

IT'S NOT OVER 'TIL IT'S OVER:  
LEADERSHIP AND FINANCIAL REGULATION

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The views expressed by the author are his own and do not necessarily reflect those of the Federal Reserve System, its governors, officers or representatives.

## **Introduction**

I was honored to be asked to speak at this year's William Taylor Memorial Lecture. I worked with Bill from the time he arrived at the Board of Governors until he left to lead the FDIC. During the period that he led bank supervision activities for the Federal Reserve, I was in banking supervision at the Federal Reserve Bank of Kansas City, serving in a variety of areas from banking economist, to merger analyst, to discount window officer, to the officer in charge of Financial Supervision. During that period, including the crisis of the '80s, nearly 350 banks were closed or received open assistance in the Kansas City District states alone. I think it's fair to say I was a student of Bill Taylor.

During the recent financial crisis, as ever more serious problems emerged, I couldn't help but think back to Bill. I remembered how he managed the numerous problems that emerged with almost infinite regularity during that earlier period; how he led our efforts in dealing with the Ohio thrift crisis, the New England financial crisis, the Midwest ag crisis, the Southwest energy crisis and bank failures as large as Continental Illinois, which at that time was the seventh largest bank in the United States with operations in 29 countries. I recall how Bill coolly dealt with CEOs of the largest banks in America. He also was blunt and straight with the facts when working with us in the field or in talking to a senator, or even to his boss, Paul Volcker.

As I looked back to this period, it occurred to me that few of our current examiners were around during those years and fewer still knew Bill, so at our Bank we wrote a small book called [Integrity, Fairness and Resolve: Lessons from Bill Taylor and the Last Financial Crisis](#), which has circulated to bank examiners pretty broadly. A copy is available for each of you this evening, and I hope you will take the opportunity to read this short biography that explains why so many respect Bill Taylor so highly.

I cannot say with certainty how Bill would have dealt with all aspects of this most recent crisis. But like Paul, I am confident we would have been well served had Bill Taylor been with us in the times leading up to this crisis, and that the regulatory reform legislation just enacted would have been something less than 2,300 pages long. That said, the Bill Taylor story isn't just the what-if musings of a bank supervisor. The story is about leadership and is particularly timely now because without strong leadership, current regulatory reform efforts will fail.

The president's signature on the Dodd-Frank Act is only the beginning of a process. The Act is long, complex, sometimes extremely precise and other times vague and confusing. It has

provisions which require that an enormous number of rules be written and expertise be developed across a host of financial activities and firms. With that in mind, I will touch on only a sample of the key issues that confront us with this legislation and its implementation.

First, the Act outlines a method to resolve our largest firms, and I am hopeful that it will be implemented with force and clarity. However, until proven otherwise, it would be unwise to ignore the reality of size and influence on future decisions regarding these largest institutions.

Second, uncertainty around “too big to fail” makes the Volcker Rule and the implementation of strong capital rules all the more critical in minimizing the likelihood that these institutions again cause a financial crisis that undermines our national and global economies.

Third and most important, we need leaders like Bill Taylor who understand financial institutions and have the wisdom to ask the right questions, the courage to call it as they see it and the resolve to overcome the inevitable obstacles to strong supervision.

### **Resolution and the Future**

As we think about a resolution process for this country’s largest financial institutions, it is important first to consider what the failure of such a firm implies for our economy. The largest bank holding company in the United States controls more than \$2.4 trillion of assets, which is roughly 16 percent of GDP. The largest five institutions control \$8.4 trillion of assets, nearly 60 percent of GDP, and the largest 20 control \$12.8 trillion of assets or almost 90 percent of GDP.

It's pretty certain that should any one of these firms encounter significant trouble, the negative, systemic effects for creditors would be immediate and the adverse impact on businesses and consumers would soon be evident. The uncertainty from such a failure on other firms who are interconnected or who followed the same lending path would affect confidence in the entire national and global economies.

