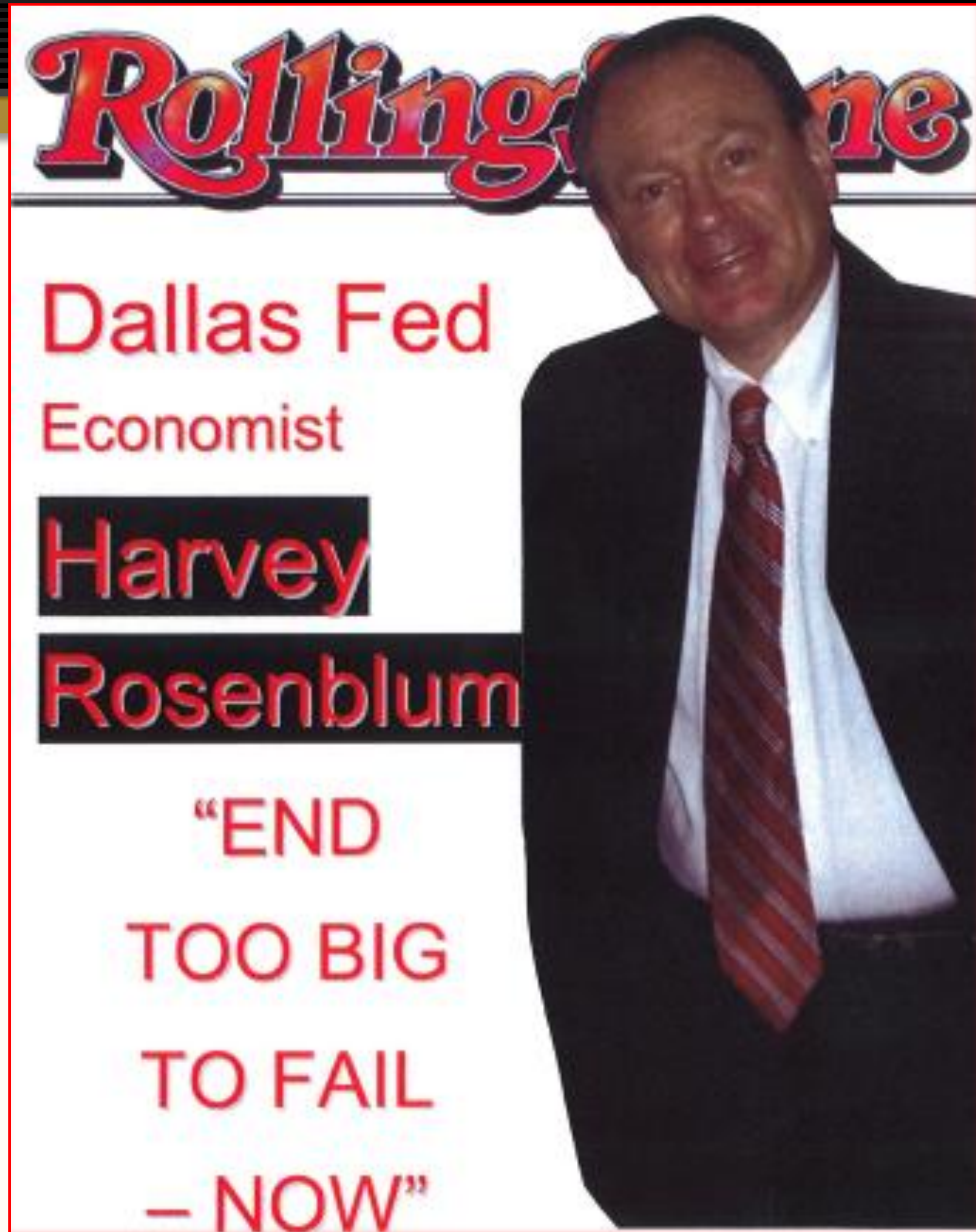
"Choosing the Road to Prosperity: Why We Must End Too Big to Fail—Now"

Economic Insights:

Conversations with the Dallas Fed Webcast

Federal Reserve Bank of Dallas
May 1, 2012


Rolling
Dallas Fed
Economist
Harvey
Rosenblum
“END
TOO BIG
TO FAIL
– NOW”

