VIEWPOINTS

The Last Crisis, the Next Crisis and the Future of Large Banks

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Introduction

The future of large banks depends on the effectiveness of the post-crisis regulatory system, which is ironic: the reaction of large banks to the 2010 Dodd-Frank law was broadly negative, even while many people working at large banks recognized that changes were needed in the wake of the financial crisis and are now striving diligently to comply with the new regime. But the success of the new regulatory regime now stands between large banks and the political forces pushing for their breakup. If the post-crisis regulatory regime does not work effectively (and is not seen as working effectively by policymakers and the broader public), then large financial institutions will be forced to make fundamental changes. The measures that large banks initially opposed may prove to be the changes that permit them to continue in their current form; their survival depends in large part on the effectiveness of the post-crisis regulatory regime.

Here I examine the future of large banks by looking at the post-crisis policy response, focusing on how the new tools and legal authorities put in place in the wake of the crisis would have been used had they been available in 2006, 2007, and 2008. While necessarily somewhat of an artificial exercise, such a counterfactual history is still valuable for thinking about the future of the post-crisis regulatory regime. After all, the Dodd-Frank reforms and suite of regulations from the Basel process were designed with the previous crisis—the last war, so to speak—firmly in mind.

I conclude by looking forward to consider how the new post-crisis legal authorities would be used in a future crisis. The exercise here is even more speculative in hazarding the nature of the next crisis—if we could know this, policymakers would work now to avoid it. Still, considering possible crisis scenarios can help policymakers assess the effectiveness of the new regulatory regime, and thus the future of large internationally active banks. The most critical component of the Dodd-Frank changes for large financial institutions is the new resolution authority, meant to make it possible for a large institution to fail while limiting the negative consequences for the broader economy. If the new resolution authority can be made to work so that large banks fail with limited broader consequences, then these institutions will no longer be "too big" in terms of systemic stability (even while arguments continue about whether their size is appropriate on other grounds, such as competition). The large banks should still expect to be treated like political punching bags, but a successful regulatory reform would allow them to continue.

Many policy steps have been taken to improve the stability of the U.S. (and global) financial systems in the wake of the financial crisis. Among other things, regulators have raised capital standards and for the first time imposed liquidity requirements on large banks; they have mandated that large banks issue long-term debt that can be converted to capital in the form of the total loss-absorbing capacity (TLAC); they have required increased transparency on derivatives; they have adopted a statutory framework, regulations, and procedures to facilitate the resolution of non-banks including non-bank subsidiaries such as broker-dealers within bank holding companies; they have implemented stress tests and required large banks to develop living wills; and in the United States, the U.S. Consumer Financial Protection Bureau (CFPB) has been established. Some changes remain to be decided or finalized, including dozens of required Dodd-Frank rules still outstanding (21.3 percent of the rules had not yet been proposed as of the September 30, 2015, according to the progress report from the Davis-Polk law firm[1]).

Increased capital undoubtedly contributes to improved financial sector stability, as do many of the other changes made in the wake of the crisis. The value of some changes, however, is less certain in terms of striking a balance between financial stability and economic growth. For example, while the Fed deserves credit for implementing the Volcker Rule in a way that is not as harmful to economic growth as could have been the case, the rule still fails to pass a reasonable cost-benefit test. It imposes costs in exchange for improvements in stability that could have been achieved within the pre-existing regulatory framework—since supervisors already had the authority to ensure that banks put in place appropriate risk management frameworks.[2]

More worrisome are instances in which there are problems that policymakers seem to downplay or even deny. The cumulative impact of regulation on the activities of community banks is a notable example, and of both economic and social importance, given the role of these institutions in providing credit to smaller local businesses that are not always well-served by larger banks. Another concern for policymakers relates to the difficulties posed by internationally active banks that "live globally but die locally." The new regulatory regime could result in bank balance sheets that are chopped up in the next crisis by the effective implementation of country-by-country ring-fencing. Because the post-crisis regulatory regime depends on cooperation between national regulators, that may be difficult in the midst of a financial crisis. National regulators may adopt measures that result in the undesirable hoarding of capital and liquidity within countries rather than allowing internationally active banks to shift resources to address location-specific funding challenges. The possibility that such regulatory

