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Too Big to Fail Financial Institutions?

International Perspectives and Possible Remedies

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"Too Big To Fail and the Gramm-Leach-Bliley Act: we can't solve the first without reversing the latter"

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Logic of the Dodd–Frank Wall Street Reform and Consumer Protection Act

"An Act

to promote the financial stability of the United States by improving accountability and transparency in the financial system,

to end "too big to fail",

to protect the American taxpayer

by ending bailouts,

to protect consumers from abusive financial services practices, and for other purposes."

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To Make Fiscal Policy Independent of the Stability of the Financial System!

- Remember
  - The Push to Central Bank Independence?
  - To Isolate the Central Bank from the Profligate ways of Politicians
  - Present Central Bank Financing of Deficit Spending on Populist Political Programs
  - To make Monetary Policy independent of political control

- Now,
  - Dodd-Frank seeks to make the US Fiscal System Independent of the Profilgate ways of Politicians
  - In September 2008 the Chairman of the Fed went to the Treasury Secretary and said:
  - "I can't handle this anymore: The Treasury and Congress have to come up with support"
  - TARP produce a massive bailout of the Financial System
  - Dodd-Frank thus seeks to eliminate Fiscal Policy "Bailouts" of Banks that are

"Too Big to Fail"

- D-F seeks to create mechanism to allow "systemically significant" financial institutions to fail without systemic consequences
- The two major pillars of the D-F reform package are thus
  - Effective means to force liquidation with only temporary public assistance when regulation proves to be inadequate
  - Regulations to better manage risk of large, "systemically significant" financial institutions

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Can this be done?

- D-F is based on belief that Crisis caused by lack of regulation on Large Systemically Significant Banks
- But Regulators accept that banks will continue to be large
  - Treasury Secretary Geithner "I don't have any enthusiasm for . trying to shrink … the financial system in our economy as a test of reform, because we have to think about the fact that we operate in the broader world"
  - "Financial firms are different because of the risk, but you can contain that through regulation."
- Or that it is possible to identify Large Systemically Significant banks:
  - "It depends too much on the state of the world at the time. You won't be able to make a judgment about what's systemic and what's not until you know the nature of the shock." This would make the identification of systemically important financial and nonfinancial firms difficult and make the identification of emergent risks nearly impossible.
- Or to design effective regulation:
  - lenders would simply "migrate around" whatever objective criteria of emergent risks or significant institutions that policymakers developed in advance.
- Or that insolvent banks will be resolved without government bailouts or taxpayer support for shareholders or management,
  - Geithner takes the contrary view that "In the future, we may have to do exceptional things again if we face a shock that large. . . . You just don't know what's systemic and what's not until you know the nature of the shock" (quoted in SIGTARP 2011).

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Where did "Too Big to Fail" Banks Come from?

- <u>1999 Financial Services Modernization Act</u>
  - Abolished the segregation of financial institutions and allowed creation of integrated multi-function financial holding companies
  - Allowed US banks to compete on level global playing field with "universal banks"
  - Based on increased efficiency achieved by
    - cross-sales of financial services
    - cross-hedging of risks within large multifunction financial conglomerates.
    - symbiosis across different financial services would increase incomes as well as decrease the risks borne by the larger institutions.

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Consequences of Multifunction FHCs

- Larger financial institutions
  - Larger than either commercial deposit-taking banks or noninsured investment banks had been in the past
  - Expansion not limited to the provision of any particular service as under Glass-Steagall.
- Risk spread across activities increased the correlation of risk across activities.
- **RESULT**: Financial conglomerates that were both too big and too integrated to be resolved if they became insolvent.
  - Rather than distributing risk to those most able to bear it, risk was distributed and redistributed until it became impossible to locate who was in fact the counterparty responsible for bearing the risk.
  - Counterparty risk thus joined the more traditional funding/liquidity and interest rate risks facing financial institutions. It replaced what was initially the most important of bank risks: lending or credit risk.