The Dodd-Frank Act outlines a process for resolving failed “systemically important” firms at no cost to taxpayers. It calls for taking a firm into receivership when it defaults and having stockholders and creditors absorb the losses to avoid taxpayer bailouts. It allows for bridge banks and transitional funding to continue essential operations and services for maintaining financial stability. To the extent that we achieve this outcome, our economy and our country will be well served.

However, the reality is that the possible adverse effects on the global economy of a failure of such a firm would be enormously destabilizing and harmful.

What Federal Reserve chair, FDIC chair, or secretary of Treasury would risk an economic collapse when by making some creditors whole, the panic might be stopped? And I can assure you that when the regulatory authorities begin the process for recommending receivership, they almost certainly will find themselves facing an atomic force of resistance from those at risk.

I have another practical reason for doubting that our too-big-to-fail problem has been solved. Prior to Dodd-Frank, the Bank Holding Act allowed regulators to force the termination of activities or sale of subsidiaries that are a risk to the safety and soundness of an affiliate bank. To my knowledge, this authority has never been successfully used for a major banking organization.

The reality is that unless the rules are written so tightly that there remains no bailout option, we cannot be confident that “too big to fail” has ended.

### **Volcker Rule**

The possible continued existence of “too big to fail” highlights the importance of other provisions of the Act, especially the Volcker Rule.

It has been noted that commercial banks hold the franchise for our nation’s payments system. They carry the responsibility of trusted intermediary for our deposits used in payments and trusted repository for much of our savings and trust assets. These critical roles explain why commercial banks are provided a substantial safety net – which includes access to the enormous resources of the central bank and deposit insurance.

For several decades following the Great Depression and the reforms of that time, it was understood that commercial banks would be afforded these special protections and privileges but in return they would be limited in their risk-taking. The Glass-Steagall Act codified this understanding.

In 1999 with the Gramm-Leach-Bliley Act, the separation of commercial banks and the more highly risk-oriented investment banks was ended under the rationale that it would enhance competition and extend services to the public. The largest institutions lobbied extensively for this change using their great wealth and influence to see it successfully passed.

Some of us who had experienced the chaos of the '80s, including individuals like Paul Volcker and Bill Taylor, had long-held concerns that if the separation of commercial and investment banking activities were ended, it would lead to ever-larger concentrations of financial assets and would worsen the problem of “too big to fail.” The truth is it took less than a decade for our first major crisis related to this merging of activities to occur.

In the period leading up to this most recent crisis, the regulatory authorities, like the industry, trusted that the market would self-regulate. It didn't, it can't and it won't. The industry's structure and incentives are now inconsistent with the market being the disciplinarian.

The Volcker Rule does not reinstitute Glass-Steagall. It does improve the odds toward financial stability by instituting a partial return to the separation of commercial and investment banking activities. It strives to affirm the principle that those institutions that by their franchise have access to the safety net should be separated from those firms that are free to speculate with shareholder, not taxpayer, funds.

Paul has it right.

## **Capital Standards**

What about capital and our banking system? To me, it is a simple fact that the rules around bank capital define the strength of our financial system in the long run. Capital, which I define simply as tangible common equity, serves first as a discipline on a bank's appetite for risk and, when needed, helps absorb losses from unexpected shocks. And finally, it gives confidence to depositors and other creditors that a firm can reasonably be expected to withstand an economic downturn.

However, the expansion of the safety net and the incentives this engenders discourages equity capital on a bank's balance sheet. Financial firms enhance the returns to investors by “leveraging up” assets against this capital. The market, knowing the safety net is in place and assuming the most influential firms will be bailed out, lends at favorable rates and facilitates the trend toward ever-greater leverage and risk. Like Gresham's Law on money, bad capital drives out good capital.

To address this weakness in the system, the Dodd-Frank legislation instructs the regulatory authorities to set up appropriate capital and leverage standards. This process is also

under way at the international level, with the completion of the Basel standards, requiring higher levels and stronger forms of capital.

