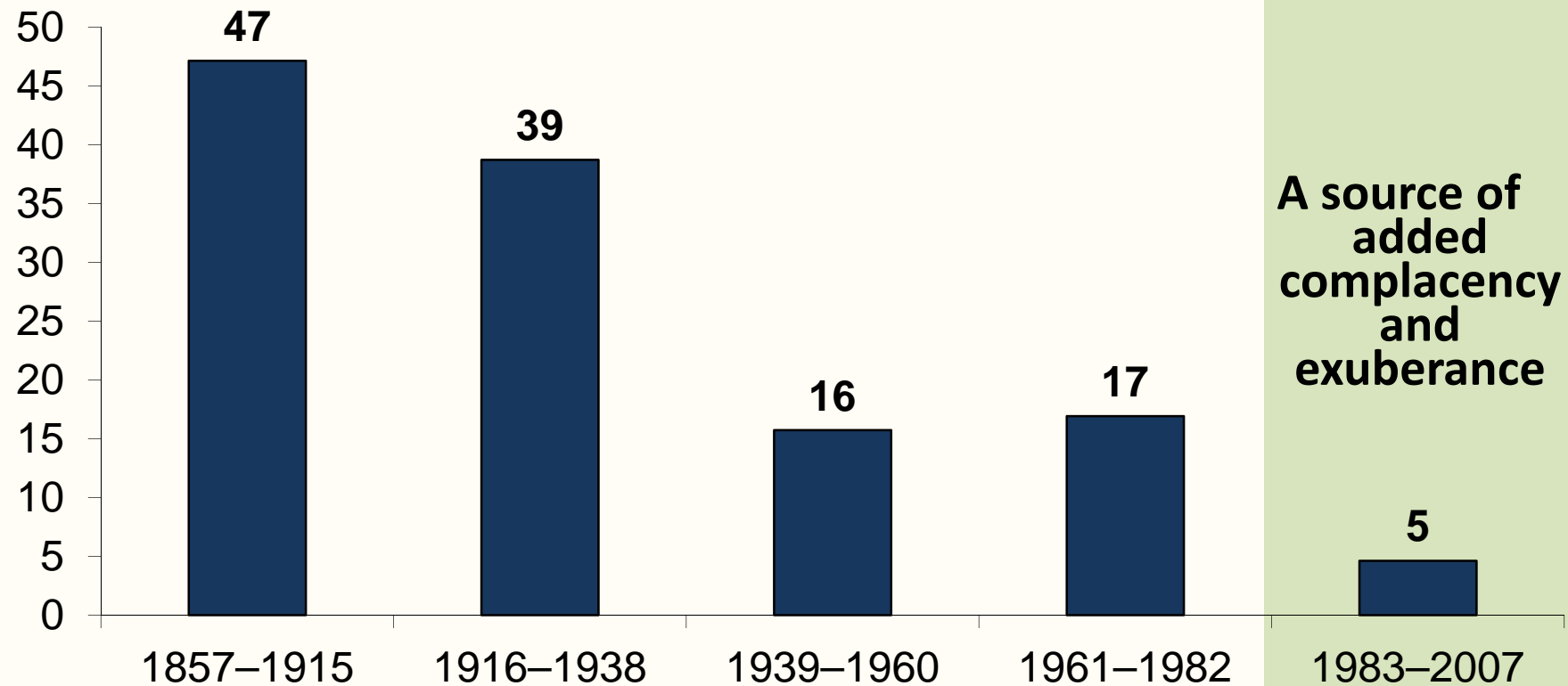
These human traits and weaknesses result in market disruptions that are generally occasional and manageable

More severe crises occur if implicit government support undermines market discipline



Time Spent in Recession Declined

Percentage of time spent in recession



Source: National Bureau of Economic Research



Willful Blindness

Practice of **willful blindness**:

the human tendency to see what we want to see
or are conditioned by our life experience to see

All Players

- Banks / Lenders
- Rating agencies
- Regulators
- Bank creditors
- Borrowers
- Prominent economists



Governor Sue Bies

FOMC May 10, 2006

Public Transcript p.64–65

- ❖ These mortgages say, “Just borrow for your house. You have a monthly payment, no amortization of principal, and you do not even have to pay the full rate. We will just continue to add to your principal, and you pay what you can afford every month versus what you really owe us on the fixed rate every month.” This process just continues... bothers me for the long run is the extent to which housing could slow this year and slow the economy.
- ❖ So the growing ingenuity in the mortgage sector is making me more nervous... rather than comforted that we have learned a lesson. Some of the models the banks are using clearly were built in time of falling interest rates and rising housing prices. It is not clear what may happen when either of those trends turns around.



