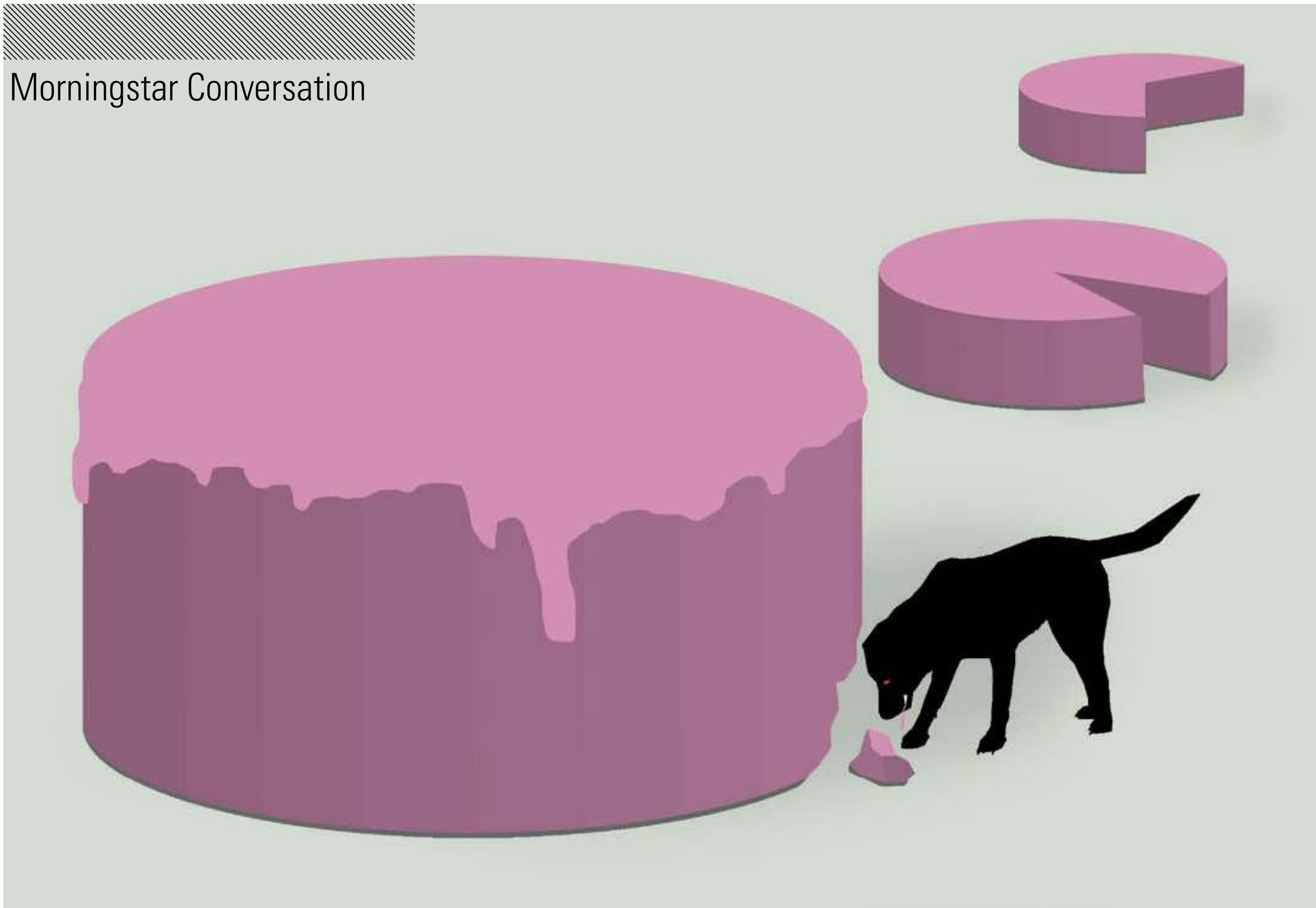
Morningstar Conversation



Unjust Desserts

By Francisco Torralba

Harvey Rosenblum saw all kinds of financial collapses during a 40-year career with the Federal Reserve. His ideas on how to avoid the next one aren't without some controversy.

