

A black and white photograph of a city street corner, likely in New York City. The image shows several tall, modern skyscrapers with glass facades. In the foreground, a black street sign is mounted on a pole. The sign has white text that reads "WALL ST" in large, bold letters. Above "WALL ST", there is a smaller arrow pointing left with the text "105-120" next to it. The background is a bright, slightly overexposed sky.

# BETTER MARKETS

## The Too BIG to FAIL Problem Is Alive, Well, and Getting Worse

Financial Stability Board Symposium | September 16, 2019

Dennis M. Kelleher

# Better Markets' Mission

---

Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again.

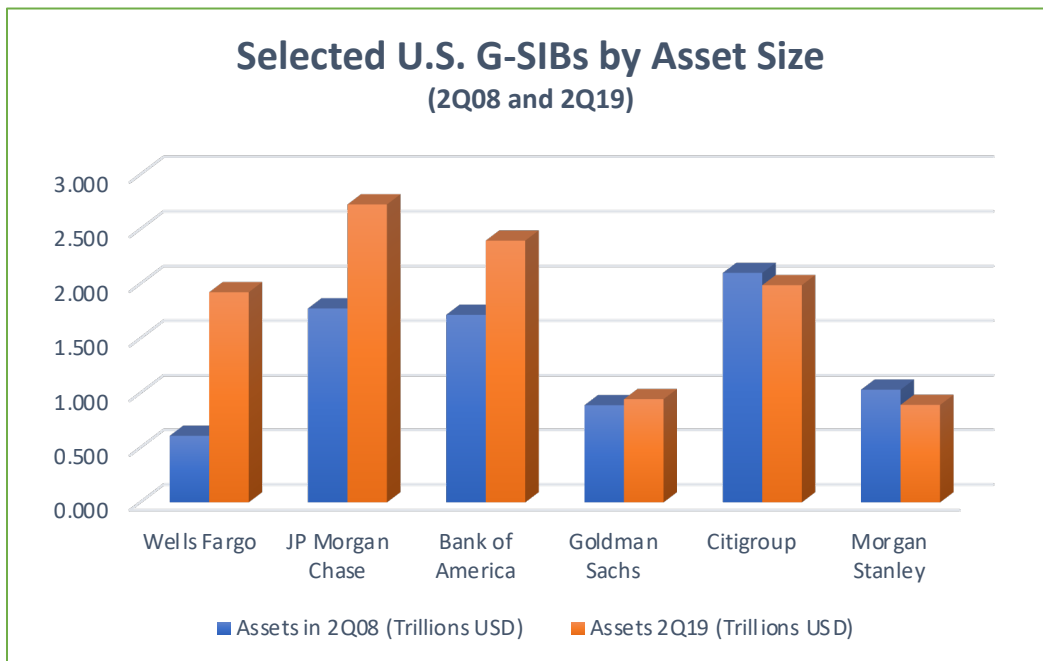
Better Markets also works to restore layers of protection between hardworking Americans on Main Street and Wall Street's riskiest activities. We work with allies—including many in finance—to promote pro-market, pro-business and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements and more.

Although often referred to as a "Wall Street watchdog," Better Markets is also a government watchdog, calling attention to those who fail to serve the public, including regulators and prosecutors who fail to enforce the law on Wall Street.

# Too BIG to FAIL Is Alive and Well

The 2008 financial crisis was caused by poor risk management and other reckless practices that led to the failure or near-failure of numerous too-big-to-fail (TBTF) financial institutions.

The Global Systemically Important Banks (G-SIBs) today acquired most of the 2008 TBTF financial institutions, creating even bigger, even more complex institutions.



Although assets (size) represent only a single measure of TBTF, other factors considered in connection with G-SIB designations lead to a similar conclusion that TBTF is alive and well.

- Financial institutions at the center of the 2008 financial crisis—e.g., Lehman Brothers, Bear Stearns, Citigroup, and AIG—were actually smaller and less complex.
- The designation of these firms and their successors as G-SIBs suggests that financial reforms have not succeeded in ending TBTF.
- G-SIBs also continue to be substantially interconnected, critical nodes in the global financial system and they control or participate in all systemically important infrastructure (e.g., exchanges, OTC execution venues, clearinghouses, and data repositories).