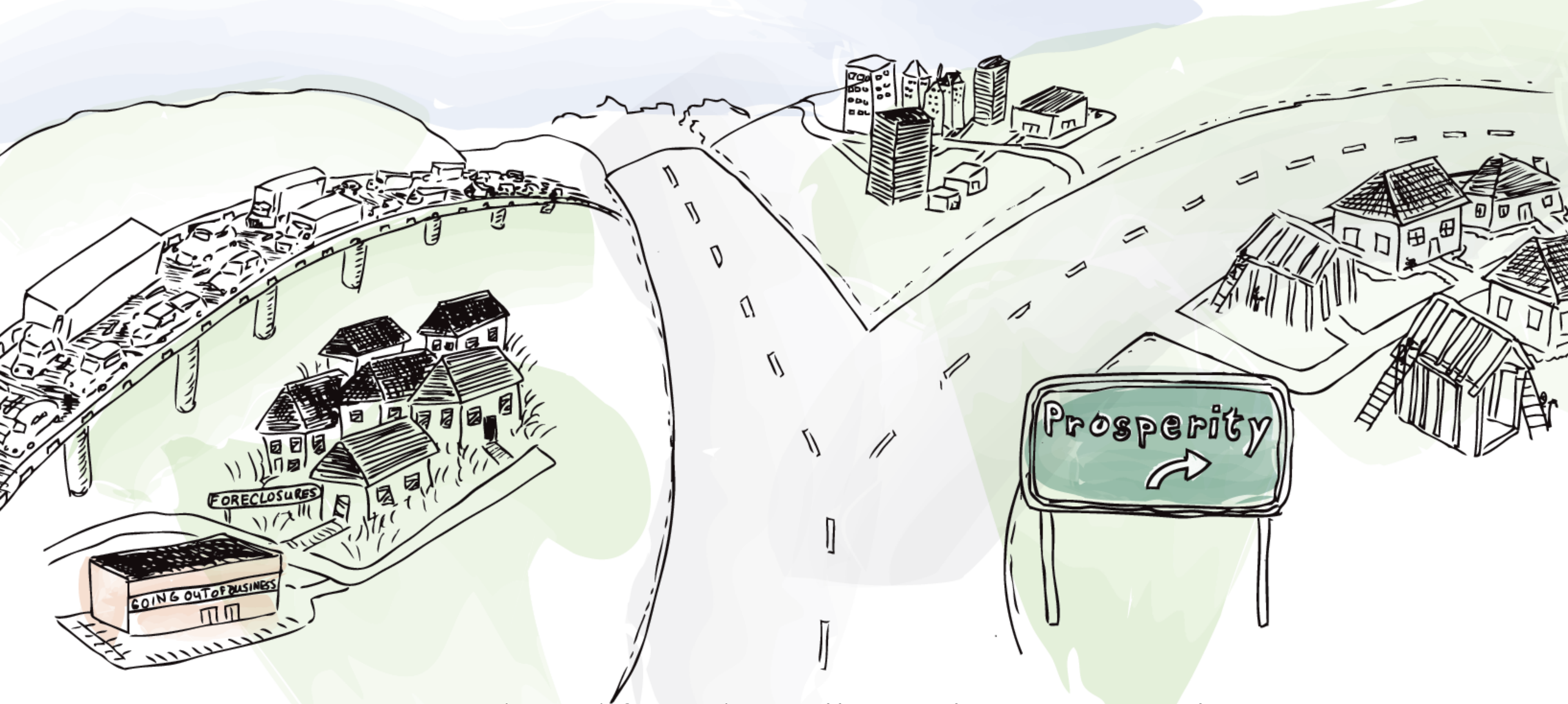
Economic Insights:
Conversations with the Dallas Fed

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

Harvey Rosenblum
Executive Vice President
and Director of Research

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

by Harvey Rosenblum and David Luttrell



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

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

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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:

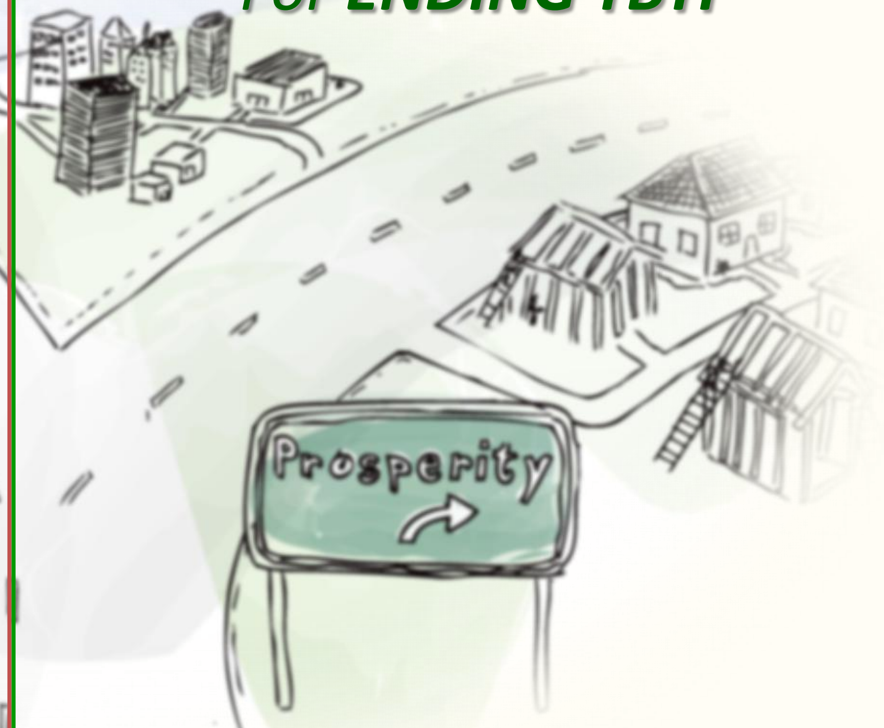
- ✓ Forbes
- ✓ Rolling Stone
- ✓ PBS Frontline
- ✓ CNBC
- ✓ The NY Times
- ✓ Wall St. Journal
- ✓ American Banker

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

For Keeping TBTF

No action needed,
status quo

For ENDING TBTF



*Follow Dodd-Frank and **reinforce** with better **market incentives** that **internalize the costs of failure***

*No Middle Ground, really, with regards to **ENDING TBTF***

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

UNLESS, the perverse incentives of implicit government guarantees destroy market discipline

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* (or *not to see*)

All Players

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

Willful Blindness

The call for caution was not heeded:

Governor Sue Bies
FOMC May 10, 2006 Public Transcript p.63–65

- The extent to which housing could slow and sink the economy had bothersome implications
- Enormous ingenuity in the mortgage sector made her nervous
- Questioned what may happen if the trends in falling interest rates and rising housing prices turned around

❖ Current Dallas Fed financial analyst, **Danielle Dimartino Booth**, was **sounding the alarm about the easy-mortgage boom** in her Dallas Morning News column in **2003-06**