In 2012, Harvey Rosenblum caused a stir in the typically stolid U.S. Federal Reserve banking system. From his position as the director of research for the Federal Reserve Bank of Dallas, Rosenblum wrote a controversial essay in the agency's annual report that said the U.S.'s largest banks still posed a grave threat to the economy. Oligopolies, he called them. Rosenblum was trying to point out that just four years after the nation's financial system almost collapsed, the same financial institutions at the heart of the downturn were still big and getting bigger.

Rosenblum retired last year after 40 years with the Federal Reserve. He now teaches at Southern Methodist University. But he isn't going quietly into retirement. Rosenblum is still vocal about steps the United States and the world must take to avoid another financial calamity. His ideas will find their way into a forthcoming book. I sat down with Rosenblum on Feb. 20 at the Morningstar Ibbotson Conference in Phoenix.
The conversation has been edited for clarity and length.

Francisco Torralba: You've done a lot of work with Dallas Federal Reserve president Richard Fisher about the too-big-to-fail problem. Let's start by defining the problem. What is too-big-to-fail with regard to U.S. banks?

Harvey Rosenblum: The problem is that the public believes, especially after the experience of the past few years, that if a large bank gets into trouble, somehow not only the bank, but its creditors, will get government assistance. In the case of some of the largest banks in 2008 and 2009, it was truly extraordinary government assistance that came to the fore to protect the bank, its shareholders to some extent, and creditors to an enormous extent.

Assets continue to pile up in the large banks at the expense of assets going to more efficient, smaller banks that do most of the lending in our economy. The largest banks in recent years have diversified away from lending and have become casinos operating extensively in the derivatives markets, investment banking, and a number of other things. "Casinos" is too harsh a word, perhaps. But they are risk-taking traders. Their lending to the economy is a much smaller proportion of their asset base than it's ever been before.

I have nothing against them doing those businesses. What bothers me is when they engage in those businesses with the belief that if they get into trouble somehow the public safety net is there to protect them.

The 'Too-Big-to-Fail' Subsidy

Torralba: From reading the papers and speeches that you and Fisher have given, I gleaned that there are two problems here with too-big-to-fail. One is this implicit guarantee leads to excessive risk taking and concentration of risk. The other problem is that it's unfair to the smaller banks, which don't have the same implicit guarantee and, therefore, operate at a disadvantage. Would you say that that's a fair statement?

Rosenblum: Well, it's really one problem that compounds itself in that way. The subsidy that the large banks get varies from year to year, depending on the nature of the economy. But most estimates put that too-big-to-fail subsidy for U.S. banks in the range of $50 billion to $100 billion per year. It's going to be there in perpetuity unless Congress decides to do something to reduce that subsidy.

What's even more unfair is Congress never voted for that subsidy. It's unconstitutional. A subsidy should be the opposite of a tax, and Congress needs to vote on it. We have subsidies in the farm bill, for example. Congress votes on it. Everything's aboveboard. But this has snuck in through the back door.

Torralba: Just to clarify, this subsidy we're talking about: It's not like Congress or taxpayers are giving any money to these banks. What's happening is that through this implicit guarantee for too-big-to-fail banks they enjoy a lower cost of capital. Is that correct?

Rosenblum: Lower cost of capital, lower cost of funding than they otherwise would have. And it's not just in the bank. It is across the board on all of their activities.

Torralba: For example, a Citibank can borrow in the market at a lower interest rate than some local community bank.

Rosenblum: Absolutely correct.

Torralba: This implicit subsidy, is it benefiting shareholders, management, both, or one more than the other?

Rosenblum: It's very difficult to measure. There's no line item on a bank's income statement or on its balance sheet that says "too-big-to-fail subsidy." But the fact of the matter is they end up with much more in the way of profitability through their lower costs than they otherwise would if they had to compete on the same basis as other banks.