# Known Consequences of Too BIG to FAIL

**The \$20+ trillion in bailouts associated with the 2008 financial crisis are a direct consequence of permitting financial institutions to grow to a size and complexity that makes them TBTF.**

- Policymakers continue to be faced with potentially devastating consequences for the economy and markets in the event of failure or even near-failure of a TBTF financial institution.
- The precise extent of those consequences cannot be known ex ante, so policymakers are very likely to assume the worst. Accordingly, they are going to look for ways to stem a financial crisis.
- TBTF financial institutions essentially extort policymakers into providing financial support to ***insolvent*** institutions, as well as fundamentally solvent institutions facing ***liquidity*** constraints.
- Therefore, TBTF financial institutions act knowing that they have the option to privatize gains in good times and publicize losses in bad times.
- **The result is de facto public insurance of excessive risk-taking in G-SIBs.**

# Known Consequences of Too BIG to FAIL

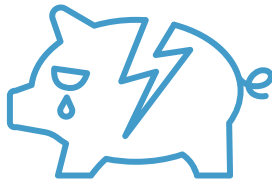
The reality of that de facto public insurance was made clear during the 2008 financial crisis, where trillions of dollars of extraordinary government assistance was openly and also too often secretly given to insolvent (or nearly insolvent), poorly managed TBTF institutions.

What happened in 2008 as a consequence of failing to correct the TBTF problem?

---



UN- AND UNDER-  
EMPLOYMENT



LOW WAGES  
AND SAVINGS



EXCESSIVE  
DEBT



DAMAGED  
CREDIT



FORECLOSURES  
AND LOST EQUITY



PERSONAL  
DEVASTATION

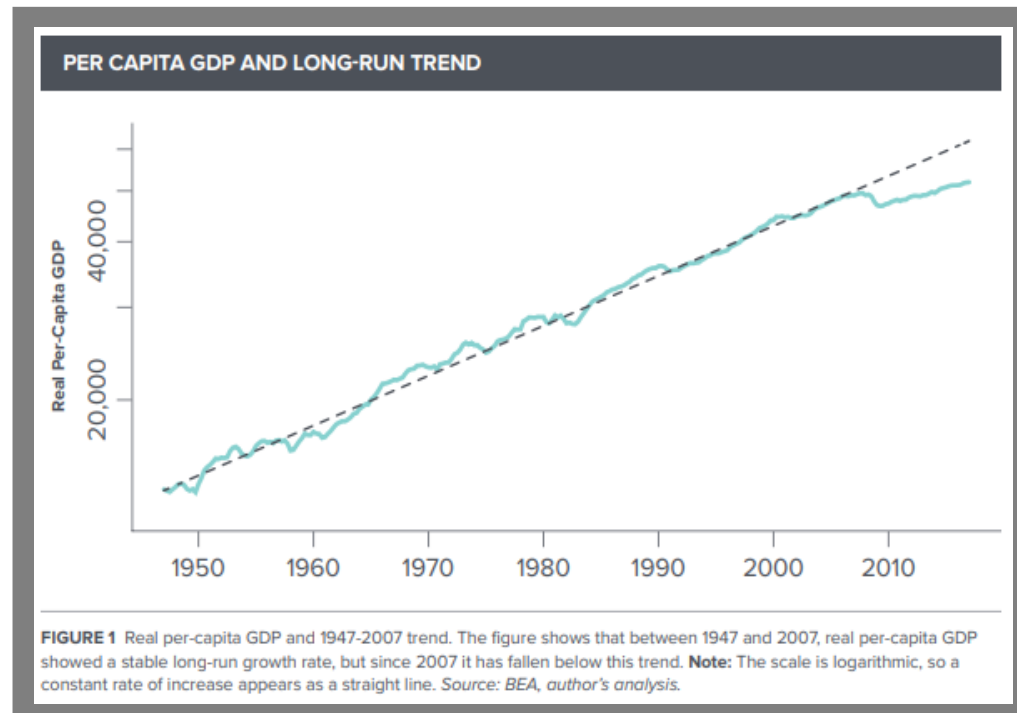
See Better Markets, The Cost of the Crisis: \$20 Trillion and Counting (July 2015), essentially consistent with the findings of the Federal Reserve Bank of San Francisco staff and Federal Reserve Bank of Dallas staff.

Facing such consequences, policymakers are almost certain to intervene to prevent a crisis. But the certainty of such interventions creates moral hazard, because senior management, shareholders, and creditors behave in risk-enhancing ways.