All Booms End Up Busts

Boom

- Easy money
- Speculation
- New, risky instruments
- Run-up in asset prices
- Borrow and consume

Buying into the exuberance

History is easy to forget

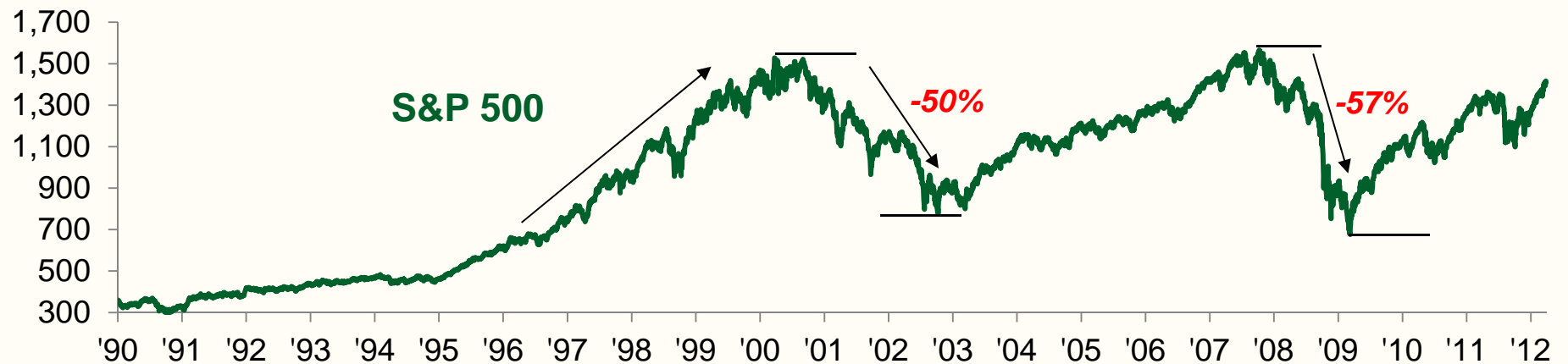
- ❖ 1637 Dutch tulip mania
- ❖ 1720 South Sea bubble
- ❖ 1989 Japanese RE & Equity
- ❖ Late '90s Beanie Baby bubble
- ❖ 2000 Dot-com bubble

*Recent
memory*

*But then comes a sad refrain of regret:
How could we have been so foolish?*

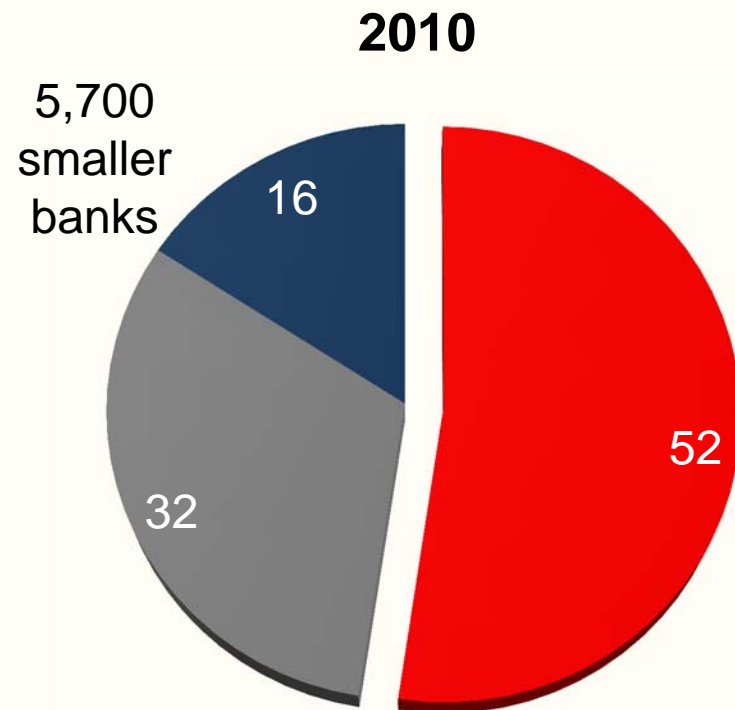
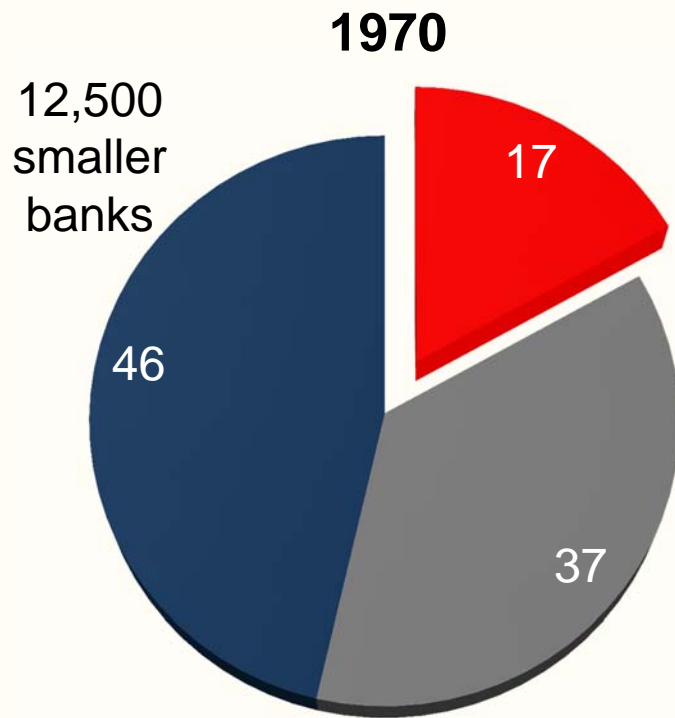