All Booms End Up Busts

Boom

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

Buying into the exuberance

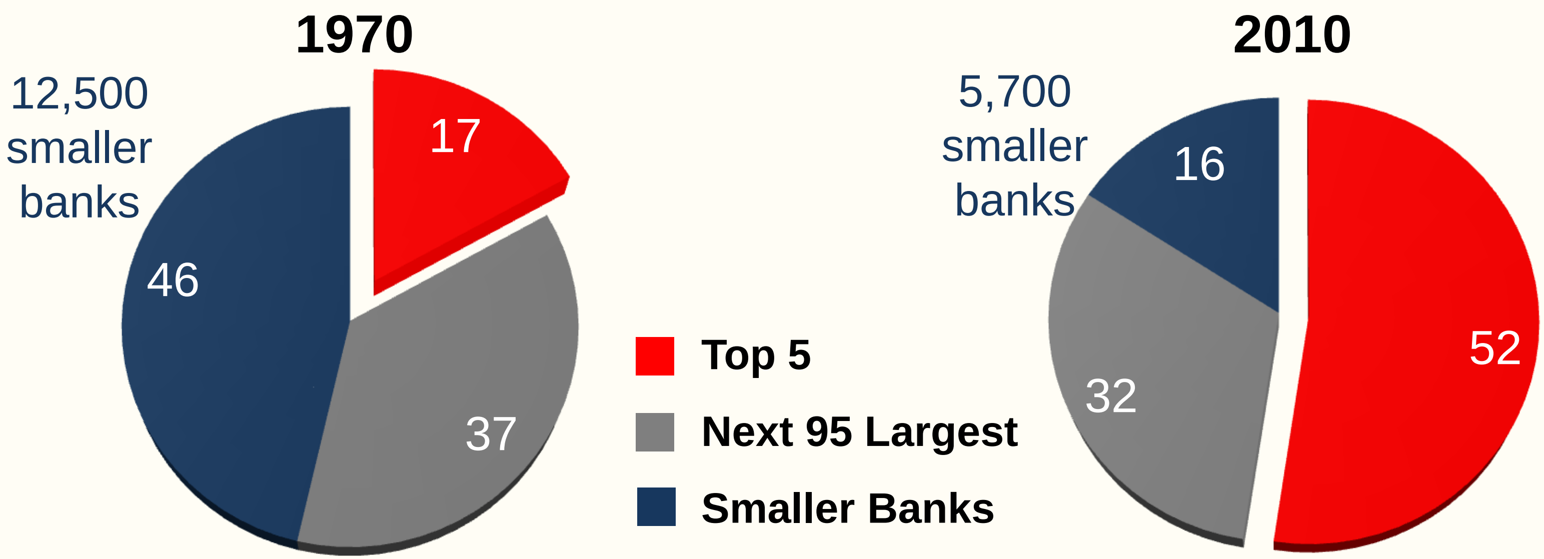
History is easy to forget

- 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?

U.S. Banking Industry Concentration



➢ **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

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."

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. Therefore, ***"too big to fail"*** is actually a misnomer; sheer size matters, but it is not the only issue.

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)***

TBTF is a Misnomer

<u>Degrees of Failure:</u>

- **Bankruptcy**
- **Buyout**
- **Bailout**

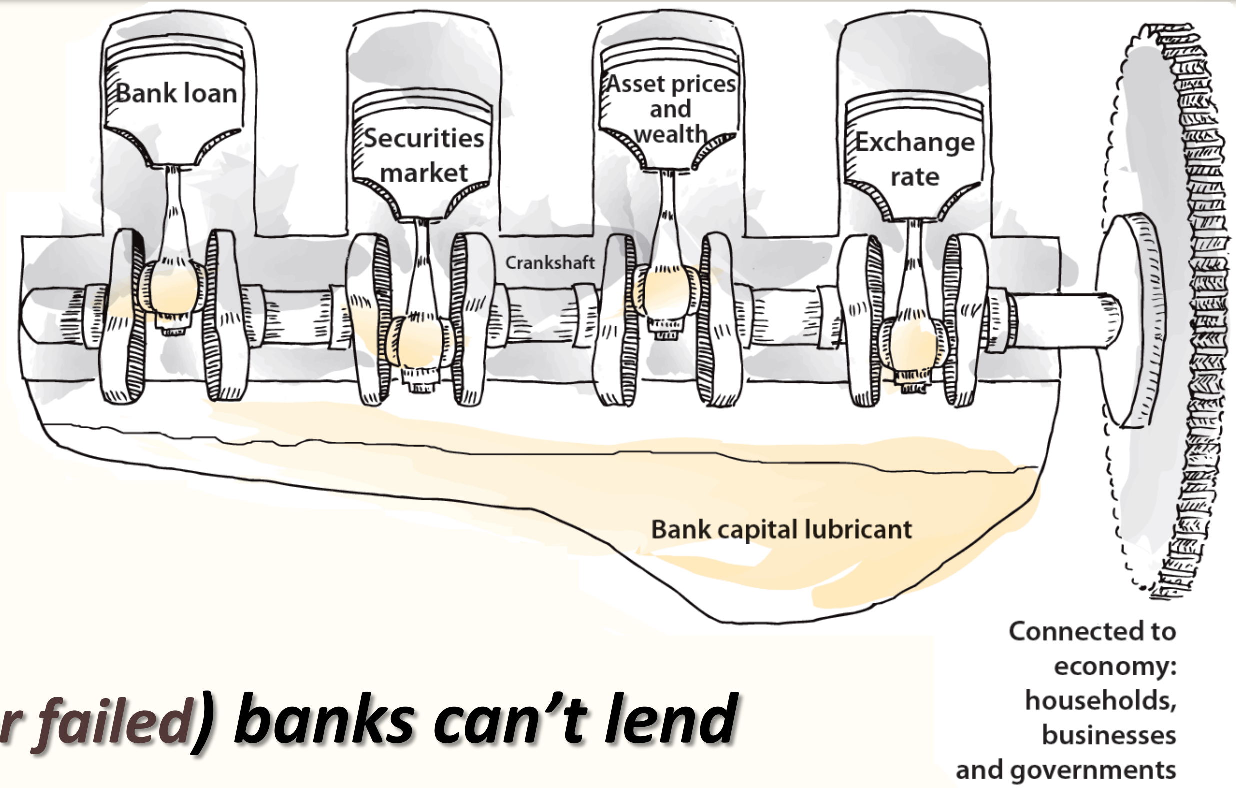
Different labels, but all very similar:
part of the process of *<u>creative destruction</u>*

