“It is necessarily part of the business of a banker to maintain appearances and to profess a conventional respectability which is more than human. Lifelong practices of this kind make them the most romantic and the least realistic of men. It is so much their stock-in-trade that their position not be questioned, that they do not even question it themselves until it is too late. Like the honest citizens they are, they feel a proper indignation at the perils of the wicked world in which they live,-when the perils mature; but they do not foresee them. A Bankers’ Conspiracy! The idea is absurd! I only wish there were one! So if they are saved, it will be, I expect, in their own despite.”

- John Maynard Keynes *(*“The Consequences to the Banks of the Collapse of Money Values,” Chapter 7 in *Essays in Persuasion.* London: Macmillan, 1931, *p. 178)*

Genie out of the Bottle:
The Evolution of Too-Big-to-Fail Policy and Banking Strategy in the US

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June 8, 2012

“Goldman Sachs Chief Regrets Leveraged Transactions: Report,” REUTERS, May 20, 2010

MUMBAI (Reuters) - Goldman Sachs Chief Executive regretted having participated in transactions that brought too much leverage into the world, he said in an interview …

“I regret that we participated in transactions that brought too much leverage into the world. It led to people taking too much leverage. But those were the standards of the moment,” Lloyd Blankfein told the newspaper, while on a four-day trip to India.

"In our market-making function, we are a principal. We represent the other side of what people want to do. We are not a fiduciary. We are not an agent. Of course, we have an obligation to fully disclose what an instrument is and to be honest in our dealings, but we are not managing somebody else's money"

- Lloyd Blankfein, Goldman Sachs CEO, February 2010 statement to the Financial Crisis Investigation Commission:

Principal Line of Argument, 1/3

- This paper critically examines the emergence of "too big to fail" (TBTF) banking policy: the extension of implicit public insurance guarantees to a small set of large financial institutions. TBTF policy has evolved from a tool used by government authorities to maintain financial-market stability, into a constraint imposed by a megabanking complex on financial and regulatory policy.

- Regulators and analysts favoring TBTF have attempted to draw a line between the more restricted and more expansive versions of this policy: on one hand, a guarantee that prevents bank runs, and on the other, a pre-commitment to preserve some financial firms as operational entities, no matter the economic damage their risk-taking may have caused.

Principal Line of Argument, 2/3

- But this line is too easily manipulated in a political system that places few constraints on regulatees' financial contributions. The beneficiaries of expanded TBTF protection, even in their weakened post-crisis condition, have argued that financial reforms aimed at controlling systemic risk will prevent the resumption of normal loan-making activity.

- This argument fails: the economic functionality of the financial system has not been restored, and is unlikely to be if megabanks are permitted to oligopolize banking with 'light-touch' regulation.

- There are alternatives: put size limits on banks, restructure financial relations so that no financial firms are too big to fail, or reconstruct banking using a public-utilities model.

Principal Line of Argument, 3/3

- Assessments of the nature of TBTF and of the threat posed by TBTF policy to financial stability and economic prosperity have lagged the institutional evolution of banking. Experts have focused largely on how TBTF interferes with market discipline, forgetting that the strategic transformation of banking has unfolded in the evolving regulatory environment created by TBTF interventions.
- Ironically, most analysts have argued until recently that overcoming the adverse consequences of TBTF is best done by giving banks maximum freedom of action, including mergers and acquisitions; yet precisely this freedom of action has permitted megabanks to create a more institutionally entrenched version of TBTF.
- A growing number of economists see the need for regulation that prevents financial firms from taking systemic risks. The question is how to put the genie back into the bottle.

The origins and elements of the "Too-Big-to-Fail" doctrine in banking 1/2

- The legal basis for "too big to fail" interventions was established in the Federal Deposit Insurance Act (FDIA) of 1950, which gave the FDIC power to provide "assistance" option in cases where "continued operation of the bank is essential to provide adequate banking service."
- A TBTF *intervention* has four elements:
  1. One or more large institutions in danger of insolvency
  2. Their operation in a government with capacity to prevent their failure
  3. An action by the regulatory authority that prevents failure
  4. An awareness by market participants that this action was needed primarily not to block the bailee's insolvency but to prevent adverse spillover effects on financial markets and the broader economy.

Origins & elements of "TBTF" doctrine 2/2

- TBTF *policy*: a pre-commitment to prevent failure of those financial intermediaries whose actual or prospective failure could compromise the integrity of the financial system and/or economy, by a regulator with the capacity and authority to do this.

- This policy depends on two untestable counterfactuals and one precondition:
  - (1) the regulator will permit failure of large banking institutions whose failure would not compromise the integrity of financial markets and the economy; and
  - (2) failure of large banking institutions *would* compromise the integrity of financial markets and the economy
- Precondition: TBTF policy is never formally declared.

Financial strategy and the logic of TBTF 1/1

- Banks maximize profits, and their employees maximize their prospective gains. This may or may not involve core ("traditional") banking – providing transaction services, storing wealth, supplying credit while absorbing default/liquidity risk(s).
- Changes in technology and product-line deregulation opened new possibilities for making point-in-time profits – selling services, originating and selling loans, offloading risks.
- In the US, easing of anti-trust considerations in merger policy and the S&L crisis facilitated the rapid growth of ambitious large banks hoping to get larger
  - Initially these were called the "super-regional banks" (examples: BancOne, NationsBank, First Union, Corestates, First Interstate)

Triple banking crisis at the end of the Golden Age 1/2

- The money-center banks had always been regarded as systematically important.
- The growth of some large banks led them toward the (untestable) status of being systemically essential; the incentive for big banks was thus to get bigger.
- The late 1970s brought disintermediation and customer loss, leading to a 1980 bank deregulation act.
- The 1980s began with the Volcker interest-rate shock, then double-dip recession. So 1981-82 brought a triple banking crisis:
  - The savings and loan debacle, and the collapse of housing-finance
  - The Latin American debt crisis, triggered by Mexico's non-payment of its August 1981 repayment obligations
  - The collapse of oil-boom-based prosperity in US "oil-patch" states, and of banks that had financed (bet) on the oil bubble.