Equity Boom and Bust





U.S. Banking Industry Concentration



■ Top 5 ■ Next 95 Largest ■ Smaller Banks

Source: Federal Financial Institutions Examination Council, Reports of Condition and Income; Fed, National Information Center.



Concentration Kills

- **Concentration** intensifies the impact of mistakes

“Human weakness will cause occasional market disruptions. Big banks backed by government turn these manageable episodes into catastrophes.”

p. 21, 2011 Dallas Fed Annual Report



The Banking Bust 2008–2009

Total \$\$ of 165 failed institutions: \$542 billion

TOTAL ASSETS OF (essentially 2) ASSISTED BANKS:
(failure with a different label) \$3.22 TRILLION

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!



Too Big to Fail

TBTF */tee-bee-tee-ef/*

The unwillingness of a government entity to abruptly close an insolvent company and force its creditors to sustain sizeable losses due to the company's size, complexity, interconnectedness and general significance within the financial system.

Related: If taxpayer funds are used to prolong the life of the company, it is generally labeled a **bailout**.

Reference: *zombie, living dead and walking dead.*

See also: **systemically important financial institution (SIFI)**



We Were at the Edge of the Cliff

Jamie Dimon

Saturday, Sept. 13, 2008

As quoted in **Sorkin, "Too Big To Fail,"** pg. 3

"Then he dropped his bombshell ...

Here's the drill. We need to prepare right now for **Lehman Brothers** filing... and for **Merrill Lynch** filing... and for **AIG** filing. *Another pause.*

And for **Morgan Stanley** filing.

After an even longer pause, he added:

and potentially for **Goldman Sachs** filing...

There was a collective gasp on the phone."



Too Big to *Fail* is a Misnomer

Degrees of Failure:

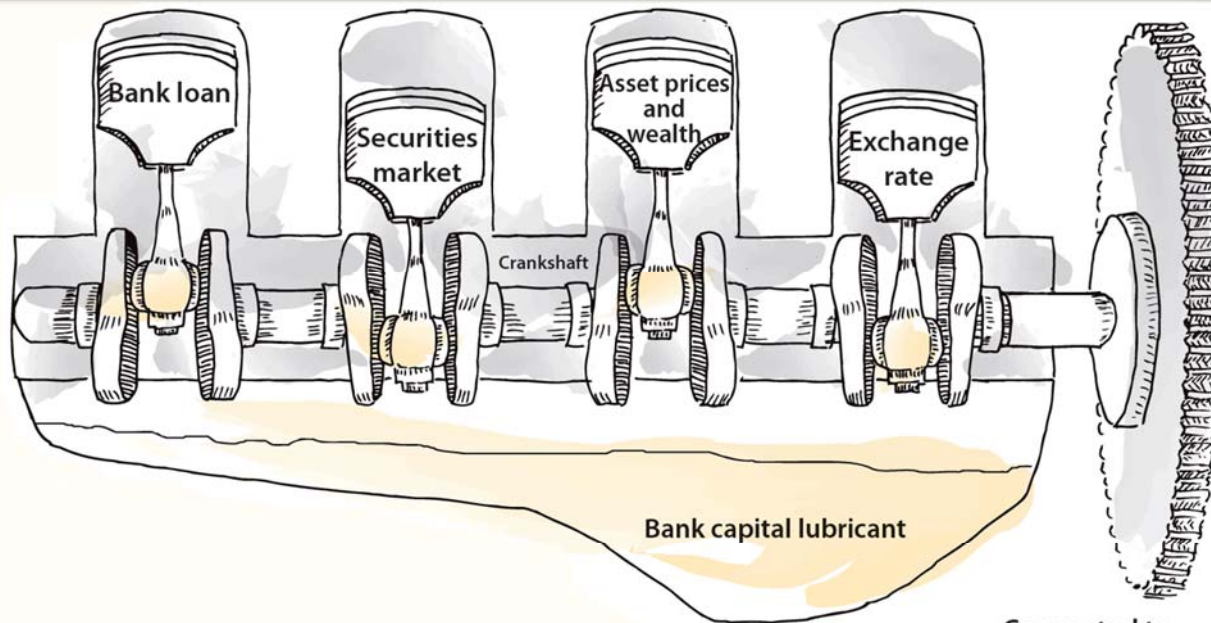
- ❖ Bankruptcy
- ❖ Buyout
- ❖ Bailout

Different labels, but all very similar:
part of the process of *creative destruction*

*But with several important differences—
especially PRIVATE v. TAXPAYER FUNDING*



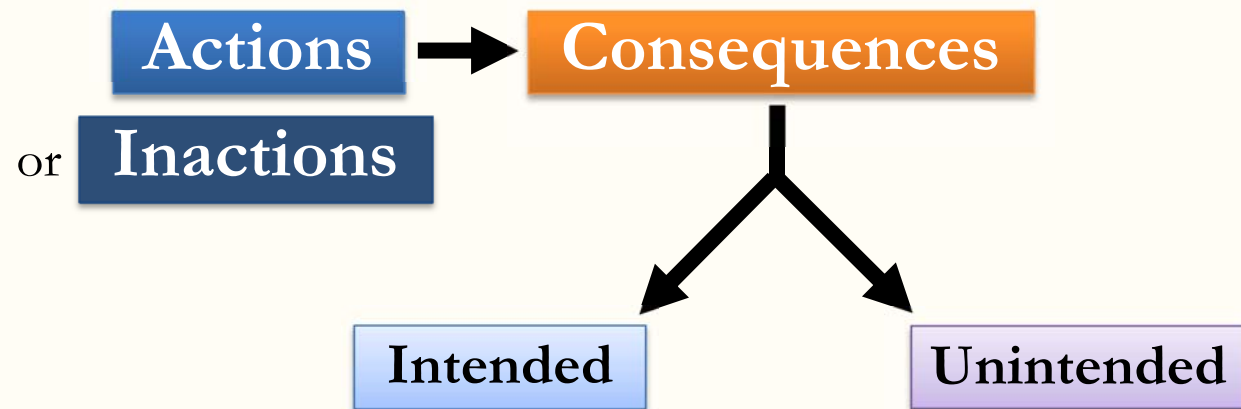
Monetary Policy Engine Is Not Hitting on All Cylinders



- ***Sick (or failed) banks can't lend***
- **Undercapitalized banks gum up the working of the interdependent moving parts of the monetary policy engine**