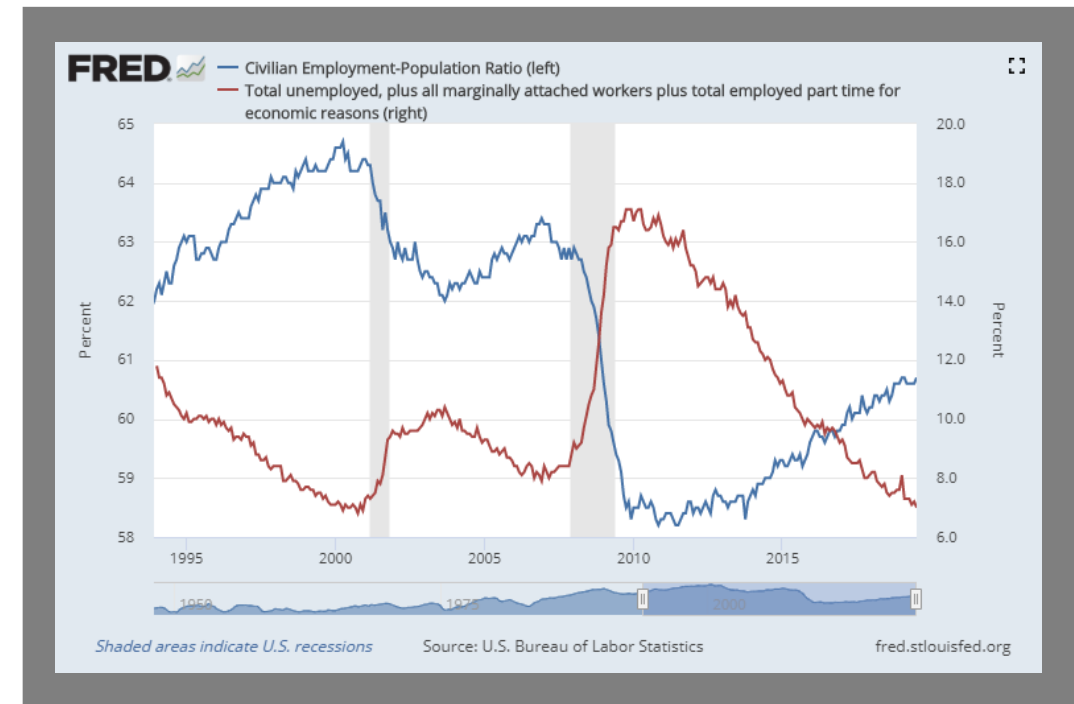
# Known Consequences of Too BIG to FAIL

**Two charts demonstrate that (other than war) nothing is more devastating to a country's economy and markets than financial crises.**

The U.S. economy has not recovered from the output loss caused by the 2008 financial crisis. In 2017, output remained 15% lower than the pre-crisis trend line.



U6 under- and unemployment soared to 17.1% in 2009 and slowly improved. But the employment-population ratio has barely begun to return to its pre-crisis level.





# Known Consequences of Too BIG to FAIL

**The above mentioned adverse effects are certain to affect the decisions made by financial markets policymakers.**

---

- It is hard to predict future sources of financial distress.
- But when they manifest, policymakers managing the failure or near failure of any single G-SIB likely would be confronted with the following choice:
  - 1) Bail-out the G-SIB and hope to contain adverse effects; or
  - 2) Permit the G-SIB to fail and risk the consequences, including the potentially devastating effects on the real economy.

The first choice is at least likely, if not certain.

**Of course, such bailouts would be unnecessary if we solved the TBTF fail problem, because the failure of smaller, less complex, less interconnected financial institutions would not have the same impacts on the broader economy and other institutions.**

**The TBTF regulatory paradigm therefore needs to be advanced to make senior management, shareholders, and creditors to expect and be accountable for the consequences of failures when they occur, which would address moral hazard and make such failures less likely in the first instance.**

# Social Benefits in Exchange for Too BIG to FAIL?

**What are we getting in exchange for the clear risks and perverse incentives associated with maintaining TBTF financial institutions? *The pursuit of profits, bonuses, and power, not prudent and economically beneficial finance.***

**TBTF banks too often are focused on activities that increase profits but do not benefit the real economy.**

---

- TBTF institutions are less likely to engage in productivity-enhancing intermediation functions. For example, proprietary trading may benefit senior management bonuses but provide little real economy benefit.
- That kind of trading activity will always be a temptation, even where it requires resources to be deployed into socially useless activities and markets.