But with several important differences–
especially PRIVATE v. TAXPAYER FUNDING

The Federal Reserve's Policy Responses:

Extraordinary Firepower Met with Limited Results

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**

Monetary Policy Responses

‘07–’08	Late ’08	Spring ‘09	Fall ‘10	Fall ‘11	Early ‘12
Special facilities	ZIRP 1	QE 1	QE 2	ZIRP 2 + MEP	ZIRP 3

- Term Auction
- Term Securities Lending
- Primary Dealer Credit
- Money Market Investor Funding
- Commercial Paper Funding
- ABCP MMMF Liquidity

Purchase up to $1.25 trillion in agency MBS, $200 billion in agency debt and $300 billion in longer-term Treasurys

Purchase $600 billion more longer-term Treasurys by Q3 ‘11

“exceptionally low levels… at least through late 2014”
+ projections
+ goals & policy communication

Key:

ZIRP: *zero interest rate policy*
QE: *quantitative easing*
MEP: *maturity extension program*

Fed's Monetary Policy Toolbox

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

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

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 | Comments (48)

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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 what needs to be done

At best, it's 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

<u>Some possibilities</u>

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

<u>Goal</u>: 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
- Reduced monopoly power
- Costs of failure are private costs, and not socialized
- Level playing field
- Restore faith in market capitalism
- Safer, more resilient financial and economic system

Costs

- May forego some benefits of economies of scale and scope
- One-stop shopping for financial services becomes more difficult, 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 nets** to **legally-separable depository institutions** – and NOT their affiliated companies

End banking oligopoly power

- **Level the playing field** – taxpayer assistance is a federal subsidy that adversely affects competition
- **Reduce industry concentration** – significant economies of scale/scope need to be weighed against *economies of specialized expertise* and ***diseconomies of dysfunctionality, 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 taxpayer assistance

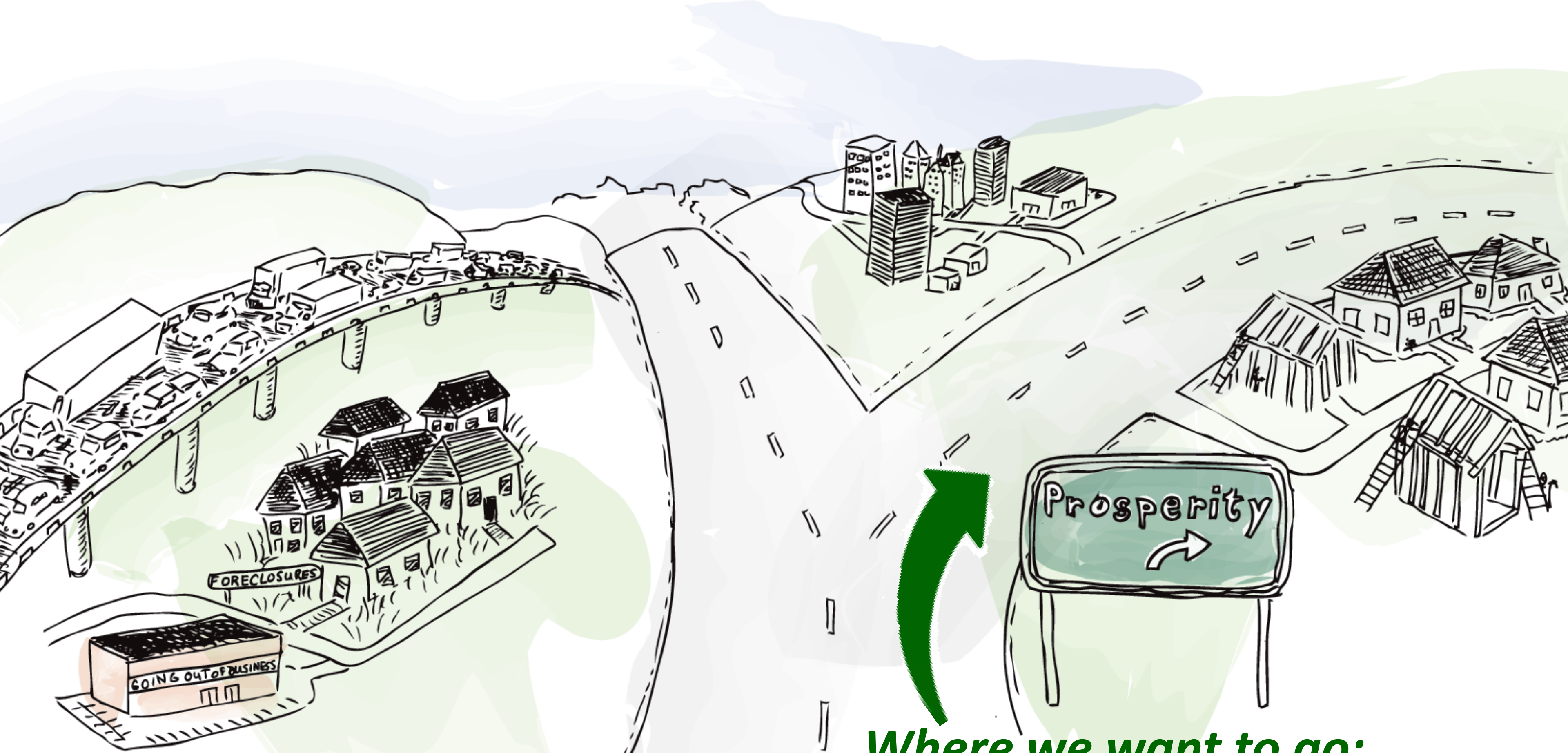
Change the "do-or-die" decision-making paradigm

- Steer the evolution of the financial structure so **policy makers are unlikely to face edge-of-the-cliff decisions** to provide taxpayer assistance or be held responsible for a great depression
- Actively guard against ***willful blindness***

....