[1] http://www.davispolk.com/Dodd-Frank-Rulemaking-Progress-Report/

[2] Phillip Swagel, December 13, 2013. "A Modest Volcker Rule." http://economix.blogs.nytimes.com/2013/12/13/a-modest-volcker-rule

directives could exacerbate a global financial crisis contrasts with the positive view of country-specific ring-fencing put forward by U.S. policymakers.[3]

It remains desirable to improve legislation and address features of financial regulation that fare poorly on the tradeoff between stability and economic costs. Senator Richard Shelby (R-Alabama), the chairman of the Senate Banking Committee, has put forward a bill with a number of desirable features to reduce regulatory burdens. At the same time, a case can be made as well to allow the industry to adjust to post-Dodd-Frank changes, and for policymakers to study the attendant impacts and adjust over time. To its further credit, the Fed has said that it will take this approach with the Volcker Rule.

The Last Crisis: 2008

If the many changes instituted after 2008 had been in place then, one could imagine that the last crisis might not have taken place at all. Perhaps the advent of the Consumer Financial Protection Bureau, for example, would have prevented the last crisis by heading off the low-quality mortgage origination at the root of the crisis. A more active regulator would have made a difference, but it is not clear that the existence of the CFPB by itself would have prevented the last crisis (and to be sure, the CFPB itself does not make this claim). The bureau is having its first experience with a crisis in the form of the difficulties experienced by users of the RushCard payments product, and the CFPB does not appear to be faring well in terms of a rapid response for people in trouble—in this case, low- and moderate-income families cut off from access to their funds by a non-bank financial institution. The RushCard situation is the sort of problem that CFPB was meant to address, but the bureau has not been adept or able. Indeed, this is an agency with a keen focus on public relations, and yet the CFPB has been relatively muted in the face of what is reported to be a crisis for those affected.[4] At the same time, even if the creation of the CFPB would not have prevented the last crisis, the creation of the bureau remains an important element of the crisis response—indeed, the 2008 Treasury Blueprint called for it.[5] The challenge remains for the CFPB to find the right balance between effectively protecting consumers and ensuring that its actions do not have a negative impact on innovation and growth, or needlessly cut off consumers from access to credit.

Bank funding has also changed considerably since the crisis. Large banks today are funded with much more capital than was the case going into the last crisis, both because of their own decisions and in response to regulatory changes such as those stemming from the Basel process. This is a good thing.

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[3] Daniel Tarullo, 2015, "Shared Responsibility for the Regulation of International Banks," November 5. http://www.federalreserve.gov/newsevents/speech/tarullo20151105a.htm

[4] CFPB Director Richard Cordray put out a statement on October 23, 2015: "The CFPB is taking direct action to get to the bottom of this situation that may have harmed thousands of innocent consumers already" and, "Further, we indicated that the CFPB is prepared to use all appropriate tools at our disposal to help ensure that consumers obtain the relief that they deserve." http://www.consumerfinance.gov/newsroom/statement-by-cfpb-director-richard-cordray-on-rushcard-prepaid-card-incident/ News reports into November, however, indicated that users of the RushCard continued to have difficulty accessing their funds and had suffered meaningful financial losses and personal inconveniences as a result. https://finance.yahoo.com/news/rushcard-fiasco-how-customers-aftermath-180105818.html The Bureau in early December directed the company behind the RushCard product to cooperate with an investigation, but individuals affected by the situation have obtained relief instead by having news organizations inquire on their behalf.