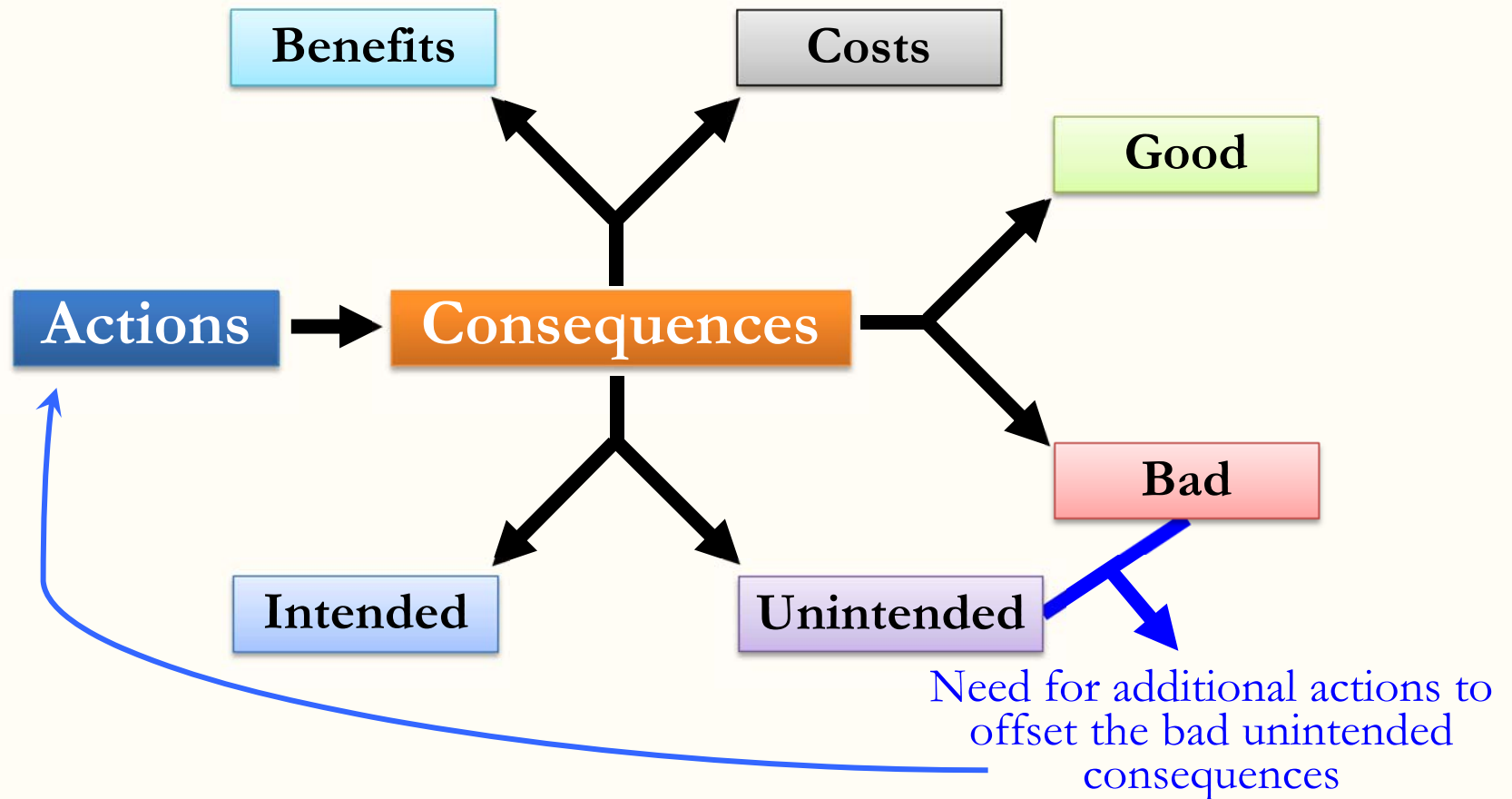


The Federal Reserve's Policy Responses





Policy-Making Is Complicated





Murphy's Fourth Corollary:

If you perceive that there are four possible ways in which a procedure can be wrong, and circumvent these, then a fifth way will promptly develop