✓ **Some streamlining and refocusing is already underway**

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

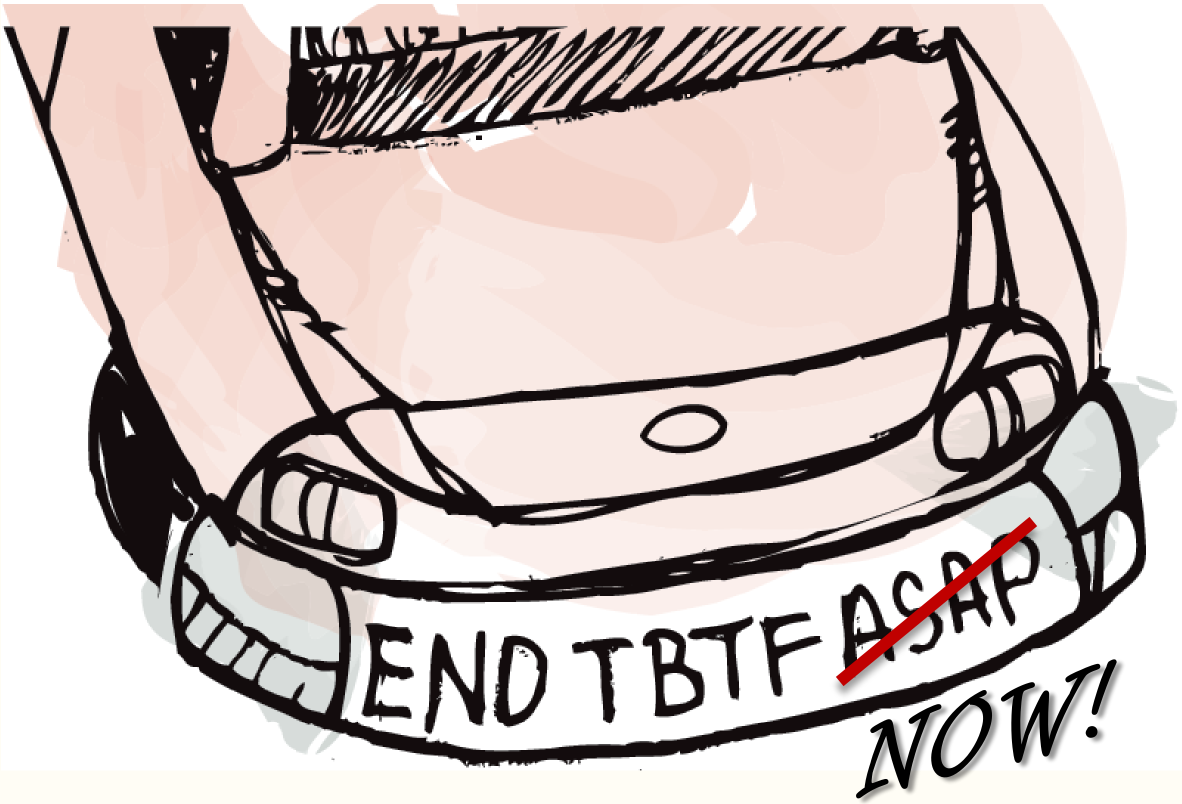
*Suffering and perpetuating
perverse incentives*

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*

SWGSB
SW Graduate School of Banking Foundation

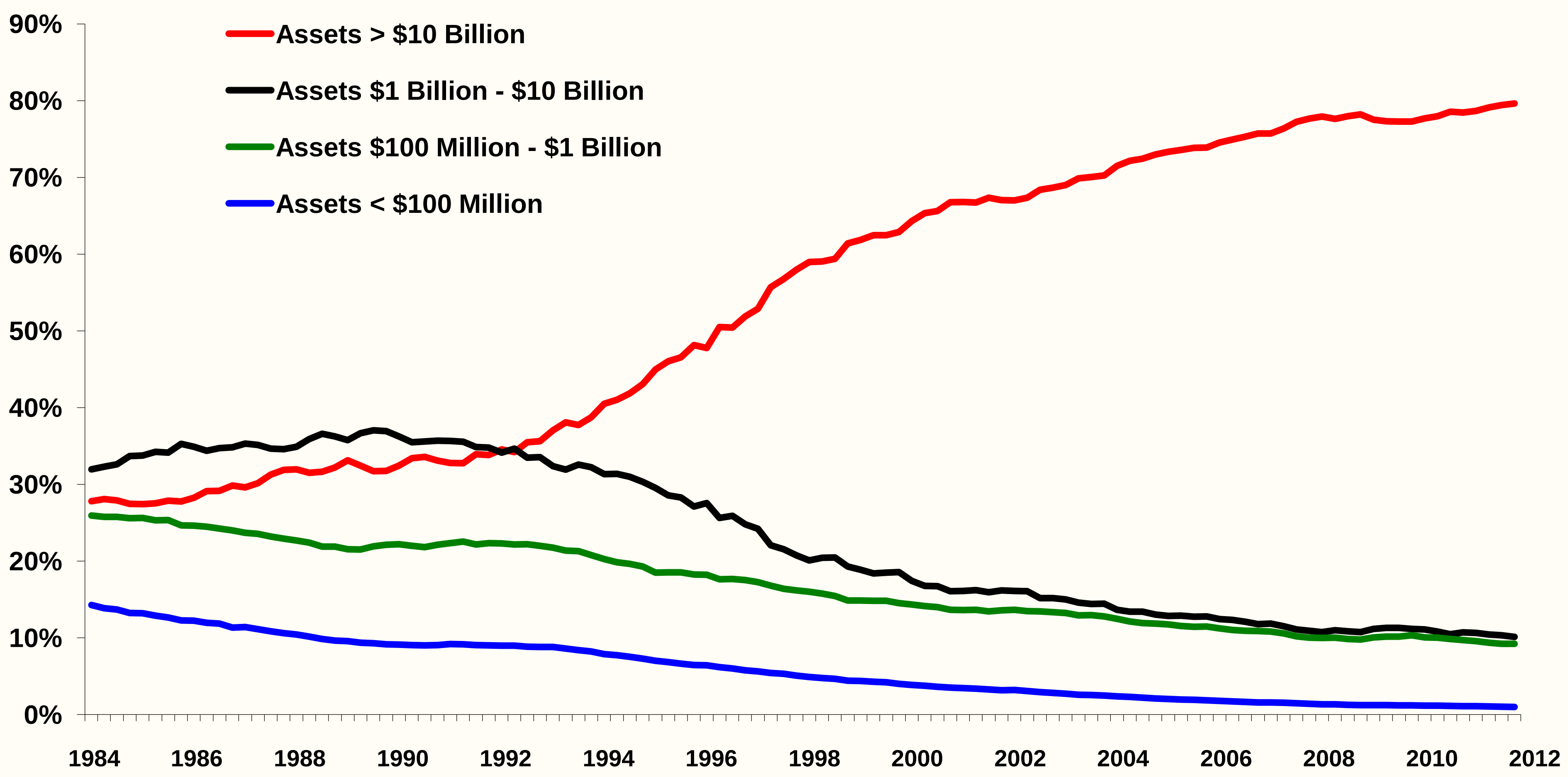
Concentration of Assets in the Financial Services Industry