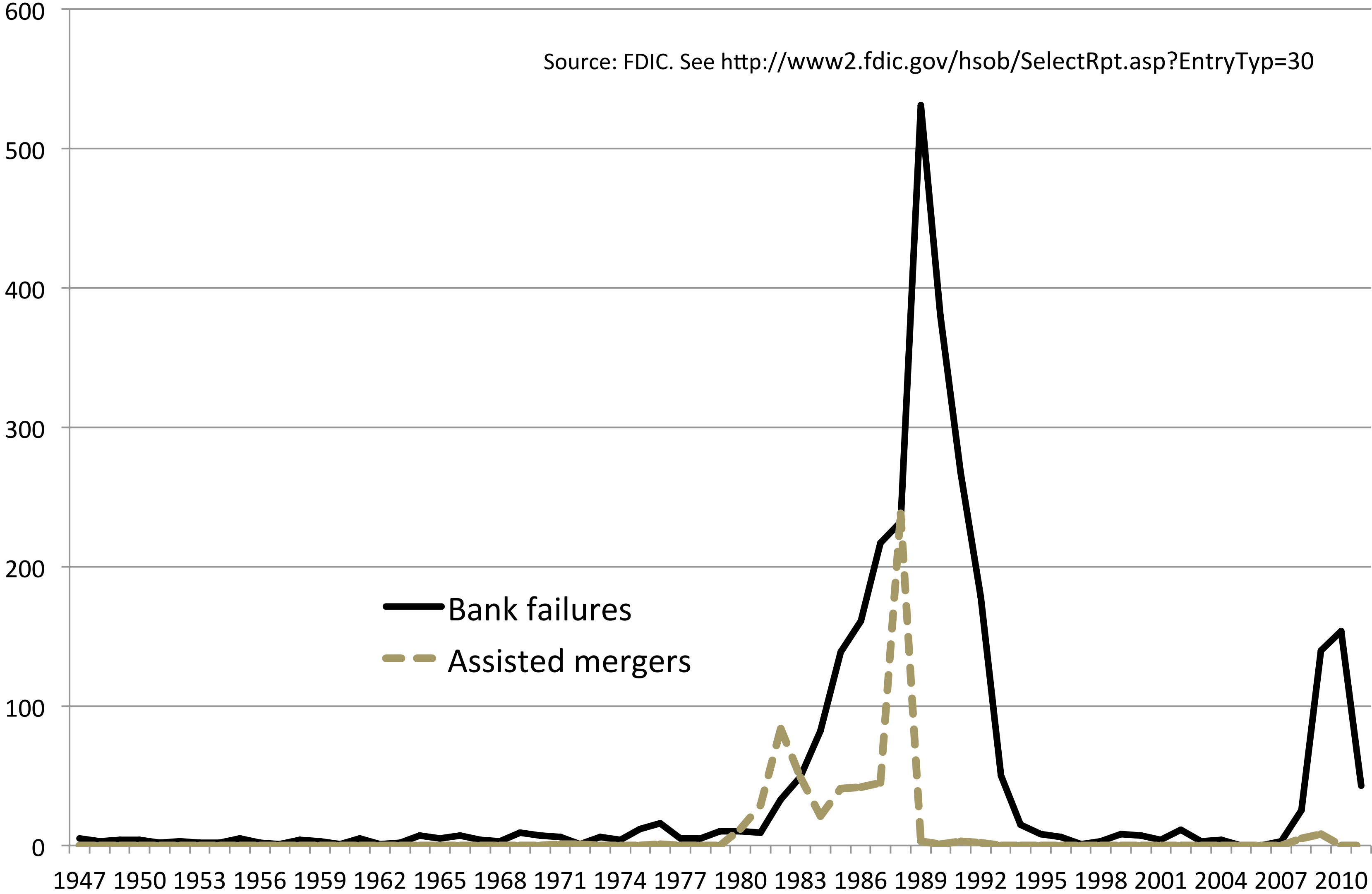
Figure 1: Commercial bank failures and assisted mergers, 1947-2011
Source: FDIC. See http://www2.fdic.gov/hsob/SelectRpt.asp?EntryTyp=30
Bank failures
Assisted mergers
0
100
200
300
400
500
600
1947 1950 1953 1956 1959 1962 1965 1968 1971 1974 1977 1980 1983 1986 1989 1992 1995 1998 2001 2004 2007 2010

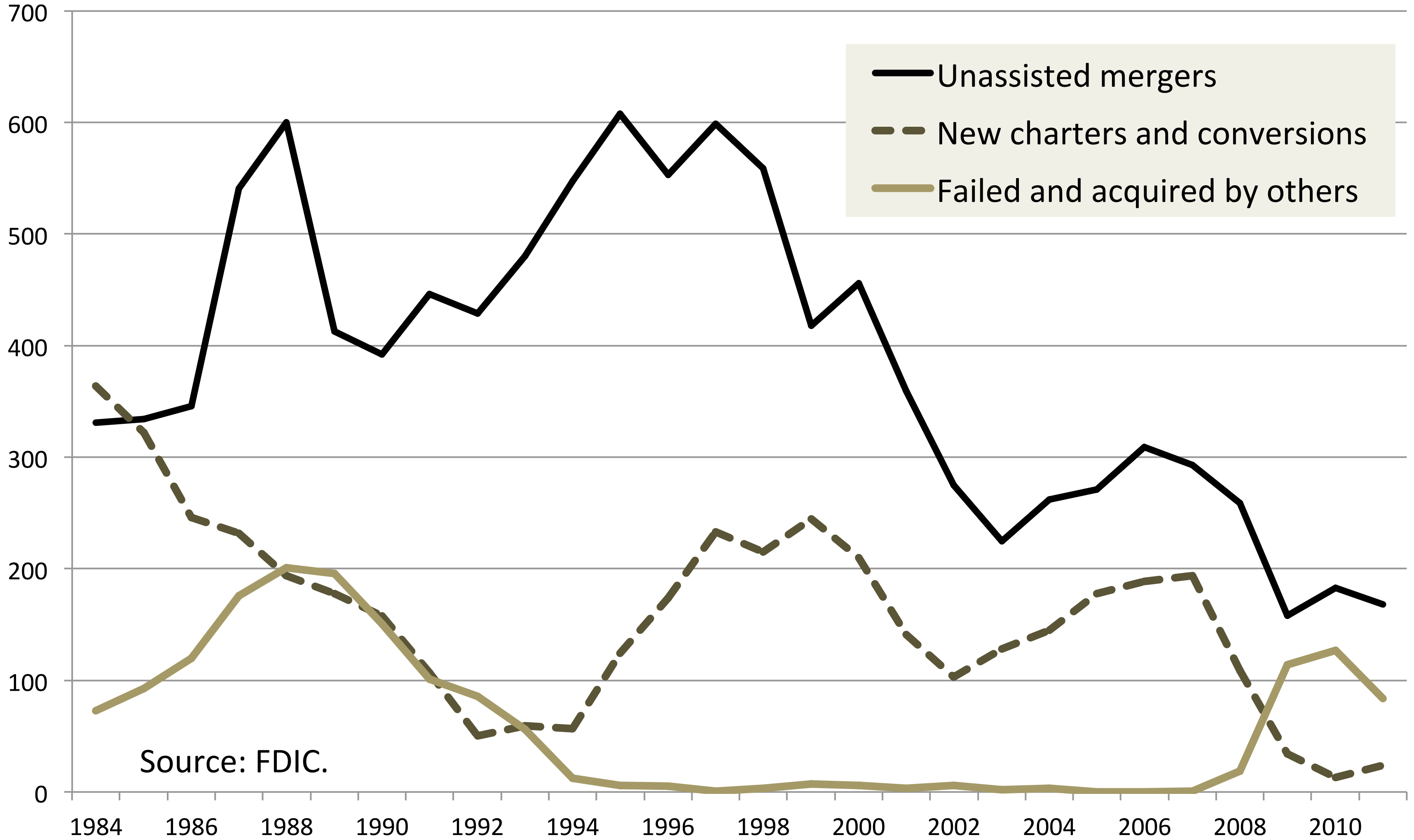
Figure 2: Unassisted mergers, new charters and conversions,
and acquisitions of failed banks, 1984-2011
700
600
500
400
300
200
100
0
1984
1986
1988
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008
2010
Unassisted mergers
New charters and conversions
Failed and acquired by others
Source: FDIC.

Triple banking crisis at the end of the Golden Age 2/2

- Mergers and acquisitions were used to resolve many problems of insolvency among both S&Ls and banks
- Continental Illinois
  - A money-center bank (7th largest in US) lagging others in Latin American lending
  - A target (met) of being the largest C&I lender in the US
  - Provider of substantial credit to Penn Square Bank
- May 1984: An electronic bank run on Continental Illinois, which depended heavily on "bought funds"
  - On May 14, 16 large banks provided a line of credit
  - The FDIC had been using "Open Bank Assistance" (14 times for mutual savings banks in 1981-83)
  - A buyer for Continental was sought; none was found; so as time went on, Continental either had to be liquidated or resolved under OBA.

Table 1: The 11 "Too Big to Fail" US Banks of 1984

1. BankAmerica*
2. Continental Illinois – brought under FDIC receivership in September 1984, operated with 80% government ownership as Continental Bank until 1994, when BankAmerica acquired Continental Bank
3. Security Pacific National Bank – merged with BankAmerica in 1992

4. Citibank*

5. Bankers Trust* – suffered major losses in 1994 and 1998, acquired by Deutsche Bank in November 1998.

6. J.P. Morgan and Company* – merged with Chase Manhattan Bank in 2000 and created the JP Morgan Chase Bank as a subsidiary
7. Manufacturers Hanover Trust* – merged with Chemical Bank in 1991
8. Chase Manhattan Bank*– purchased by Chemical Bank in 1996
9. Chemical Bank* – took on the name Chase Manhattan Bank after acquiring Chase Manhattan Bank in 1996
10. First Chicago* – after bad-loan-loss problems in 1970s and 1990s, merged with Banc One Corporation in 1994; Banc One merged with Chase in 2004.