– Murphy's Law 2012 Calendar, by Arthur Bloch



Financial & Economic Events

'07-'08

Nonbank
SIFIs get
in trouble

'08-'09

Big banks
suffer
significant
losses

Economy
in trouble

'09-'10

Small and
medium
banks
struggle

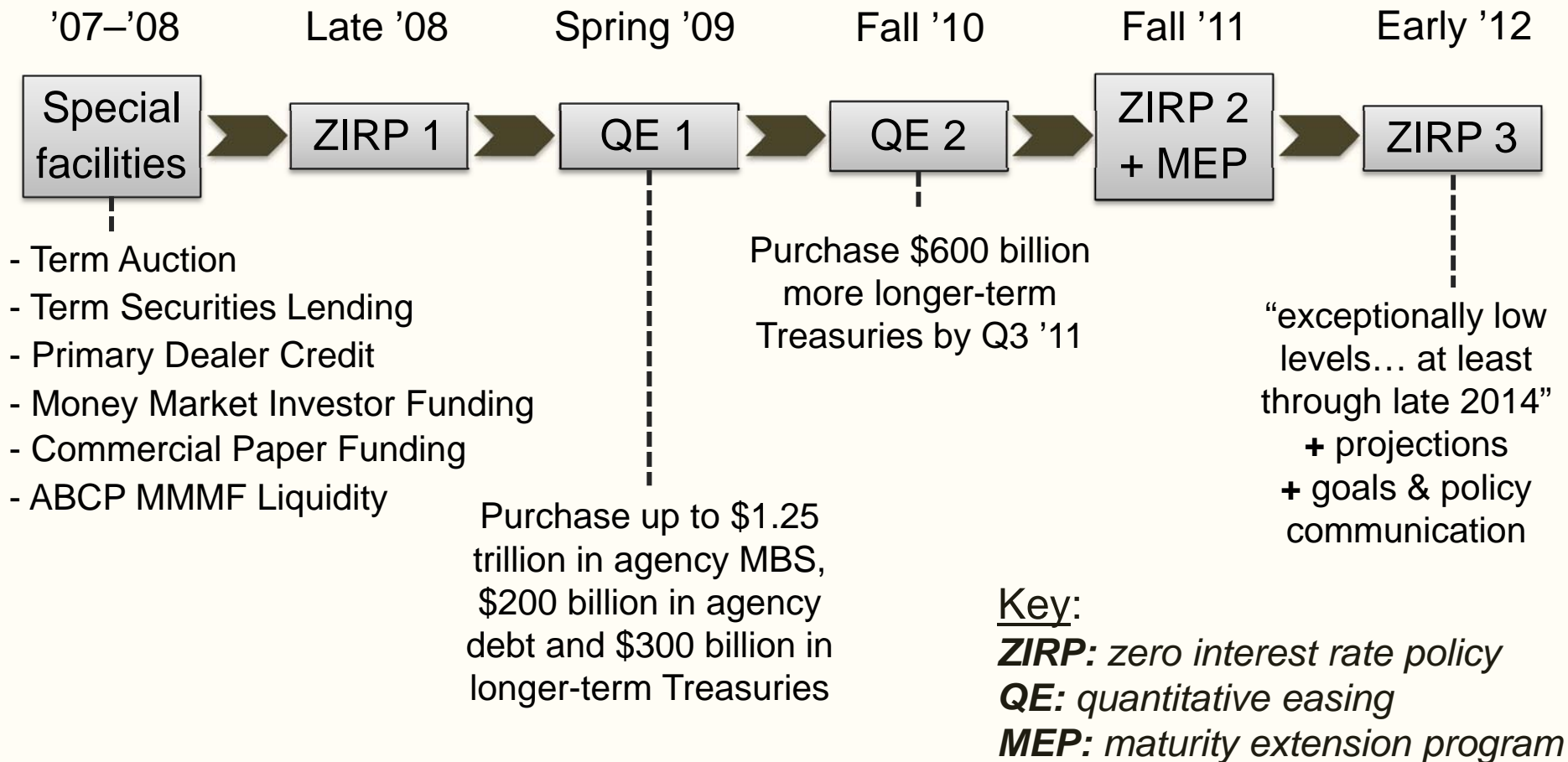
'09-'12

Sluggish
recovery





Monetary Policy Responses





Financial & Economic Events

'07-'08

'08-'09

'09-'10

'10-'12

Nonbank
SIFIs get
in trouble



Big banks
suffer
significant
losses



Economy
in trouble



Small and
medium
banks
struggle



Sluggish
recovery

Monetary Policy Responses

Special
facilities

ZIRP 1

QE 1

QE 2

ZIRP 2
+ MEP

ZIRP 3

'07-'08

'08-'09

'09-'10

'10-'12

"If your only tool is a hammer, every problem looks like a nail"



Fed's Monetary Policy Toolbox

The Fed actually has 2 instruments:

- 1. THE HAMMER – FED FUNDS RATE**
- 2. A SCREWDRIVER – LENDING FUNCTION**

Both provide LIQUIDITY

- ❖ **Fed's lending function is designed to be a standing facility generating support for banking system commitments**

**But they do not address SOLVENCY,
*and they won't in the next crisis either***

Need appropriate **fiscal policy and **regulation** to address solvency issues.**



The BLOB That Ate Monetary Policy

**Why so much monetary policy
firepower to deal with the crisis?**

**Central Bank Balance
Sheet Expansion**
since July 2007

Fed: 3.3X

ECB: 2.2X

BoE: 4.2X



The BLOB That Ate Monetary Policy

OPINION

September 27, 2009, 7:38 p.m. ET

THE WALL STREET JOURNAL

The Blob That Ate Monetary Policy

Banks that are 'too big to fail' have prevented low interest rates from doing their job.

Article

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By RICHARD W. FISHER AND HARVEY ROSENBLUM

Fans of campy science fiction films know all too well that outsized monsters can wreak havoc on an otherwise peaceful and orderly society.

