ENDING "TOO BIG TO FAIL"

By U.S. Senator Edward E. Kaufman

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Mr. President, I have spoken twice on the floor in the past few weeks on the problem of "too big to fail."

This is the critical issue in any financial reform legislation. Each Senator must ask whether this issue is effectively addressed in the landmark legislation that the Senate will soon consider. I will limit my remarks today to this central aspect of the challenge we face.

In particular, does this bill take the necessary steps to reduce the size, complexity and concentrated power of the behemoths that currently dominate our financial industry and our economy? If not, what is the justification for maintaining their status quo, what is the risk that one might fail, and – if that were to occur – what is the likelihood that the American taxpayer will once again have to bail them out?

The answer is that there is little in the current legislation that would change the behavior or reduce the size of the nation's six mega-banks. Instead, this bill invests its hopes in two ideas: First, that chastened regulators (who failed miserably in preventing the crisis) will this time control these mega-banks more effectively – today, tomorrow and decades into the future. And, second, that a resolution authority designed to shield the taxpayers from yet another bail-out will be able successfully to unwind incredibly complex mega-banks engaged across the globe.

In the midst of the Great Depression, Congress built laws that maintained financial stability for nearly 60 years. Through the Glass-Steagall Act, which included the establishment of the Federal Deposit Insurance Corporation, Congress separated investment banks, which were free to engage in risky behavior, and commercial banks, whose deposits were federally insured. As I described in a previous speech, during the last 30 years, that division was methodically disassembled by a

deregulatory mindset, leading to the reckless Wall Street behavior that caused the greatest financial crisis and economic downturn since the 1930s.

What walls will this bill erect? None. On what bedrock does this bill rest if the nation is to hope for another 60 years of financial stability? Better and smarter regulators, plain and simple. No great statutory walls, no hard divisions or limits on regulatory discretion, only a reshuffled set of regulatory powers that already exist. Remember, it was the regulators who abdicated their responsibilities and helped cause the crisis.

Thus far, on the central aspect of "too big to fail," financial reform consists of giving regulators the authority to supervise institutions that are too big, and then the ability to resolve those banks when they are about to fail. Upon closer examination, however, the former is virtually the same authority regulators currently possess, while the latter – an orderly resolution of a failing mega-bank – is an illusion. Unless Congress breaks up the mega-banks that are "too big to fail," the American taxpayer will remain the ultimate guarantor in an almost certain-to-repeat-itself cycle of boom-bust-and-bailout.

Banks Too Big to Fail

The first question is how big must a financial institution be to be "too big to fail?" Let us examine how concentrated some of our giant financial institutions have become. Only 15 years ago, the six largest U.S. banks had assets equal to 17 percent of overall GDP. The six largest U.S. banks now have total assets estimated to be in excess of 63 percent of our GDP. Three of these mega-banks have close to two trillion dollars of assets on their balance sheets.

Their gigantic size, and the perception in the marketplace that they are indeed too big for the government ever to permit them to fail, gives these mega-banks a competitive advantage over smaller financial institutions. It also instills a dangerous willingness to engage in excessive risk-taking. As Federal Reserve Chairman Ben Bernanke recently stated, "if a firm is publicly perceived as too big, or interconnected, or systemically critical for the authorities to permit its failure, its creditors and counterparties have less incentive to evaluate the quality of the firm's business model, its management, and its risk-taking behavior. As a result, such firms face limited market discipline, allowing them to obtain funding on better

terms than the quality or riskiness of their business would merit and giving them incentives to take on excessive risks."

In other words, with a taxpayer safety net beneath them, these Wall Street firms will continue to have an irresistible incentive to keep walking across a financial high-wire of speculative investments in search of ever greater profits.

Some might say that Canada and other countries also have large banks and didn't encounter serious problems. But this ignores the obvious facts that our economy is about 10 times the size of Canada's and our financial ecosystem is far more complex. It also ignores that Canada's largest banks rest on a bedrock of government-guaranteed mortgages and a social compact between those banks and their regulators. To adopt a Canadian-type model in the U.S., we would need to merge our banks into even fewer banking giants, and then re-inflate Fannie Mae and Freddie Mac to guarantee some of the riskiest parts of the bank's portfolios.

Moreover, for every example of a country (usually far smaller than ours) that has coped with mega-banks, there are at least as many where this system has failed spectacularly. Take Ireland, for example, whose largest banks went on a credit binge that ended in disaster. Now, Ireland's citizens are paying the price through draconian pay cuts and higher taxes, to say nothing of the country's lost economic growth.