11. Wells Fargo National Bank

Source: The 11 TBTF banks were cited as such by Conover (1984) and named by Carrington (1984). The two internal boxes indicate 1984 TBTF banks that were later merged into other members of the 1984 TBTF bank list. The eight banks considered to be money-center banks (FDIC 1997, Vol. 1, page 202) are designated by an asterisk (*).

The Shadow Financial Regulatory Committee 1/1

- The S&L crisis crystallized a moral-hazard attack by Kane, Kaufman, others, on excessive regulation of banking markets.
  - A public-choice theoretic, Chicago School call for discipline by enhancing competition: let "market-driven change" open new possibilities, and provide market discipline via bank runs
  - The SFRC came into existence in 1986, with an agenda of overturning geographic and product-market restrictions (ultimately, the Glass-Steagall Act)
- SFRC's great triumph was the 1991 FDICIA, which replaced flat- with risk-based deposit insurance, and prevented the FDIC from assisting shareholders *except for* a "systemic risk exemption"
  - The US banking system had resolved its TBTF problem (George Kaufman 2002) [1980s forbearance/support for money-center banks involved in Latin American crisis was not considered]

Banking strategy in the 1990s: competition-by-merger-and-acquisition 1/1

- Banks shifted to retail markets: upscale retail banking, and expansion of higher-risk (predatory) lending and lower-end services
- Offloading of risk: from syndication to securitization, emergence of the "originate-and-distribute" approach to lending
- Meanwhile, contingent claims (derivatives) were expanding, many customized (over-the-counter), with no organized secondary markets.
  - The Commodity Futures Trading Commission tried to regulate, but was rebuffed by a 2000 law that required off-balance sheet positions to be evaluated under general "safety and soundness" provisions.
- Money-center banks faced competitive pressure on three fronts: from super-regional banks; from investment banks; and from other money-center banks. The solution: grow or be left behind. A game of thrones.

The TBTF Debate Reconsidered 1/1

- For SFRC, no success yet: deposit insurance remained. So no bank runs as expressions of consumer dissatisfaction with their banks.
- Another view, by Kane, was that government officials should be "specifically accountable for delivering and pricing safety-net benefits fairly and efficiently."
- Meanwhile, continued mergers and the Gramm-Leach-Bliley Act of 1999 (which ended Glass-Steagall) led to the creation of "large complex banking organizations" (LCBOs)
- A 2004 book by Stern and Feldman identified 31 LCBOs, and cited Drexel-Burnham (1998) and LTCM (2001), cases wherein extensive Federal Reserve intervention "supports our claim that fear of financial market instability drives government response to the failure of financial firms" (page 83).
- The Genie was out of the bottle.

Table 2: The Stern-Feldman 2004 List of "Large Complex Banking Organizations"

Bank	Note
Banks Headquartered in the US	
1. Citicorp	
2. JP Morgan Chase	
10. Bank One Corp	Merged with JP Morgan Chase on July 1, 2004
3. Bank of America	
14. FleetBoston Financial Corp	Merged with BankAmerica in 2004
33. Countrywide Financial Corp.	Purchased by BankAmerica in January 2008
9. Wells Fargo	
8. Wachovia Corporation	Purchased by Wells Fargo on October 3, 2008
13. MetLife	
15. US Bankcorp	
18. SunTrust Banks	
23. Bank of New York Company	
28. Mellon Financial Corporation	Merged with Bank of New York on July 2, 2007
26. State Street Corporation	
27. PNC Financial Services Group	
20. National City Corporation	Purchased by PNC Financial on Oct 24 2008
28. KeyCorp	
32. Charles Schwab Corporation	
34. Northern Trust Corporation	
Banks Headquartered Outside the US	
4. Deutsche Bank AG	
5. Mizuho Holdings	
7. UBS AG	
11. Credit Suisse Group	
13. HSBC Holdings PLC	
16. BNP Paribas SA	
17. Mitsubishi Tokyo Financial Group	
19. Societe Generale	
21. Bank of Montreal Holdings	
22. RBS Group PLC	
6. Abn Amro	Acquired in 2007 by RBS, Fortis, Santander
25. Toronto-Dominion Bank	
29. Royal Bank of Canada	
30. Bayerische Hypo-und Vereinsbank AG	
31. Desdner Bank AG	

Source: Stern and Feldman 2004, page 39. This list is in turn based on DeFerrari and Palmer 2001, p. 501.

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27. PNC Financial Services Group	
20. National City Corporation	Purchased by PNC Financial on Oct 24 2008
28. KeyCorp	
32. Charles Schwab Corporation	
34. Northern Trust Corporation	

28. KeyCorp
32. Charles Schwab Corporation
34. Northern Trust Corporation

Banks Headquartered Outside the US
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5. Mizuho Holdings
7. UBS AG
11. Credit Suisse Group
13. HSBC Holdings PLC
16. BNP Paribas SA
17. Mitsubishi Tokyo Financial Group
19. Societe Generale
21. Bank of Montreal Holdings

22. RBS Group PLC	
6. Abn Amro	Acquired in 2007 by RBS, Fortis, Santander

25. Toronto-Dominion Bank
29. Royal Bank of Canada
30. Bayerische Hypo-und Vereinsbank AG
31. Desdner Bank AG

Source: Stern and Feldman 2004, page 39. This list is in turn based on DeFerrari and Palmer 2001, p. 501.

TBTF and the 2007-09 Subprime Crisis 1/1

- A bank "jog" in 2007, then Bear Stearns in May-June 2007, the collapse of the asset-backed commercial paper market, Lehman Brothers
- More mergers to save the system: Merrill Lynch to Bank America, Wachovia to Wells Fargo.
- Inclusion of new institutions under the TBTF umbrella, by designating them as bank holding companies (Goldman Sachs, Morgan Stanley, Metlife)
- The use of TARP monies to bolster these institutions' balance sheets.
- And what has been the result? Let's go to some graphs….