**TBTF banks are exceedingly difficult to monitor by shareholders, depositors, other creditors.**

---

- In other words, TBTF banks are too complex to manage and monitor, as well as TBTF—a dangerous combination.
- Shareholders and creditors may assume TBTF banks will not be permitted to fail and therefore have little incentive to monitor or curb investment/lending. This reduces necessary market discipline.
- Bank supervision and strict, unambiguous regulatory rules and restrictions are critical, because regulators perform monitoring functions that shareholders and creditors can't or won't. Market discipline alone will not force de-risking or changes in management behavior.



# Social Benefits in Exchange for Too BIG to FAIL?

**What are we getting in exchange for the clear risks and perverse incentives associated with maintaining TBTF financial institutions? *The pursuit of profits, bonuses, and power, not prudent and economically beneficial finance.***

**Funding advantages for TBTF banks create competitive disparities.**

---

- The lack of competition provides opportunities to siphon funds away from working Americans (e.g., late fees; credit card fees).

**TBTF banks may use their economic power to increase political power, further disincentivizing prudent management.**

---

- Too big to jail.
- Senior management is layered and insulated from accountability.

# Potential Solutions to the TBTF Problem

**Rather than discouraging TBTF, a number of current U.S. policies may exacerbate TBTF or fail to address incentives problems leading to TBTF:**

- Tax cuts that provide disproportionate benefits to TBTF financial institutions.

**How do we address economic realities?**

- Bank balance sheets continue to grow, and there is continued, unquestioned consolidation (e.g., Truist Bank likely to be a new TBTF bank).
  - Market concentration.
  - Economies of scale.
  - Customers find domination of markets convenient, despite less apparent, externalized effects on financial stability.

# Potential Solutions to the TBTF Problem

**There are logical policy steps that have been taken and could be further taken to address or at least mitigate TBTF.**

**Conventional Balance Sheet Framework: We should properly address *risks* throughout the bank balance sheet**

## ASSETS

The Leverage Ratio has been slowly taking on risk weighting for certain types of assets (e.g., cleared collateral, government debt), contrary to its fundamental purposes.

### Leave it alone!

Its fundamental purpose is to address the challenges of risk-weighting assets for capital requirements, which are imprecise, gameable, and incentivize holding certain assets.

***But . . .***

**This conventional approach to mitigating the risks of TBTF ultimately may be insufficient. We need to consider more seriously structural, activities-based regulation of at least the largest TBTF banks.**

## LIABILITIES

Regulators have improved bank resilience through the Liquidity Coverage Ratio and the Net Stable Funding Ratio.

However, there are a lot of open questions on the effectiveness of Total Loss Absorbing Capacity in the event of an insolvency:

- If there are correlated losses in the event of a failure of a G-SIB, who holds the bailed-in debt across the markets?
- What are the mechanisms for, and what is the timing of, debt conversion?
- Are we, in essence, substituting debt for loss absorbency that should come from capital?

## EQUITY

The Minneapolis Fed recommends significantly higher capital for G-SIBs.

But in the U.S., some propose that capital requirements go down, not up (e.g., to eliminate or adversely reform the G-SIB surcharge, the post-stress leverage ratio for G-SIBs).

# Potential Solutions to the TBTF Problem

## Considerations Beyond the Conventional Regulatory Framework

---

- For example, we should think much more carefully about changing bank management incentives and imposing further restrictions on **activities** likely to induce bailouts in extreme but plausible circumstances.
  - G-SIBs are undoubtedly too complex to manage; there are inadequate monitoring incentives even for banks involved in limited capital markets activities.
  - In addition, the regulatory framework must be sustainable. There would be strong incentives for senior management to seek changes to regulatory requirements that increase monitoring and monitoring incentives. Consider the Volcker Rule.
- We also should more seriously consider whether TBTF can be addressed through caps on capital measures (which would suffer any defects of the underlying capital framework) or perhaps even caps on total assets (which would be blunt, hard-to-evade measures but would not necessarily incentivize asset quality).
  - Is there any reason to believe that capped financial institutions would make fewer investments in the productive economy?
  - Is there any reason to believe that capped financial institutions would diminish the quality of capital markets?

**Please do not hesitate to reach out to discuss any of these TBTF issues.**

**Dennis M. Kelleher**  
**[dkelleher@bettermarkets.com](mailto:dkelleher@bettermarkets.com)**

**Better Markets**  
1825 K Street NW, Suite 1080, Washington DC 20006  
**(202) 618-6464** | © 2019 Better Markets, All Rights Reserved