Regulations Also Created Large Size and Complexity

- Impetus for large size was also the result of a change in the instruments of monetary policy introduced by the globalization of the market for provision of financial services.
- The Basel Committee global rules for risk-adjusted capital adequacy ratios.
  - Up to that time, monetary policy had been primarily implemented through adjustment of reserve ratios, and then, more exclusively, through open market operations. While the capital ratios were meant to make riskier activities more expensive to fund, and thus less profitable and less attractive, they had a rather perverse result.
  - First, this encouraged banks to expand their activities in the riskiest, highest-return activities in each particular risk category.
  - Second, it encouraged banks to move as much as possible of their lending that had the highest risk weight off their balance sheets and into special-purpose vehicles (SPVs) that largely escaped regulation and reporting.
- Created a new type of counterparty risk
- Since credits no longer formally the responsibility of the bank, transferred credit risk to the SPVs and removed incentives to apply creditworthiness analysis of securities sold off-balance-sheet entity.
- When the crisis hit the risks came back to the banks

"Benefits" of Large Size

- Even regulators admit that such institutions will not be allowed to fail.
- Implicit Government Guarantee (moral hazard):
  - allows use of riskier, higher-return investments, bolstering the top-line earnings
  - Lower credit risk lowers borrowing costs
  - Improves earnings
- Smaller banks find it more difficult to compete
  - Returns are lower
- Resulting concentration allow larger banks to impose higher charges for customer services
- Cumulative process supports increasing size,
- Minsky: both borrowers' and lenders' risks are reduced for large conglomerate banks and have increased monopoly power over prices.
  - This may be the real cause of the favorable performance of large bank groups.
  - This may not be the result of the efficiency of large banks
  - It may be the result of a government "subsidy" that can only be withdrawn with difficulty

Major Provisions of Dodd-Frank

- The Financial Stability Oversight Council
  - Definition of Systemic Significance
  - See the Systemic Future: Forecasting Financial Fragility
- Resolution of failed institutions: OLA+Living Wills
- The Volcker Rule: Ban Proprietary Trading
  - "Business of Banking" client exemptions
- Ban Derivatives Dealing: Lincoln Push Out Amendment
  - "Business of Banking" client exemptions
- Swaps and futures regulation
  - Clearing and Market trading for all Derivatives
  - Proprietary clearing and Non-exstence of Markets
  - No exemptions for CDS
- Provision of Liquidity: section 13(3)
  - LLR lessons of Bear, Lehman, AIG Lehman
  - Minsky: A Fully Open Fed Window

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Major Provisions of Dodd-Frank

- The future of securitization: risk retention
  - Off balance sheet regulations
  - SEC regulations
- Capital and leverage ratios: BIS rules
  - Micro approach to systemic risk
- Reform of credit rating agencies
  - Why do they exist?
- Regulation/Registration of hedge funds:
  - Are they a Risk?
- Multiple and overlapping regulatory authorities
  - Conflict in the Fed's Role

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Who Creates Liquidity in Shadow of Prudential Regulation?

- **What is "liquidity"?**
  - Insured deposit-takers acting as acceptance houses
  - Investment banks acting as market makers
- **Who Else Creates Liquidity**?
  - Money Market Mutual Funds
  - Derivatives – create shadow assets
  - Securitisation: maturity conversion long to short
  - Repo markets – collateralised lending
  - Prime brokerage business
  - Hedge Funds
- **Does Dodd-Frank effectively limit these sources of liquidity?**

Can Dodd-Frank prevent "It" from happening again?

- Full implementation will require over 250 rule-making provisions by regulatory agencies, over 60 special reports and, and an additional 22 reports.
- Places major responsibility on those writing the specific rules
- Places an even greater burden on supervision of those rules.
- Already includes the exemptions of the activities incidental to the business of banking that brought down Glass-Steagall
- **The most important failing is that it leaves in place the underlying business model for financial institutions and the contradictions inherent in the GLB 1999 legislation that were at the core of the crisis.**
- **It was this business model that led to the creation and dominance of "Shadow Banking" , i.e. unregulated creation of liquidity**
- The logic of the Fed and Treasury rescue operations has been to restore this financial structure.
- If the problem was the structure of the financial system, and unregulated shadow banking, then Dodd-Frank will not prevent another crisis.

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