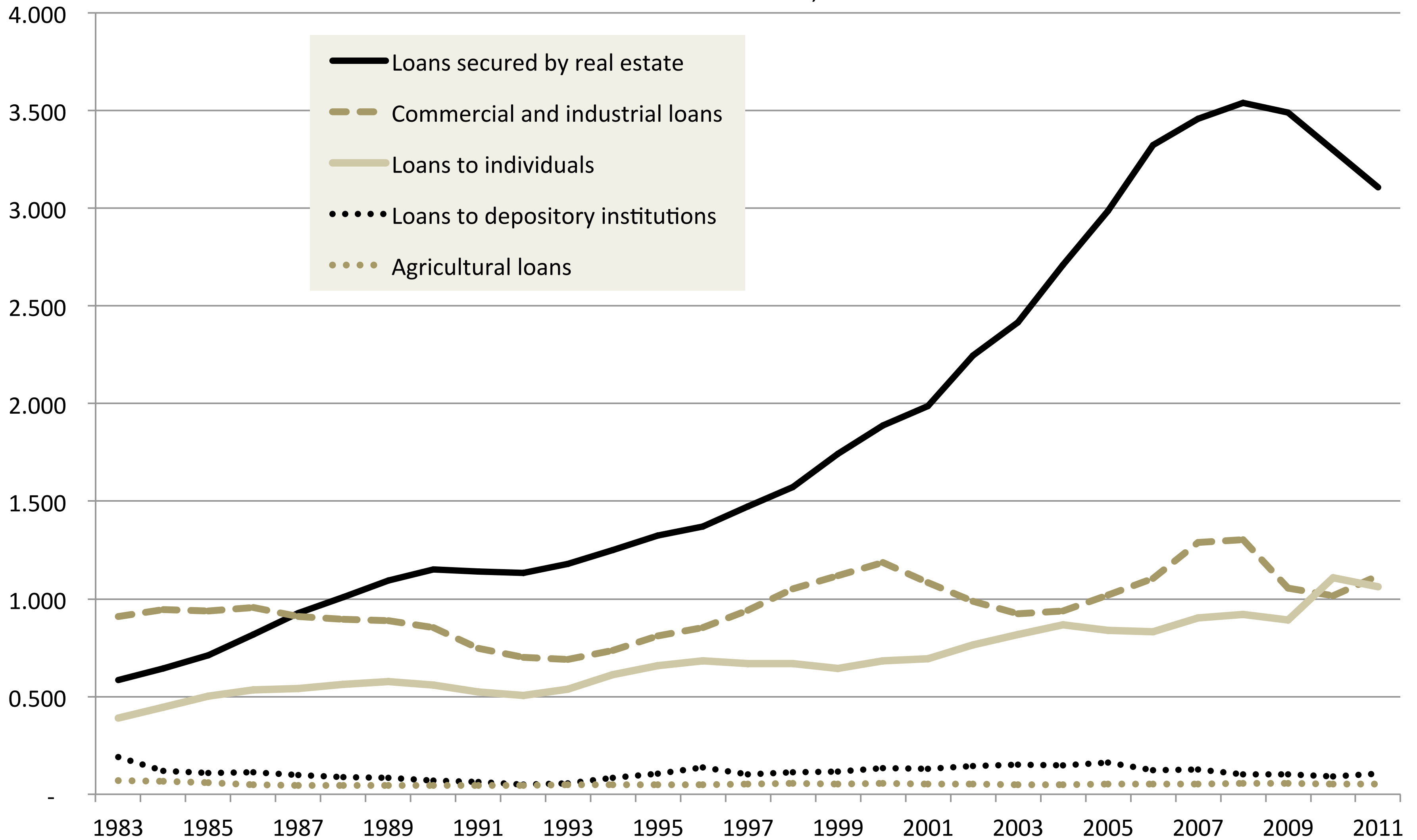


Figure 5: Outstanding loans at US commercial banks, by loan category, in trillions of 2005 dollars, 1984-2011
Loans secured by real estate
Commercial and industrial loans
Loans to individuals
Loans to depository institutions
Agricultural loans
4.000
3.500
3.000
2.500
2.000
1.500
1.000
0.500
-
1983
1985
1987
1989
1991
1993
1995
1997
1999
2001
2003
2005
2007
2009
2011

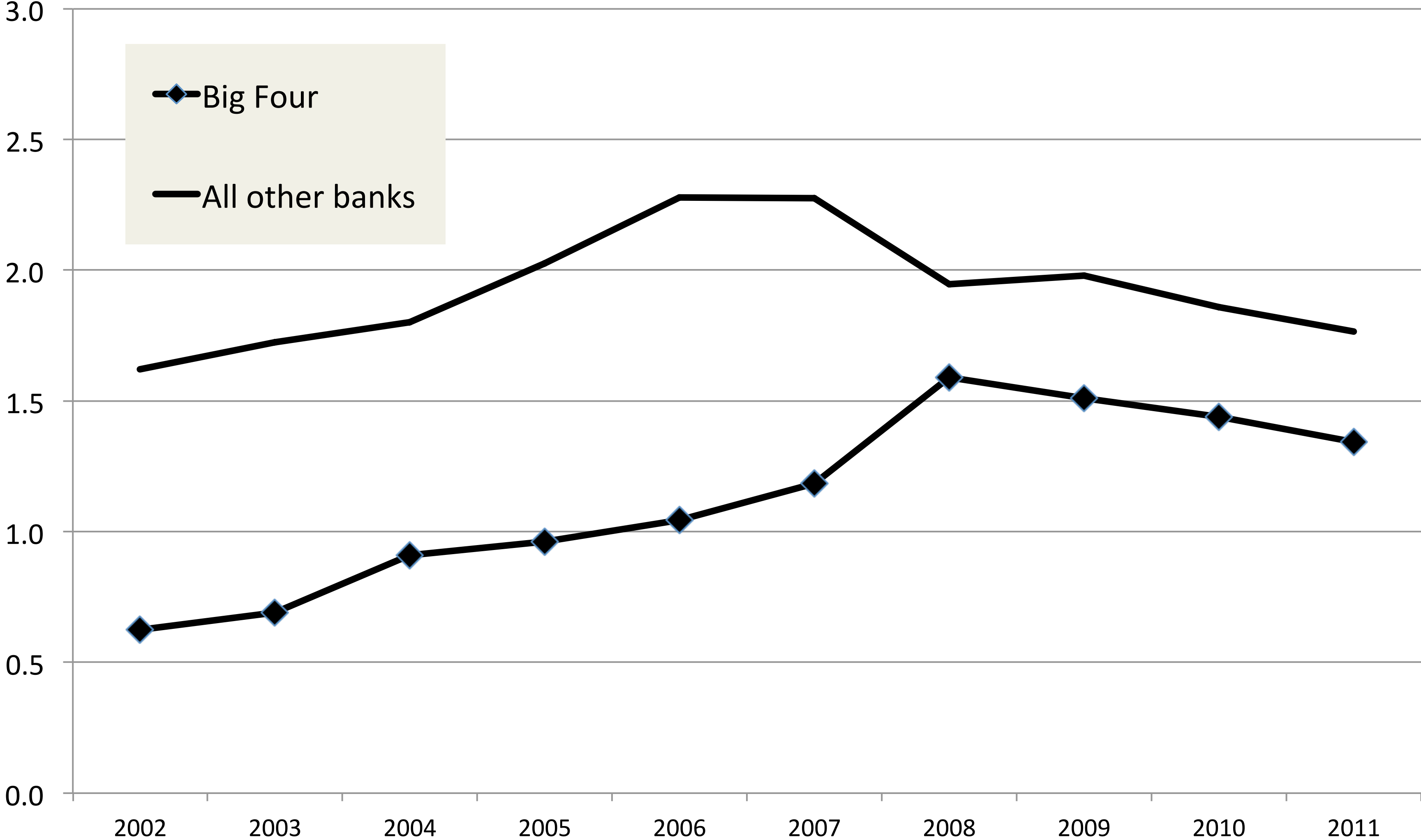


Figure 4a: Outstanding real-estate-secured loans at "Big Four" and all other US commercial banks, in trillions of 2005 dollars, 2002-2011
Big Four
All other banks
3.0
2.5
2.0
1.5
1.0
0.5
0.0
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011