But what B-movie writer could have conjured up this scary scenario—Too Big To Fail (TBTF) banks as the Blob that ate monetary policy and crippled the global economy? That's just about what we've seen in the financial crisis that began in 2007.

While the list of competitive advantages TBTF institutions have over their smaller rivals is long, it is also well-known. We focus instead on an unrecognized macroeconomic threat: The very existence of these banks has blocked, or seriously undermined, the mechanisms through which monetary policy influences the economy.

***Monetary policy
is undermined
by TBTF banks***



What's Being Done?

Dodd-Frank Act (DFA)

Primary goal: *End TBTF*

Means / efforts to that end:

- Raise capital
- Increase liquidity
- Implement an **orderly liquidation authority** for SIFIs

Procedure:

- Will likely work for closing a single large financial firm
- Relies on FDIC
 - Good at closing small banks
 - However, limited experience with large banks or SIFIs



The DFA Distraction

DFA still doesn't address all that needs to be done

DFA is a **distraction if it doesn't buttress market discipline**

Bigness / Concentration



Complexity



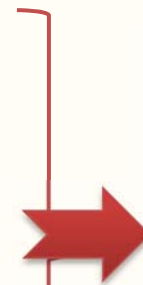
Difficult to manage



Difficult to supervise



Lack of market discipline



**TOO
MANY
TO
FAIL**



Options to End TBTF

In order to keep the TBTF behemoths from crushing the financial system again in the future

Some possibilities

- **Follow DFA as enacted**
 - Negatively impacts community banks (*unintended consequence*)
- **Encourage restructuring and streamlining**
- **Overregulate / TBTF tax**
 - TBTF banks will find ways to become smaller

Goal: choose the *LEAST BAD* solution
There are no "good" solutions



Restructuring Less Radical Than Most Alternatives

The “WHAT” is determined:

- ❑ Congress and Justice Department design the general rules / guidelines

The “HOW” is left to others:

- ❑ Banks choose how to streamline and refocus
 - ❑ Private-sector buyers help rationalize the business model
 - ❑ CREATIVE DESTRUCTION allowed to work
- least bad*

Otherwise, consider the alternatives:

- ❑ Quasi-nationalization as in 2008–2009
 - ❑ **Full nationalization**, a Great Depression-type scenario
- truly bad to worst*



Ending Too Big to Fail

Benefits

- ❖ Enhanced market discipline
- ❖ Costs of failure are private costs, and not socialized
- ❖ Reduced monopoly power
- ❖ Level playing field
- ❖ Safer, more resilient financial and economic system
- ❖ Restore faith in market capitalism

Costs

- ❖ May forego some benefits of economies of scale and scope
- ❖ One-stop shopping for financial services becomes more difficult, perhaps weakening “customer experience”

.....

On net, benefits of ending TBTF far outweigh the costs



A Few Guiding Principles for Financial System Reform

To achieve a more competitive & resilient financial system:

Harness market forces and incentives as much as possible

- **Limit the federal safety net** to federally insured deposits and a fully collateralized lender-of-last-resort facility **available only to legally separable depository institutions** – and NOT their affiliated companies.
- All creditors and counterparties of financial companies / entities other than federally insured depository institutions put on notice that there is no federal safety net covering their transactions. NONE.



A Few Guiding Principles for Financial System Reform

End banking oligopoly power

- *Quasi-nationalized* companies receiving taxpayer assistance are by definition getting federal subsidies and are provided an unfair advantage over other “nonsubsidized” competitors.
- A level playing field requires that assisted companies be wound down and closed quickly. In addition, the largest financial institutions should be *last in line* to acquire the assets of failed institutions; **reduce**, not increase, **industry concentration**.
- While there may be significant economies of scale / scope, they need to be weighed against *economies of specialized expertise* and ***diseconomies of dysfunctionality, monopoly power, TBTF subsidies*** and ***devolution of cross-border banking institutions***.



A Few Guiding Principles for Financial System Reform

Punish failure quickly

- Specify, in advance, a set of **harsh, non-negotiable consequences** for requesting or requiring U.S. Treasury (taxpayer) assistance (or capital injections of any kind).

Such as:

- Removal of CEO and top executive team, replacement of Board of Directors, and making all employment / compensation and bonus contracts null and void as a precondition for taxpayer assistance. No golden parachutes.
- Clawback of any bonus compensation (cash and stock) paid to the top management team in the two years prior to receiving federal assistance.