Ireland provides a cautionary tale. These mega-banks, whether they are legally domiciled in our borders or beyond, are simply too big to manage and too complicated to regulate.

There are also those who argue that we have had financial crises caused largely by small institutions. That's absolutely true. But those problems were managed without bringing our entire financial system to the brink of disaster, the signature and near-cataclysmic event of the last crisis. In the S&L crisis, more than 700 thrifts – both large and small – failed, many wrongdoers were sent to prison and the Resolution Trust Corporation was created to liquidate the assets of failed institutions. In short, the crisis was managed and our financial system absorbed the blows. Compare that to the last crisis when our financial system barely recovered from a black hole that threatened to suck into oblivion our entire financial system after the failure of just one large investment bank.

Regulating Institutions that are "Too Big"

The legislation proposes that we must improve the regulation of institutions that are "too big." The reform proposals would put in place a systemic risk council to monitor for such risks and to identify financial institutions that should be subject to enhanced supervision. Next, they would have the Federal Reserve act as the de facto regulator of these systemically significant financial institutions.

The truth is that we have had a de facto systemic risk council for decades. It's called the President's Working Group on Financial Markets. Chaired by the Treasury Secretary, it includes the heads of the Federal Reserve, the Securities and Exchange Commission and the Commodities Futures Trading Commission, and it was established by President Reagan following the 1987 stock market crash. Its track record in spotting incipient financial risks has been abysmal. Notably, Treasury Secretary Paulson used the President's Working Group as a form of a systemic risk council, but it achieved essentially nothing to reduce those risks. While adding additional members and providing some additional powers, the new systemic risk council is the President's Working Group by another name.

The reform proposals would also give the Federal Reserve the authority to supervise institutions that the council deems are systemically significant. Under the proposed legislation, the Federal Reserve would have specific powers to impose higher leverage, capital, liquidity and other requirements upon these institutions.

The Federal Reserve *already* has the power to impose such standards on most of these institutions. The proposed regulatory reforms are mainly a redundant statement of the Fed's existing powers. Just this week, a Moody's report stated: "…the proposed regulatory framework doesn't appear to be significantly different from what exists today." Moody's went on to explain that "the current regulatory regime is already authorized to protect the soundness of banks and the financial system as a whole. In addition, the current banking laws give bank regulators the power to have banks cease and desist from activities and to require banks to have higher capital ratios."

No doubt the bill does contain some expanded tools for the Fed. For the first time, the Fed will have direct supervisory authority for not just bank holding companies,

but for their large non-bank subsidiaries as well. In addition, the Fed will also have authority over non-bank financial institutions that the council deems are systemically risky. But as Moody's has recognized, the powers resemble the current regulatory framework. Federal bank regulators, which had the responsibility to ensure financial stability before the crisis, will again bear the responsibility after the crisis. And bank regulators will continue to dance the tango with the big banks, interrupted briefly by new legislation which in fact includes few substantive changes in safety-and-soundness banking practices.

It is true that under the current Senate bill, regulators could potentially invoke the Volcker Rule, which would prohibit commercial banks from owning or sponsoring "hedge funds, private equity funds, and purely proprietary trading in securities, derivatives or commodity markets." I applaud former Federal Reserve Chairman Paul Volcker for his critical leadership on these issues, which the Administration has endorsed. Unfortunately, the legislation now being considered by the Senate requires the council first to study the Volcker Rule before deciding whether to enforce it. In the end, it could issue a recommendation not to enforce the Volcker Rule at all. Or the council might recommend simply that regulators mandate capital requirements that are adequate for any risky proprietary activities a particular bank might undertake, a power regulators already have.

The reality is that regulators have long had the authority to prohibit speculative activities at banks, but never opted to do so. Under the Bank Holding Company Act, the Federal Reserve may require a bank holding company to terminate an activity or control of a non-bank subsidiary (such as a broker-dealer or an insurance company) if that activity or subsidiary poses serious risk to the safety, soundness or stability of the holding company.

As we all know too well, in the past, these very same bank regulators failed utterly. Indeed, as the "umbrella regulator" for all bank holding companies, the Federal Reserve could have increased capital and other requirements for these institutions, but instead farmed out this function to credit rating agencies and the banks themselves.

Meanwhile, as the consolidated supervisor of major investment banks, the SEC had similar powers to those of the Fed. And it goes without saying that its track record

of regulatory enforcement was littered with colossal failures.