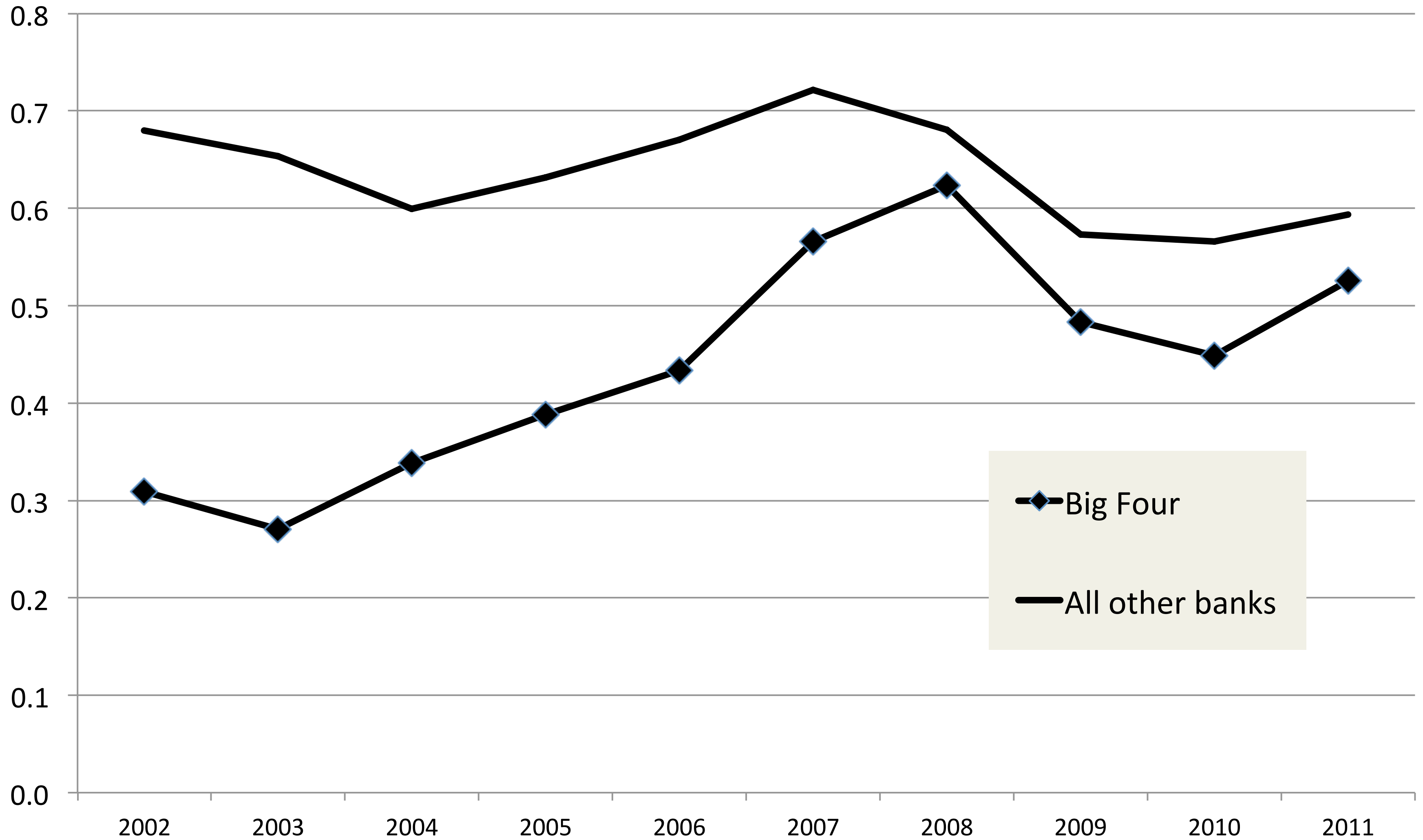


Figure 4b: Outstanding commercial and industrial loans at "Big Four" and all other US commercial banks, in trillions of 2005 dollars, 2002-2011
0.8
0.7
0.6
0.5
0.4
0.3
0.2