S. Scott MacDonald, Ph.D., President and CEO
Southwestern Graduate School of Banking Foundation
Adjunct Professor of Finance,
Cox School of Business, SMU

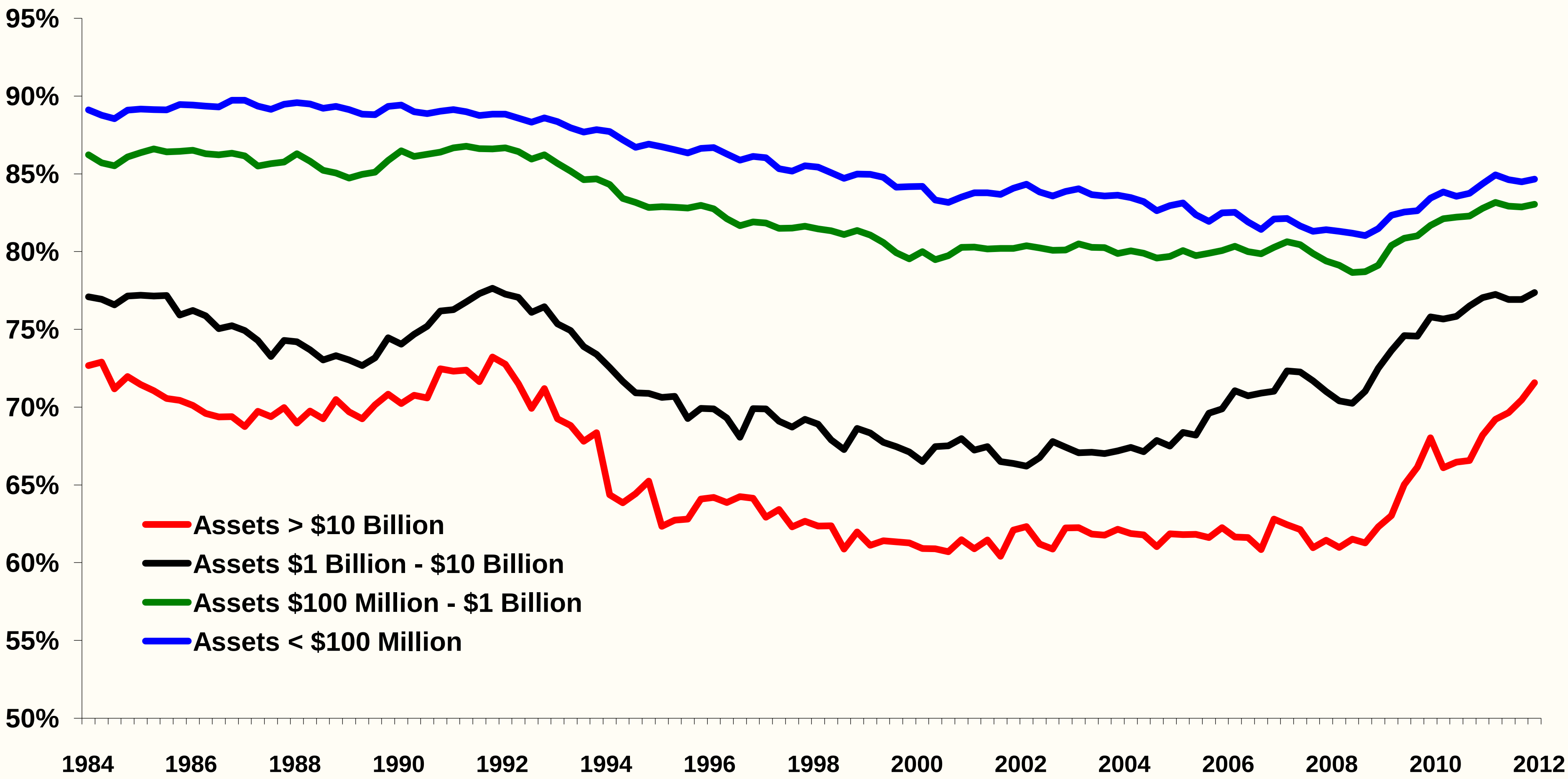
Banking Industry Concentration

- Concentration Has Occurred All Along the Size Spectrum
  - In Banking, there are many things correlated to size
  - Some good, some not so good