[5] https://www.treasury.gov/press-center/press-releases/Pages/hp896.aspx

And yet, it is again not clear that more capital alone would have prevented the last crisis (at least in the amounts commonly discussed). After all, a lesson of the collapse of Bear Stearns, Lehman Brothers, and others is that once a financial firm loses the confidence of market participants, a few percentage points of capital is not likely to be enough to ensure stability. Once short-term creditors began to run, whether these institutions were solvent or not proved to be irrelevant, because they could not meet their short-term funding needs. Even so, more capital would have helped and might have saved some firms. A similar point can be made for the post-crisis requirement of increased liquidity. Firms that arguably teetered at the brink of solvency might have made it (or survived longer) had their assets remained liquid through the crisis. AIG is often seen as the prime example of this, in that the government rescue of the firm was necessitated by a liquidity crunch. Still, AIG failed badly, and not by a little. Market confidence and liquidity evaporated in tandem. As Robert McDonald and Anna Paulson have shown, the firm might well have been insolvent, not merely illiquid, as the Fed believed at the time that it extended extraordinary financing.[6]

The non-bank resolution authority created in Title II of Dodd-Frank would have been used had it existed in 2008. It is an open question whether Title II would have been used in the case of Bear Stearns, or even whether it would have been needed if the Bear situation happened in the future, given work at the New York Fed to strengthen the tri-party repo system. Still, Title II surely would have been invoked for AIG. The firm was heavily consumer facing, and its collapse would have had important implications for pensions and other forms of retirement savings. Interconnections between the constituent parts meant that there was no way to resolve part of the firm, such as the financial products division, without having pieces of the firm seized by individual regulators around the globe. The firm would have imploded absent the Fed's intervention, an experience that informs the FDIC's single point of entry approach to resolution. In a sense, AIG was the test case for a limited version of Title II, with the Fed rather than the FDIC providing bridge liquidity.[7] A key difference that the existence of the Title II authority will make in a future crisis is that it grants the government the authority to impose losses on counterparties in a way that was not possible in September 2008. Indeed, the Dodd-Frank Act requires those losses to be imposed on bondholders and other counterparties. Still, it is striking that there is remains a good deal of discussion in financial circles, including in the government, premised on a view that Title II is unworkable or will not be used as required in the law. An example of this can be seen in the tabulation from the Richmond Fed of the federal government safety net, which effectively disregards the new authority in assessing the size of taxpayer exposure to losses.[8] A key challenge remains for the FDIC and other regulators to address this perception, that the liquidation authority cannot be used as intended.

The question then is whether the use of Title II for AIG would have been successful at ensuring financial market stability while avoiding costs for taxpayers. This is hard to answer—we will not know until the

[6] See Robert McDonald and Anna Paulson, 2015. "AIG in Hindsight," *Journal of Economic Perspectives*, Vol. 29 No. 2, Spring, pp. 81-106.

[7] For a discussion of the FDIC approach, see Thomas H. Jackson, Randall D. Guynn, and John Bovenzi, 2013. "Too Big to Fail: The Path to a Solution," May, report from the Bipartisan Policy Center, available on http://bipartisanpolicy.org/wp-content/uploads/sites/default/files/TooBigToFail.pdf

[8] See https://www.richmondfed.org/safetynet/, and page 5 of https://www.richmondfed.org/~/media/richmondfedorg/publications/research/special_reports/safety_net/pdf/bailout_barometer_faq.pdf

next financial crisis. The statute asserts that the resolution would be "orderly," presumably based on the open-ended ability to put in taxpayer money to stabilize a firm once Title II is invoked. As Morgan Ricks notes, however, bank resolution by the FDIC is "orderly" not because depositors necessarily value the FDIC's expertise at winding down institutions but rather because of the deposit insurance that shields them from losses.[9] In contrast, Title II requires losses to be imposed. The key question, then, is whether authorities will be willing to impose losses on counterparties.

In principle, market participants who purchase the securities of large banks should be aware that they are on the hook for losses in the event of a failure. This recognition should affect funding costs ahead of any crisis, so that a credible implementation of Title II would effectively contribute to market discipline on large institutions. This impact applies not just to funding explicitly designated as part of the TLAC, but to all counterparties, based on the wide grant of authority in Title II to impose losses. Still, it is hard to know for sure what will happen in the midst of a crisis, especially if policymakers worry that losses appropriately imposed on the funders of one firm will lead to a stampede to the exits at others. Indeed, during the crisis, the losses imposed on senior bondholders of Washington Mutual are widely seen as having exacerbated funding pressures for Wachovia. Confidence that Title II will work as intended, including with losses imposed on counterparties, would go a long way toward reassuring policymakers, including anxious members of Congress, that the post-crisis regulatory changes have addressed Too Big To Fail by getting at "to fail" and thus making "too big" less worrisome.