0.1
0.0
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
Big Four
All other banks

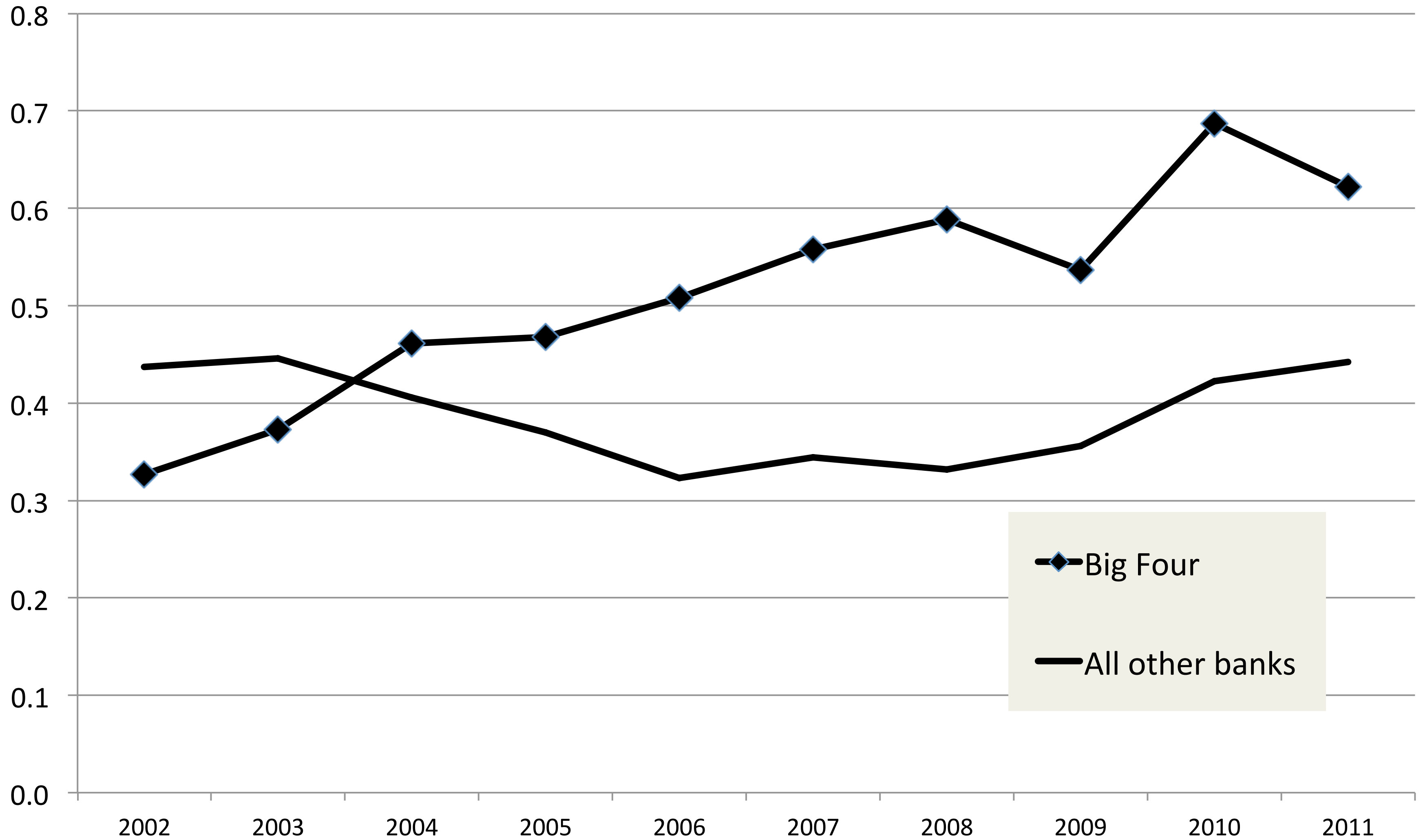
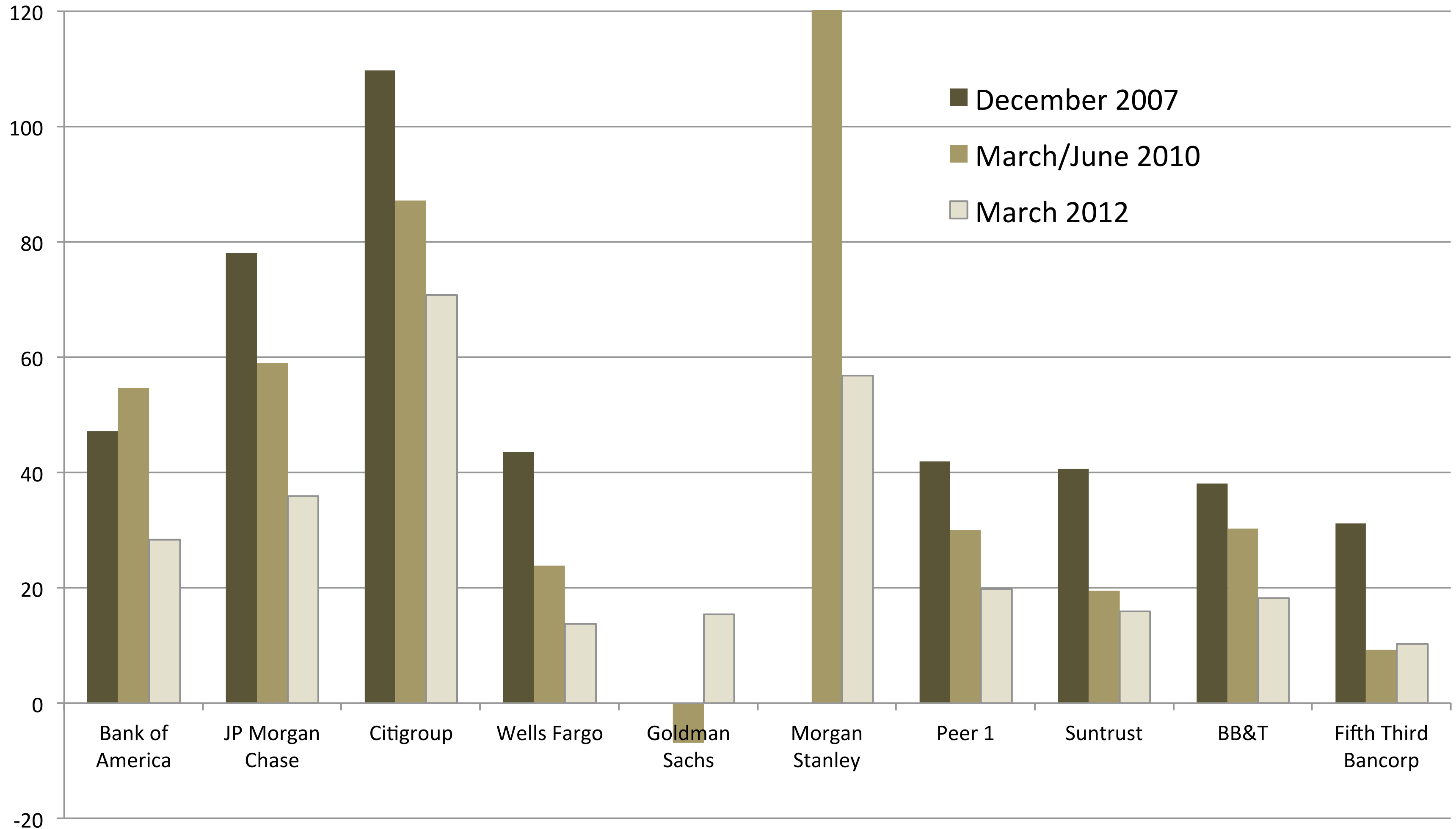
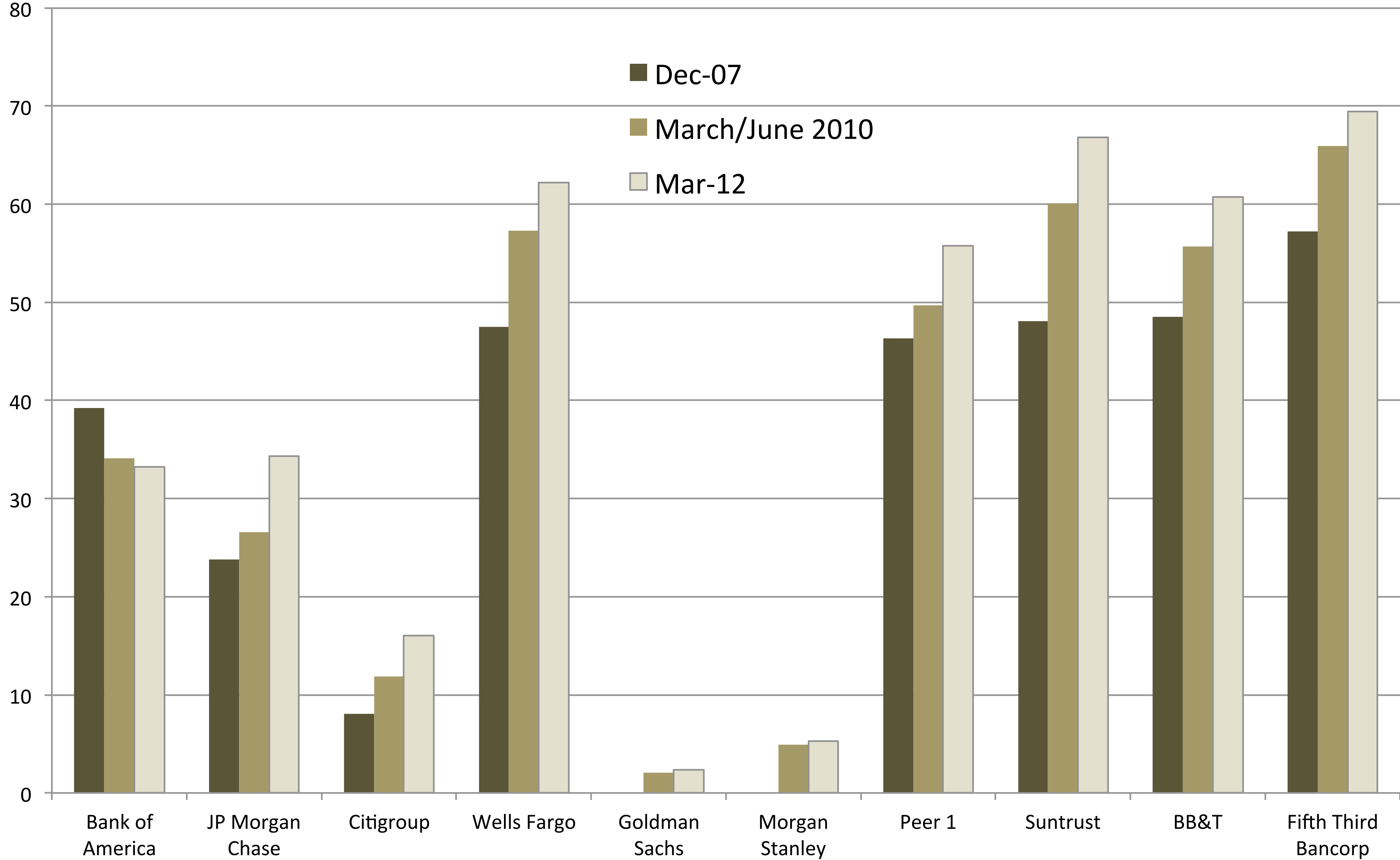