Chastened regulators may try in the coming years to be harder on the mega-banks, to increase their capital requirements, and to keep a close eye on their liquidity levels, liabilities and leverage ratios. But even if they do, history has shown us that the tango will reach the end of the dance floor, and the big banks will execute the turn and lead again, leaving our regulators hopelessly aside in understanding the complex and opaque transactions that interconnect the giant banks.

In sum, little in these reforms is really new and nothing in these reforms will change the size of these mega-banks. That is why I believe we must impose these changes by statute. I would go beyond even statutorily requiring banks to live under the Volcker Rule, by reinstating by statute the firewall between commercial and investment banking activities. Unless we break the mega-banks apart, they will remain too large and interconnected for regulators effectively to control. And once the next inevitable financial crisis occurs, and the contagion spreads too quickly for the government to believe that a failing firm won't take down others as well, the American taxpayer will again be forced into the breach.

Resolving the Mega-Banks When They Fail

The proposed plan calls for a resolution authority to deal with these institutions when they inevitably get into trouble. An early resolution, we are promised, guided by a systemic council looking into its crystal ball, will prevent the taxpayer from ever again needing to save the day. It is true that the existing mechanism, which tasks the FDIC with resolving failing depository institutions, has worked well — up to a point. The problem is that our experience with resolving banks – highlighted by the 140 bank failures that occurred last year and their cost to the deposit insurance fund – has shown us that prompt corrective action is almost always too late.

As many commentators have noted, no matter how well Congress crafts a resolution mechanism, there can never be an orderly wind-down of a $2-trillion financial institution that has hundreds of billions of dollars of off-balance-sheet assets, relies heavily on wholesale funding, and has more than a toehold in over 100 countries. A backstop of a $50 billion or even $100 billion resolution fund would come nowhere close to being enough.

As *the Economist* notes: "[Resolution authority] may prove unworkable, of course. The threat of being wiped out in bankruptcy could cause creditors to flee both the troubled firm and any firms like it, precisely the sort of panic the resolution regime is meant to avoid. 'In a severe financial crisis it will be too terrifying for politicians and bureaucrats to use' the new process, predicts Douglas Elliott of the Brookings Institution. Instead, he says, they will resort to ad hoc measures as they did in 2008."

Not surprisingly, there are many barriers to resolving large and complex financial institutions.

Most notably, there are international dimensions to the problem with depending on resolution authority. Following the collapse of Lehman Brothers, there was an intense and disruptive dispute between regulators in the U.S. and U.K. over how to handle customer claims and liabilities. While U.S. bankruptcy protection allowed Lehman Brothers' U.S. operations to continue for days as a going concern, Lehman's operations in the U.K. were halted in accordance with British bankruptcy law. Given that there apparently were more than 600,000 open derivatives contracts in the U.K. on the day that Lehman failed, many counterparties and clients were stranded, consequently hampering bankruptcy efforts in the U.S. as well.

To those who promote resolution authority as a solution, I ask exactly what would have happened differently if Lehman had been in receivership during those harrowing days in September?

Moreover, the reluctance last spring to nationalize these banks, to place them in a form of resolution receivership, was because it would have been too costly to the taxpayer to take over or put into bankruptcy the mega-banks. Why would it not be costly with a U.S.-only resolution authority? The truth is: It would be. The taxpayer will remain the ultimate guarantor.

The international difficulty of acting quickly before contagion spreads is almost impossible to overcome without a cross-border resolution agreement. Unfortunately, there is nothing in the resolution authority that the Senate will consider that would help address this problem. And we all know that it is a problem that will only get worse given the inevitability of further financial

globalization. In coming years, the U.S. mega-banks will extend their reach into global markets, relying on their funding advantages as too-big-to-fail U.S. banks to profit from increasingly sophisticated transactions in countries around the world.

The problems with resolution authority for the mega-banks aren't just international in nature. These institutions use short-term collateralized loans called repurchase agreements (repos) to finance a significant portion of their balance sheet and have massive counterparty exposures that arise out of their roles as derivatives dealers. Both repos and derivatives are qualified financial contracts, meaning that exposures that arise from them are effectively super senior to the claims of all other creditors.

By giving these trading exposures such a privileged position under the bankruptcy code, we have allowed a major part of our financial system – called the shadow banking system – to grow completely unchecked without any market or regulatory discipline whatsoever. As Peter Fisher, former Under Secretary of the Treasury and former head of the markets desk at the Federal Reserve Bank of New York, has stated, "[these changes to the bankruptcy code] transformed the 'too-big-to-fail' problem of our largest deposit takers into the 'too-interconnected-to-fail' problem of our major financial institutions."