Although this is a good start in establishing meaningful capital levels, those responsible for financial oversight will face a heavy burden to hold firms to any enhanced capital standard. It takes time to build capital. It inhibits the payments of dividends that banks are eager to restart.

We can be certain that there will be an enormous effort put forward to substitute other forms of liabilities for equity or to change the terms. The industry and others will remind us often that to place too high a capital requirement or too short a time horizon on the industry will constrain credit and slow the recovery and expansion. However, we can be just as confident that current equity capital standards must be set much higher than recent levels if the industry is to retain the public's trust and be a source of sustained credit and economic growth.

As a Swiss central banker once insisted to me many years ago, “[I]t is the central bank's job to focus on the long run so that the short run can take care of itself.”

For me, one certain lesson from this most recent crisis is that both the industry and supervisory authorities lost sight of the long run.

The industry over a series of years systematically pushed to increase its flexibility around underwriting greater levels of risk, pursuing greater leverage for the sake of short-term returns. Risk management systems were weakened or abandoned outright. Executives whose job it was to sound the alarm were ignored or in some cases dismissed.

The CEO and boards of directors of many companies didn't have any reasonable understanding of the risks they were taking and didn't care so long as profits flowed quarter to quarter. They failed in their fiduciary duties.

The regulators also came up short. They too often allowed leverage to increase to unprecedented levels without raising alarms. They backed down to congressional and industry pressure. The fallout of such failures is now all too obvious.

Any regulatory reform will fail unless the industry and the regulatory authorities are resolute in their commitment. We should not have needed legislation to tell us the necessity of maintaining strong capital and underwriting standards. It should not have taken legislation for us to recognize the importance of controlling conflicts of interest and addressing early on the issues around moral hazard that have undermined the integrity of our financial system. It also is not a matter of too many regulators because recent experience dismisses that as the core issue.

## **The Bill Taylor Rule**

No, the core issue is leadership. We need leadership that reflects the highest level of integrity, is trusted at the outset as fair and has the resolve to implement a regulatory program that looks past special interest and focuses on the system. Why don't we just call it the Bill Taylor Rule.

Bill recognized that the failure of a bank, regardless of its size, had an important impact on the community it served, its business customers and consumers. He understood that the job of a bank supervisor was not to close banks, but to enforce rules and exercise regulatory judgment that minimized bank failures. He encouraged strong capital standards, insisted on tough examinations and outlined careful actions with a focus toward mitigating problems and strengthening the system before it became subject to unmanageable crises.

There is one additional characteristic of Bill Taylor that enabled him to be a great leader in bank supervision: He was a commissioned examiner. He knew what the examiners were facing. He knew the tricks of the frauds and the arguments of desperate bankers. Bill insisted that his briefings come from the field examiner of a problem bank, not the officer in charge.

With Bill, you didn't worry about his past, current or future conflicts. Nothing prevented him from telling the hard facts. He was not concerned with re-election, reappointment or fundraising. He had no paid speeches or consulting contracts. He wasn't "giving back" or building his resume. Bill understood the unique role a financial regulator should play outside of politics and profit.

Bill Taylor was the cop on the beat and Bill Taylor is the model on which to write the job description for those who will lead financial supervision.

## **Conclusion**

I will close with an excerpt from a speech Bill gave in 1987 in which he anticipated with amazing accuracy today's events. He said:

"The banking structure of the country will change. It's ... now a matter of playing it out ... to a nationwide banking arrangement. ... Although I have some hope for moderation, the increased competition brought about by all these changes in combination with the fascination of this country for debt and leverage will continue to create stress that will require very close

attention. ... Now, one never knows. It's not over 'til it's over. ... (This) old examiner ... has these suspicions lurking in his heart. Suspicions that say the answer to world hunger is not eating someone else's lunch."

Bill called it as he saw it. And once again, Bill was right.