The State of the Debate on "Too Big to Fail"

Following the financial crisis, many new regulations have been implemented to address systemic risk within the U.S. financial system, including measures that address capital requirements, liquidity ratios and leverage levels, among others. Even with the enactment of the Dodd-Frank Act, which has yet to be fully implemented, debate continues as to whether "too big to fail" (TBTF) remains an issue or whether the legislation has mitigated this risk to the U.S. economy. Among those who believe TBTF remains a key problem for the U.S. economy, proposals to address the issue range widely. Recent symposiums held at the Minneapolis Fed, under the leadership of President Neel Kashkari, explored several of these proposals.[1] In this column, I provide a brief overview of them and share some of my perspectives on the topic.

Some researchers, such as Simon Johnson from MIT, have suggested limiting bank size. Others, such as Anat Admati from Stanford, have suggested much higher capital requirements for large banks. A third proposal, by John Cochrane from Stanford, emphasizes changing the treatment of leverage in the tax code as a way to mitigate financial fragility. A fourth proposal seeks to improve the bankruptcy laws in a way that will allow a financial firm that is in trouble to more readily go through bankruptcy court. While this last proposal has garnered attention, it is also fraught with technical complications. Therefore, I will focus on the first three proposals.

Bank Size Limits: I have been an advocate of a system with smaller financial institutions which can be allowed to fail, if necessary. Generally speaking, however, size restrictions seem arbitrary. Why should a particular bank size be risky and another size not be risky? In addition, recent evidence suggests that substantial economies of scale exist, perhaps even for the largest financial institutions.[2] Furthermore, the primary concern could be that complexity or interconnectedness is the trigger toward financial fragility rather than size itself. For these reasons, some analysts have concluded that a size restriction by itself may not be the most natural solution to the TBTF problem.

Higher Capital Requirements: Raising capital requirements for large financial institutions is emphasized in the Dodd-Frank Act. The idea is that higher capital requirements provide a larger buffer to absorb significant shocks to the institutions, reducing their risk of failure. Admati and others argue that capital requirements should be even larger, which would make their equity capital levels more comparable to those of nonbanks. These researchers also point out that banks had much higher levels of capital in earlier eras when owners and shareholders were personally liable for paying the banks' creditors, if necessary.[3] This suggests that the market solution is to have banks hold more capital than they do today.

Is there a connection between capital requirements and size requirements? Recent comments by Fed Gov. Jerome Powell and other Fed officials suggest that higher capital requirements may cause firms to rethink their optimal size.[4] Some of the largest firms, such as GE Capital, have divested in an effort not to be designated as systemically important within the Dodd-Frank Act, a designation that can lead to higher capital requirements.

Leverage: Many have suggested that leverage—rather than capital—is the issue, in which case Cochrane's proposal to rethink the tax treatment of leverage might be a good idea. Keep in mind what happened during the "tech" bubble in the late 1990s and early 2000s, when firms had to raise their financing through equity. Although investors lost money when the market crashed, the repercussions for the economy were not as significant as the crash of the housing bubble several years later. The U.S. tax system favors bond financing: Interest payments on debt instruments are tax-deductible, while dividend payments to shareholders are not. Giving a less favorable tax treatment to bond financing and a more favorable tax treatment to equity financing might lead to enhanced stability.

These are certainly interesting ideas, but there is also a global aspect. In particular, we have seen efforts on a global level to limit systemic risk through coordinated regulatory policies across countries. In my experience, however, other countries often seem to be less concerned about TBTF as an issue than we are in the U.S. There is sometimes a tendency to view large financial firms as national champions, deserving of protection. In part because of this, we are evolving globally toward a regulated utility model—whereby very large financial institutions are under heavy regulation, which in my view makes them unlikely to innovate effectively in the future. This may leave them vulnerable to coming waves of financial innovation. This is an additional consideration in the ongoing TBTF debate. Ω

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ENDNOTES

1 See www.minneapolisfed.org/publications/special-studies/endingtbtf/symposiums.
2 For instance, see Wheelock, David C.; and Wilson, Paul W. "Do Large Banks Have Lower Costs? New Estimates of Returns to Scale for U.S. Banks." *Journal of Money, Credit and Banking*, February 2012, Vol. 44, No. 1, pp. 171-99.
3 See Admati, Anat; and Hellwig, Martin. *The Bankers' New Clothes: What's Wrong with Banking and What to Do about It*. Princeton, N.J.: Princeton University Press, 2013. Also see their paper "The Parade of the Bankers' New Clothes Continues: 31 Flawed Claims Debunked," from December 2015.
4 See Powell's comments in the *Wall Street Journal* article "Fed Governors Signal Bigger Bank Capital Requirements Looming," from June 2, 2016.