The key then is to have a process for failure resolution that is set down as much as possible in advance and then followed in a crisis. The FDIC especially has done a lot of good work in providing a roadmap, and it must continue to flesh out the resolution process while building confidence that the process will be followed.[10]

A challenge for the FDIC is that there are two relevant examples for how a process akin to Title II would be used, including one in an exigent circumstance, and neither example instills confidence. This is not the fault of the FDIC but is illustrative of the pressures involved. The first example is the auto manufacturers' bankruptcies, a process in which political considerations appeared to have been paramount in allocating losses—the opposite of what would be desirable with non-bank resolution. And the politically-driven allocation of losses took place concurrently with discussions of the financial regulatory proposals that eventually included Title II, so it was clear that the actions taken with GM and Chrysler had implications beyond the auto sector.

The second example is the TARP bank fee included in Obama budget proposals. The law establishing the TARP required that losses be made up from assessments on the rest of the financial industry, but the TARP fee proposed by the Obama administration was problematic in two somewhat contradictory ways. First was that the fee was proposed sooner than it needed to be, at a time when it would actually have sapped financial sector stability. Second was that it then remained a proposal even when it seemed

[9] Morgan Ricks, 2011. "Regulating Money After the Crisis," Harvard Business Law Review. See http://www.hblr.org/wp-content/uploads/2014/09/Regulating-Money-Creation.pdf

[10] See, for example, the May 12, 2015 speech by FDIC Chairman Martin Gruenberg, "A Progress Report on the Resolution of Systemically Important Financial Institutions": https://www.fdic.gov/news/news/speeches/spmay1215.html

clear that the fee would not needed. That is, the administration's proposal gave the appearance, perhaps because this matched the reality, of being a revenue raiser under the guise of financial stability. Using these fees to raise revenue runs counter to the purposes vital for financial stability, which is to give confidence to market participants in the process by which Title II will be used, particularly in imposing losses.

The Next Crisis: 202x?

The post-crisis regulatory response can be seen as a sort of pendulum swing after the permissive environment that led into the housing bubble—which naturally raises the question whether the pendulum eventually will move back to undo some of the changes in capital and other rules. At least as of the end of 2015, it seems more likely that the pendulum will remain stuck. For the future of large banks, what matters for the foreseeable future is how the new regulatory regime works, both in normal times and in the next crisis.

One can imagine various possibilities for a future crisis. To their credit, regulators are focused on many of these. For example, federal bank supervisors have cracked down on apparently risky lending that evokes memories of the bubble, including the use of leveraged loans to fund financial engineering such as stock buybacks. Regulators have put forward analysis of potential fire sales that could result from episodes of illiquidity at mutual funds, and considered the problems that might arise from the concentration of risk at clearinghouses. (Problems at clearinghouses pose particular concern because these institutions are excluded from Title II[11]). Fed liquidity facilities seem well-targeted for other potential future financial crises such as might arise from electric grid sabotage or cyber-security problems.

On the other hand, some recent regulatory decisions seem to run counter to the idea of avoiding future crises or could make it more difficult to respond to them. The Federal Reserve is fiercely (and appropriately) independent on monetary policy—but relatively responsive to political pressures on financial regulation. The Fed's tendency to succumb to political pressure can be seen in two recent rulemakings. The first is with the Dodd-Frank requirement for risk retention on securitized lending—the so-called "skin in the game" provision—for which the Fed, under political pressure, agreed to rules that effectively eviscerated the requirement.