The proof of that statement is borne out by the data. One report by researchers at the Bank of International Settlements estimated that the size of the overall repo market in the U.S., Euro region and the U.K. totaled approximately $11 trillion at the end of 2007. Meanwhile, the total notional value of OTC derivatives contracts is equal to $605 trillion, as of June, 2009.

Large financial institutions that rely chiefly upon wholesale financing and have massive counterparty exposures from their derivatives positions are combustible. The case studies of Lehman and the other investment banks show how quickly and violently these institutions can implode.

When they do, their interconnected nature inevitably causes a contagion, leading to a collapse in confidence and the classic patterns of a bank run.   As the Moody's report summarizes the question: we must "try to assess whether or not the law could be effective in its stated objective: allowing a troubled, systemically important financial institution to default on selected obligations, while avoiding the

larger effects that such a default might have on the financial system and on the broader economy. That is a challenging objective to accomplish in reality, given contagion risk and the high degree of connectedness among such institutions, both domestically and cross border (where any such resolution authority would have no authority)."

Resolution authority is therefore a slender reed upon which to lean when it comes to institutions as large, complex and interconnected as these.

Better Too Safe to Fail than Sorry

The truth is that we need to split up and break down the largest and most complex financial institutions. As President of the Federal Reserve Bank of Dallas Richard Fisher stated on March 3rd: "I think the disagreeable but sound thing to do regarding institutions that are ['too big to fail'] is to dismantle them over time into institutions that can be prudently managed and regulated across borders. And this should be done before the next financial crisis, because it surely cannot be done in the middle of a crisis."

The first step is to separate federally insured banks from risky investment banks. As Senators Maria Cantwell, John McCain and others have urged, we should break up the largest banks and resign to history "too big to fail" banks. This worked for nearly 60 years, and would once again ensure the soundness of commercial banks while placing risky investment bank activities far beyond any government safety net.

Second, we also need statutory size and leverage limits on banks and nonbanks. We should set a hard cap on the liabilities of banks and other financial institutions as a percentage of GDP. The size limit should constrain the amount of non-deposit liabilities at large mega-banks, which rely heavily on short-term financing like repos and commercial paper. In addition, we should institute a simple statutory leverage requirement to limit how much firms can borrow relative to how much their shareholders have on the line.

Finally, we must put in place reforms for derivatives and other qualified financial contracts. The five largest banks control 95 percent of the OTC derivatives market. We must require derivatives to be centrally cleared, which will reduce the

complex web of counterparty credit risks throughout our system. CFTC Chairman Gary Gensler underscores that point by stating: "Central clearing would greatly reduce both the size of dealers as well as the interconnectedness between Wall Street banks, their customers and the economy."

In addition, we should reconsider the legal treatment of qualified financial contract exposures under the bankruptcy code (and therefore under a resolution regime, as well). Given the sheer size of cross exposures arising from derivatives and repos that financial firms have with each other, it makes sense to allow derivative and repo exposures to be netted out prior to any automatic stay. It is not apparent why that net credit exposure should come ahead of the claims of other secured creditors. This is special treatment, not market discipline.

All of these changes taken together would reduce risk in the system, impose discipline in the market and break the cycle of obligatory booms, busts and bailouts. In short, they eliminate the problem of having institutions that are both too big and interconnected to fail.

If instead our solution is to depend on regulators, and to wait with an impractical plan to resolve failing institutions, the financial system will continue on its inexorable path, growing bigger, more complex and more concentrated. And we will only be laying the groundwork for an even greater crisis the next time.

Conclusion: Mega-Banks are Too Large for Any Regulator to Handle

Mr. President, in the midst of the Great Depression, we built strong walls that lasted for generations. The devastation of our most recent crisis challenges us to do so again.

These mega-banks are too big to manage, too big to regulate, too big to fail and too interconnected to resolve when the next crisis hits. We must break up these banks and separate again those commercial banking activities that are guaranteed by the government from those investment banking activities that are speculative and reflect greater risk. We must limit the size, liabilities and leverage of any systemically significant financial institution.

Given the ever-increasing rate of financial innovation, the need for Congress – not the regulators – to impose these time-honored principles has never been greater.

The stakes have never been higher.

It is time to follow in the footsteps of those great senators who made the tough decision in the 1930s to pass the Glass Steagall Act and other landmark reform bills, which paved the way for almost 60 years without a major financial meltdown. Once again, we must ensure that government guarantees of commercial bank deposits do not enable financial institutions to engage in the risky activities of investment banks.

Finally, we must guarantee that there are no banks that are too big to manage, too big to regulate, and too big to fail.

The American people deserve no less.