A Few Guiding Principles for Financial System Reform

Change the “do-or-die” decisionmaking paradigm

- Steer the evolution of the financial structure so that the Treasury Secretary is unlikely to be faced with an edge-of-the-cliff decision to provide taxpayer assistance or be held responsible for a great depression.
 - Neither the Treasury Secretary nor Federal Reserve Chairman is trained or equipped for making “fate-of-the-world” decisions.
Nobody is, really.
- Actively guard against ***willful blindness***.



Streamlining, Reorganizing and Refocusing Already Under Way

Financial Times, p.14

April 17, 2012

Tom Braithwaite, "Sordid footnote offers important lesson for megabanks"

- Some of the largest financial institutions already recognize:
 - ❖ **"Subsidiarization"** – organizing global banks into separate national operations – is the "watchword of modern banking."
 - ❖ **"Deglobalization"** is occurring – Goldman, HSBC and Citi have recently sold stakes in international markets.
 - ❖ The new regulatory landscape – Barclays and Deutsche Bank have begun reorganizing themselves.

.....

Reorganization will enhance the effectiveness of supervision (and in times of failure, *resolution*) of systemic institutions



Status quo:

We're on the road
to economic stagnation

*Suffering and perpetuating
perverse incentives*

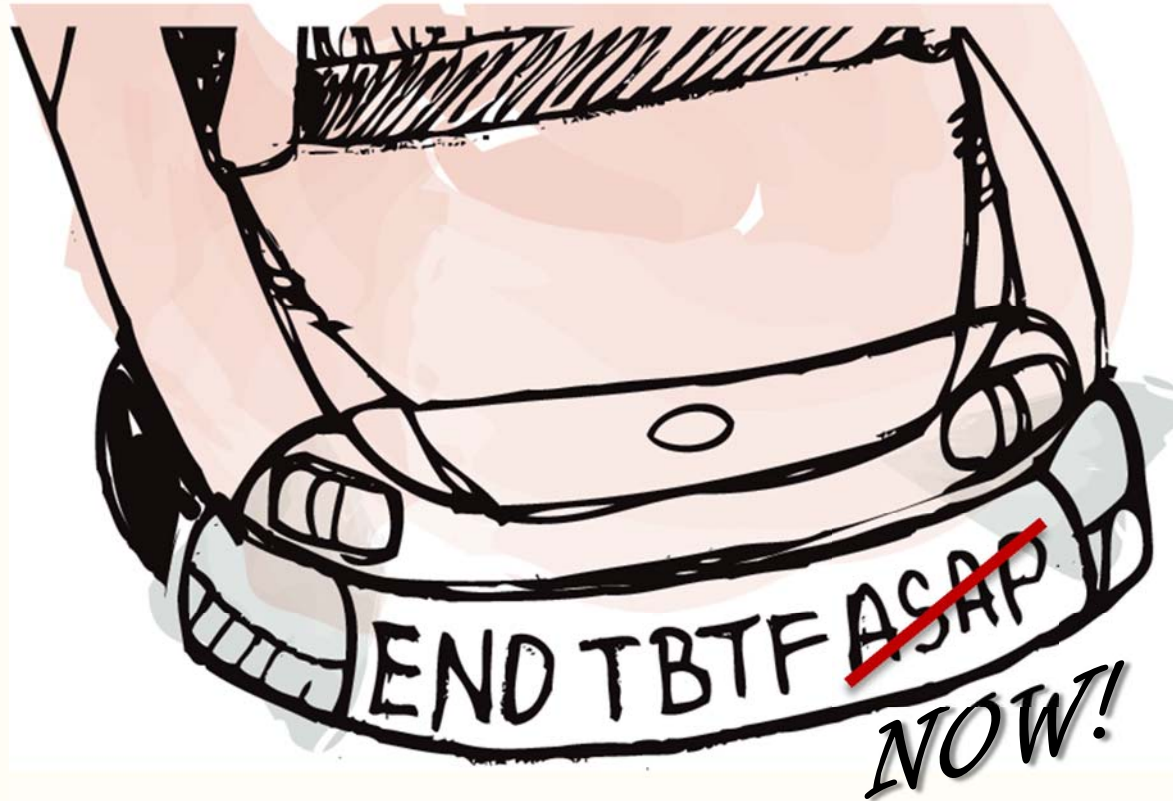
Where we want to go:

Get to the road to prosperity
and get back to basics

**Restructuring isn't so radical,
firms do it all the time**



In Conclusion



- ***THERE ARE SOME THINGS MONETARY POLICY CAN'T FIX***