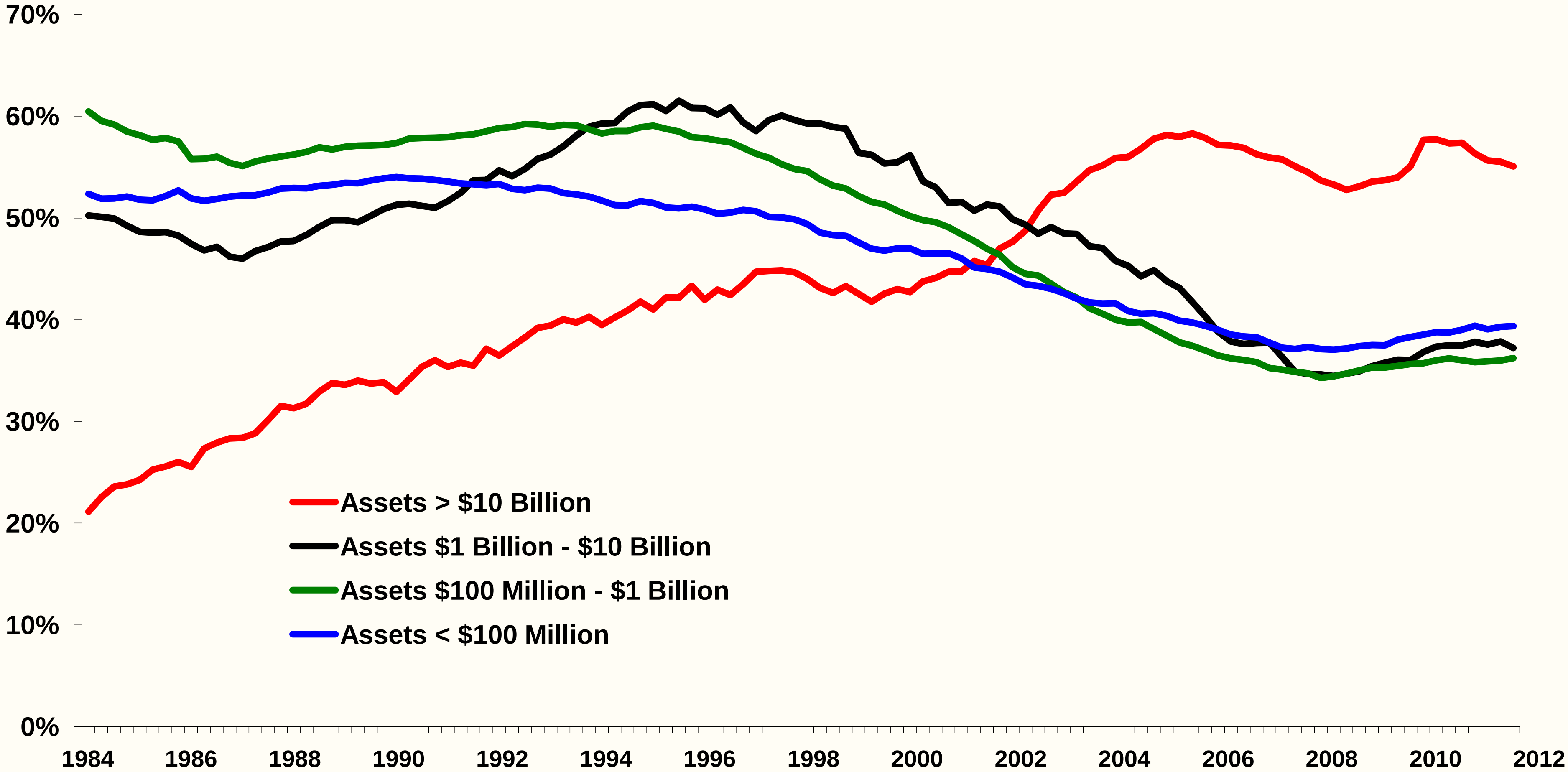
Share of Industry Assets



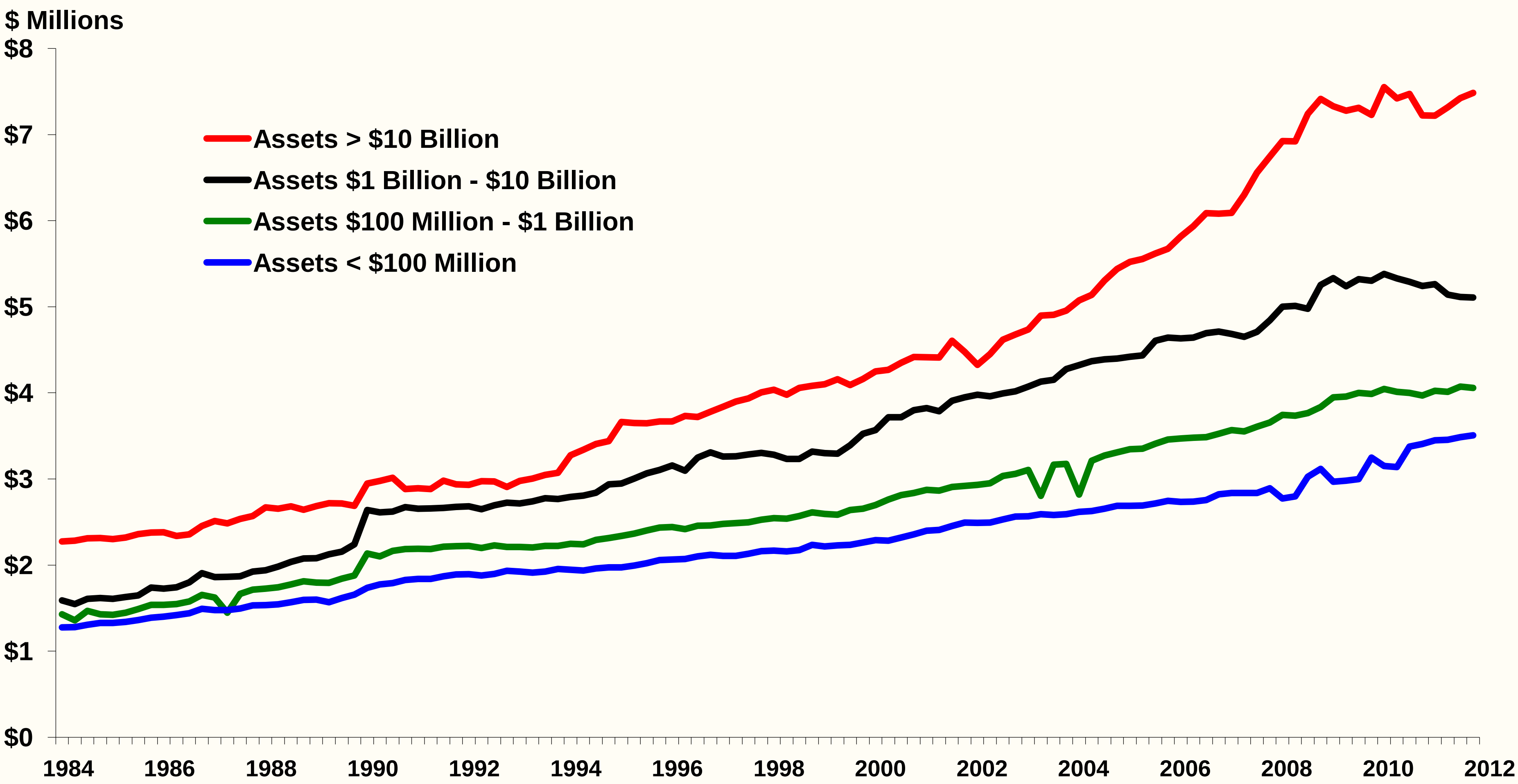
Deposits as a Percent of Total Assets



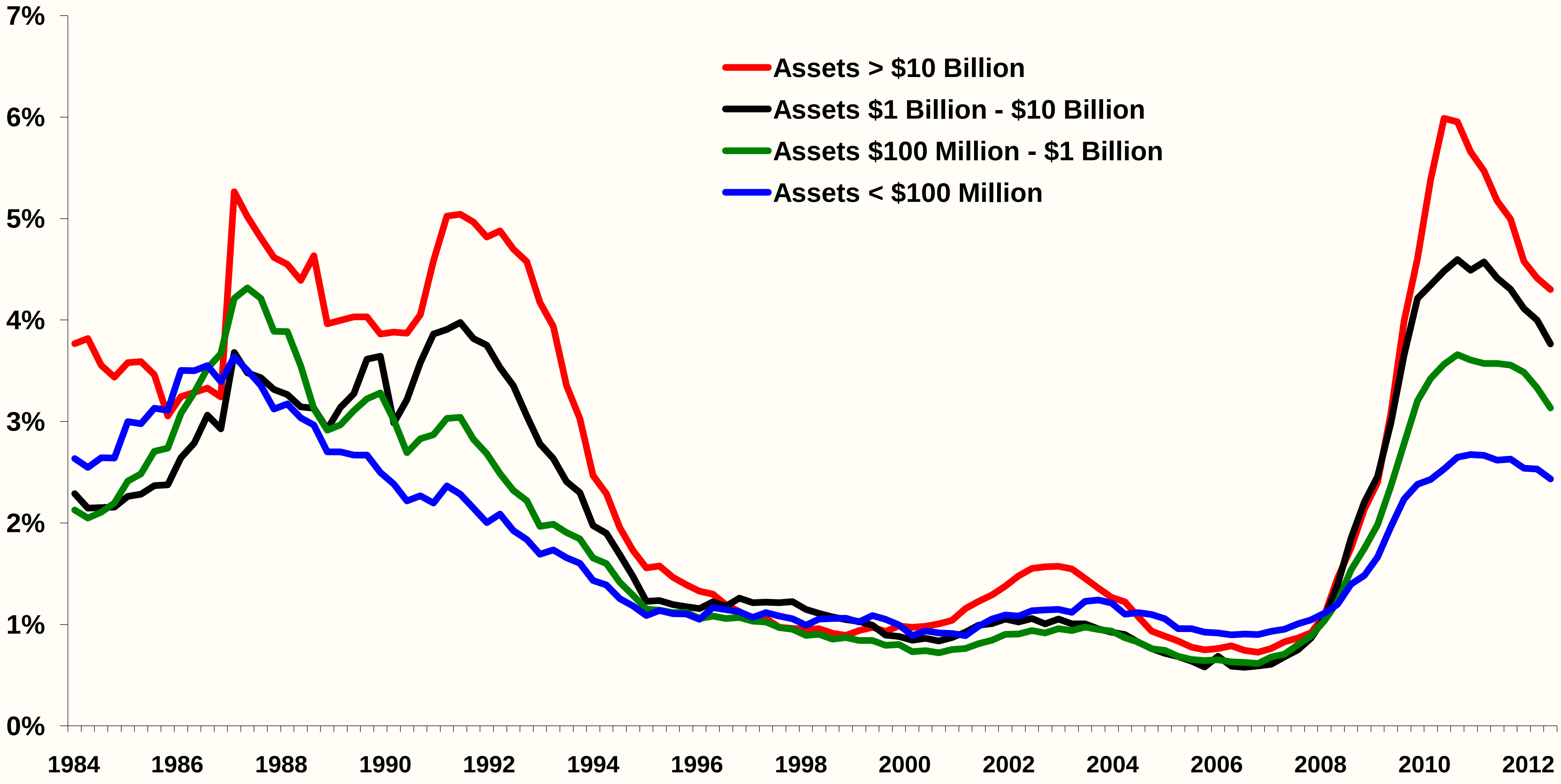
Retail (Non-Commercial) Loans as a Percentage of Total Loans



Average Total Assets Per Employee



Percent of Loans and Leases Noncurrent



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Panel Discussion

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