Figure 4c: Outstanding loans to individuals at "Big Four" and all other US commercial banks, in trillions of 2005 dollars, 2002-2011
0.8
0.7
0.6
0.5
0.4
0.3
0.2
0.1
0.0
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
Big Four
All other banks


Net Non-core Funding Dependence, as Percentage of Assets, selected large bank holding companies, December 2007, March/June 2010, March 2012
120
100
80
60
40
20
0
-20
December 2007
March/June 2010
March 2012
Bank of America
JP Morgan Chase
Citigroup
Wells Fargo
Goldman Sachs
Morgan Stanley
Peer 1
Suntrust
BB&T
Fifth Third Bancorp


Core Deposits as Percentage of Assets, Selected large bank holding companies, December 2007, March/June 2010, March 2012
80
70
60
50
40
30
20
10
0
Dec-07
March/June 2010
Mar-12
Bank of America
JP Morgan Chase
Citigroup
Wells Fargo
Goldman Sachs
Morgan Stanley
Peer 1
Suntrust
BB&T
Fifth Third Bancorp

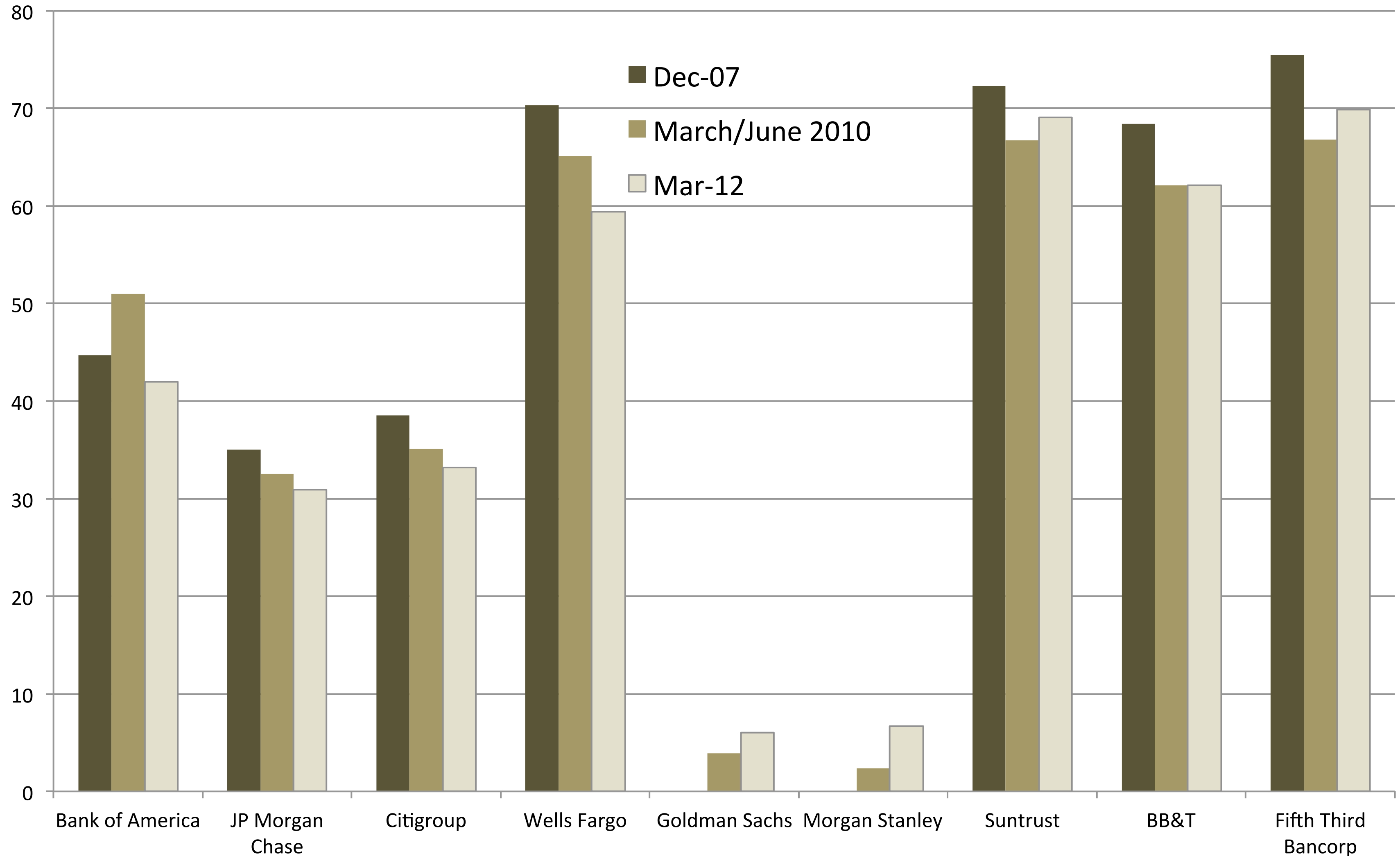
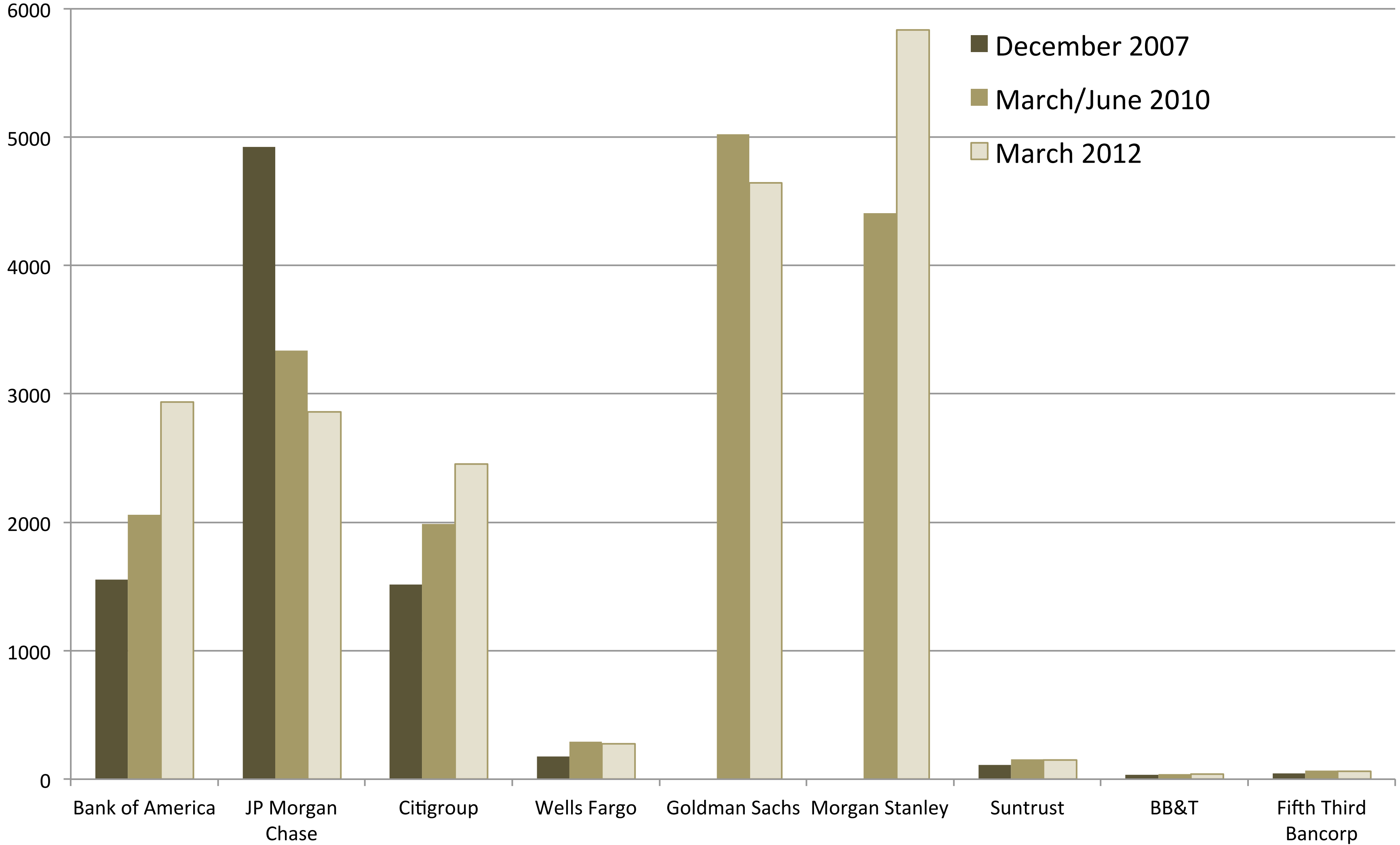
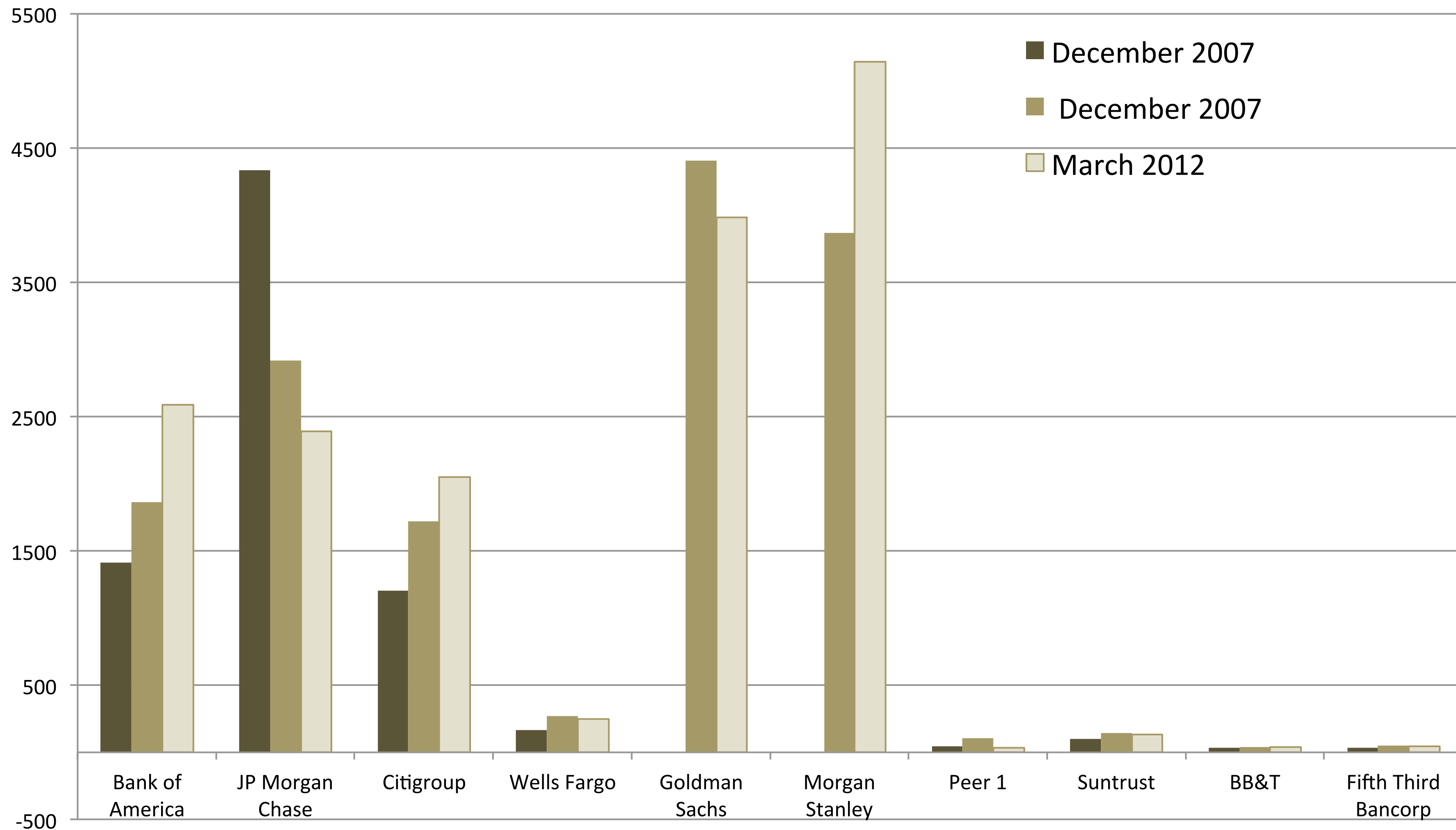