The second example of the Fed's capitulation to political pressure is with the liquidity coverage rule, where the Fed allowed certain state and municipal bonds to count as high-quality liquid assets.[12] It is easy to foresee that the Fed would face considerable political pressure to allow similar leniency for borrowers who can mobilize significant amounts of political pressure if a future crisis involves duress among this set of borrowers. It is noteworthy that the Fed has stood up to pressure mainly from the political right on monetary policy, while demonstrating its susceptibility to pressure from the left on regulatory policy. Establishing credibility and independence on regulatory policy will be an important

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[11] See Robert Steigerwald, 2012. "Orderly Liquidation in the Shadow of the Bankruptcy Code" presentation at the Chicago Fed. https://www.chicagofed.org/markets/orderly-liquidation-bankruptcy

[12] See http://www.federalreserve.gov/newsevents/press/bcreg/20150521a.htm.

challenge for the Fed, so that it preserves its ability to act (or not act) even in the face of political pressure, such as to assist with the financial rescue of a municipal borrower.

Other dangers in the face of the next crisis are restrictions on policy steps that might be needed. The limits in Dodd-Frank on use of the Fed's emergency powers—the so-called 13(3) authority—so far seem acceptable, since broad-based lending programs can still be put in place as needed. For example, the Fed could have offered the terms of its AIG bailout to other insurers, confident that healthy firms would not have taken them (the opposite situation of the TARP capital injections, which were intentionally designed to result in broad take-up). But one could imagine more serious restrictions that tie policymakers' hands in a future crisis. Restricting intermediate steps taken by the Fed to stabilize the financial system could inadvertently allow a crisis to worsen enough to lead policymakers to invoke Title II. The key to avoiding this discontinuity is both for the post-crisis regulatory changes to be developed, and for tools such as Title II to be available if needed.

The SEC's waiver regime also could lead to systemic problems that threaten the financial system. One likewise can imagine a self-created issue at the SEC, as political rhetoric leads to a situation in which commissioners box themselves into making a commitment not to take such steps as providing waivers to banks—even when these might be necessary for financial stability. A pledge by an SEC commissioner not to vote in favor of such a waiver is akin to a member of Congress opposing increases in the debt ceiling, while relying on others to take on the burden of acting in the best interest of the nation. SEC commissioners in the political majority who make a public commitment to a no-waiver regime leave themselves open to having this rhetorical bluff called by minority commissioners, with potentially fraught results for the financial system and overall economy. A broad point is that it would be useful for all participants in the regulatory system to consider issues relating to systemic risk. As Keynes pointed out, the financial system is not a morality play but a series of technical challenges to be solved.[13]

The Future of Large Banks

The post-crisis regulatory response involves measures not only to avoid a crisis, but also to deal with one if it arises. The response to the next severe financial crisis inevitably will involve two main tools: 1) the provision of liquidity from the Fed to mitigate a crisis, and 2) the invocation of Title II, with its broad authority to deal with a severe crisis that threatens the stability of the financial system. Making Title II work is the key challenge of the post-regulatory response. Success would be for the FDIC both to work out implementation details with its single point of entry approach, and to convince market participants and the broader political system that the mechanism is viable.

So long as the next failure of a large bank can be addressed in a way that does not threaten the financial system and does not involve a taxpayer bailout, the future of large banks is likely secure in the U.S.

[13] See Paul Krugman, 2008. "Keynes' Difficult Idea," December 24. http://krugman.blogs.nytimes.com/2008/12/24/keyness-difficult-idea

economy. An effective regulatory regime, with a credible Title II, will allow large banks to maintain their place in the U.S.[14]

At the same time, even if everything works well, large banks will still maintain their place in the popular and political discourse—as convenient scapegoats. But if the regulatory regime can be made to work, then large banks will be somewhat like the North America Free Trade Agreement (NAFTA), a treaty that is unpopular but continues without serious challenge because it provides economic benefits. That is, politicians might decry NAFTA, but none go so far as to suggest tearing it up. With a successful post-crisis regulatory system, large banks could have a bad reputation but remain active in the economy and provide reasonable returns for their shareholders and value for other stakeholders. The challenge, then, for big banks is to climb to the level at which they enjoy the same tepid support as NAFTA.

About the Author

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[14] See Phillip Swagel, 2012. "Don't Make Banks Too Small to Succeed." http://www.bloombergview.com/articles/2012-09-05/don-t-make-banks-too-small-to-succeed