Figure 3: Net Loans and Leases as Percentage of Assets, Selected large bank holding companies, December 2007, March/June 2010, March 2012
80
70
60
50
40
30
20
10
0
Dec-07
March/June 2010
Mar-12
Bank of America
JP Morgan Chase
Citigroup
Wells Fargo
Goldman Sachs
Morgan Stanley
Suntrust
BB&T
Fifth Third Bancorp


Derivatives as Percentage of Assets, Selected large bank holding companies, December 2007, March/June 2010, March 2012
6000
5000
4000
3000
2000
1000
0
December 2007
March/June 2010
March 2012
Bank of America
JP Morgan Chase
Citigroup
Wells Fargo
Goldman Sachs
Morgan Stanley
Suntrust
BB&T
Fifth Third Bancorp



Interest-rate Contracts (Swaps) as Percentage of Assets, Selected large bank holding companies, December 2007, March/June 2010, March 2012
5500
4500
3500
2500
1500
500
-500
December 2007
December 2007
March 2012
Bank of America
JP Morgan Chase
Citigroup
Wells Fargo
Goldman Sachs
Morgan Stanley
Peer 1
Suntrust
BB&T
Fifth Third Bancorp

Post-crisis pressures, debate, and reform efforts 1/5

- Pressures for reform: two Congressional investigations
- The SFRC had competition; eg., Acharya and Richardson (2009), criticizing LCFIs (large complex financial institutions):

> "The legitimate and worthy purpose of securitization is to spread risk. … But especially from 2003 to 2007, the main purpose of securitization was not to share risks with investors, but to make an end run around capital-adequacy regulations. The net result was to keep the risk concentrated [and] … at a greatly magnified level, because of the overleveraging that it allowed.
>
> … They managed to do so by getting around the capital requirements imposed by regulators—who, in turn, were hoping to diminish the chance that deposit insurance, and the doctrine of "too big to fail," might cause LCFIs to take just such risks."

Post-crisis pressures, debate, and reform efforts 2/5

- Darrell Duffie focuses on “large dealer banks”, who
- “act as intermediaries in the markets for securities, repurchase agreements, securities lending, and over-the-counter derivatives. They conduct proprietary (speculative) trading in conjunction with these services. They are prime brokers to hedge funds and provide asset-management services to institutional and wealth individual investors. ... some operate ‘internal hedge funds’ and private equity partnerships” ... (Duffie 2011, page 4)

- If not regulated well they will take inefficient risks, but their very centrality in the financial nexus imposes TBTF policy as a necessity:
- “When the solvency of a dealer bank becomes uncertain, its various counterparties and customers have incentives to reduce their exposure to the bank, sometimes quickly and in a self-reinforcing cascade. ... Dealer banks have been viewed, with good reason, as ‘too big to fail.’ The destructiveness of the failure of Lehman Brothers in September 2008 is a case in point.” (Duffie 2011, page 5)

Post-crisis pressures, debate, and reform efforts 3/5

What to do? Diverse views:

- Richardson, Smith, and Walter (2011): The only companies that can operate sustainably without triggering TBTF interventions eventually are smaller, specialized intermediaries that focus on a small set of financial functions.
- Johnson and Kwak (2010): an explicit rule limiting the size of all financial intermediaries as a share of GDP.
- French *et al.* 2010 and Duffie 2011:) is to permit wide-ranging activities by financial conglomerates, but to design incentive or punishment mechanisms in the various sub-areas of financial activity to avoid dangerous excess.
- Shiller (in Kroszner and Shiller 2010): the key problem is not in the size or complexity of the firms serving the market, but instead in the structure of markets available to meet banking needs. Simplify financial contracts and establish futures and derivatives markets that allow everyday people to hedge their bets (such as a hedge against falling house prices in one's hometown)

Post-crisis pressures, debate, and reform efforts 4/5

Dodd-Frank Act of 2010 embodied these contradictory impulses and its "Volcker Rule" (no 'proprietary trading' by bank holding companies) has drawn a furious response by LCFIs.

Jamie Dimon, CEO of JP Morgan Chase, at an Atlanta conference on June 10, 2011, confronting Treasury Secretary Geithner regarding the higher capital requirements for large banks such as Mr. Dimon's own:

> "Has anyone bothered to study the cumulative effect of all these things? .. And do you have a fear, like I do, that when we look back on them .. they will be the reason that it took so long that our banks, our credit, our businesses, and most importantly, job creation started going again?"

A month ago, JP Morgan Chase lost $2 billion in unwise speculative bets in the London over-the-counter derivatives markets, resulting in a $16-billion hit to Chase's equity-market value.

Post-crisis pressures, debate, and reform efforts 5/5

Tim Geithner in 2008 (Sorkin 2008), jogging in Manhattan:

> "Those ferries, freighted with office workers, gave him pause. *This is what it is all about*, he thought to himself, *the people who rise at dawn to get in to their jobs, all of whom rely to some extent on the financial industry to help power the economy. Never mind the staggering numbers. Never mind the ruthless complexity of structured finance and derivatives, nor the million-dollar bonuses of those who had made bad bets. This is what saving the financial industry is really about,* he reminded himself, *ordinary people with ordinary jobs."* (Sorkin, Chapter 17).

And there in Atlanta in June 2011:

> "The US financial system is recovering because of the "tough choices we made to fundamentally restructure the system .. we put in place the reforms necessary to preserve those changes, with a better balance of stability and innovation ... The weakest parts of the U.S. financial system – the firms that took the most risk – no longer exist or have been significantly restructured.

Conclusion 1/1

The Wall Street complex, which Johnson and Kwak (2010) characterize as a "plutocracy," has not restored the economic functionality of the US financial system, even as the Obama Administration has counted on its contribution to reinvigorating US economic growth.

There is now a holding action to defend the weak reforms of Dodd-Frank, not to take more definitive actions that protect core banking functions from the excessive risk-taking of LCFIs operating as "principals", and not to unwind the complexity of a system controlled by "dealer banks"

Many economists are blind to the fact that the transformation of TBTF has been accompanied by and encouraged the transformation of banking. There are economists on both sides of these opposed views. But banks' lobbying money weighs in on only one side.