Now, the question is where does that subsidy go to? The best I can guess is it goes to the top management team in the form of higher salaries and higher bonuses. Some of it may accrue to shareholders, but very limited amounts. I think a lot of it may actually go in general to the customers, because knowing that the profitability is there and kind of guaranteed, those institutions can spend more money on a lot of things—more branches, more convenience for their customers. Some of it may actually get invested into better technologies. We don't know.

Now, one of the issues we have is, if the stockholders are not benefiting, why don't they complain? I think they have been complaining to some limited extent, especially when I look at the book values of these institutions. The largest, most complex institutions have been trading up until very recently at about eight-tenths of book value. To me, that says the parts are worth more than the whole if the institution were broken up.

When we look at the next tier down of large banking institutions, those that are way less complex, they are trading at about 1.6 times book. What the market was saying is the large, complex institutions were being valued at roughly half of what the next five were being valued at.

More recently, the largest banking institutions have come up to roughly book value and the spread between the two has narrowed. But this has been persistent over time for the last decade or so. What shareholders are saying is, "We think you'd be worth more if we could understand what you were and you broke yourself into clear-cut pieces." But the managements resist that.

Torralba: How much of a role do you think this implicit guarantee for big banks played in the financial crisis?

Rosenblum: No secretary of the Treasury wants to be remembered in history as the person who caused the first Great Depression of the 21st century. So, instead of just saying no and trying to let the market sort it out, I think the "no other choice" was the only choice.


Harvey Rosenblum at the Morningstar Ibbotson Conference, Feb. 20, in Phoenix.

Now, can you set up rules in advance that everybody understands, so that the next time there is a potential crisis brewing the secretary of the Treasury can say, "Well, we've set it up so that market forces are supposed to work. We've got the right backstops in place. People know the rules. Let's let market forces work to a much greater extent than we have in the past."

But given the record of 2008 and 2009, when the secretary of the Treasury blinked, most actors out there on the economic stage believe that is going to be what's going to happen next time, so the too-big-to-fail problem gets worse and worse, instead of better and better.

Torralba: Was the implicit guarantee a decisive factor in getting the U.S. to that point where there was too much leverage, where lending standards were too relaxed?

Rosenblum: I don't want to blame the banks. They were responding to the incentives they had in front of them. A lot of those incentives were put in place by the government, particularly more mortgage lending—and more mortgage lending to people who would have had trouble affording the average house. Standards got relaxed.

The regulatory agencies in Washington could have exerted a tougher hand on some of those practices, but they didn't. It was regulation-light coming out of Washington, beginning with the second half of the

Carter administration back in 1978–79. That's when deregulation started in a big way. President Reagan carried that further.

Alan Greenspan was appointed to be Federal Reserve Board chairman with the order of, you know, get the Federal Reserve off everybody's back. Let's have regulation-light instead of regulation-heavy. That was in place. People liked it, and things seemed to be working OK. And if things are working OK, you see that the bad things happen with a lag.

Hindsight's 20/20. I can now look back at the transcript of Federal Open Market Committee meetings and see where there were several Fed governors who were pointing out at FOMC meetings that what was going on in the mortgage market was, in plain English, crazy. But did anybody pay much attention to those warnings? Short answer: no.

Let me just say that I sat there in that room. I could have stood up or at least talked to people during the breaks and said, "Did you hear what she had to say? Did you hear what he had to say? Why shouldn't we in the Federal Reserve be doing something about it?" I think I engaged in the same willful blindness to what was happening that other people were engaging in.

There's a great reluctance on the part of regulatory agencies to step into the private market and tell private businesses they are doing something wrong. So, it's very, very difficult for the regulatory agencies to tell people they have to stop this, particularly when the government is trying to foster wider ownership of housing. There is a machine that's running, and that machine does not want to stop.

Torralba: It was a very humbling experience.

Rosenblum: My estimates of the cost of the financial crisis for the United States are somewhere between $15 trillion and $30 trillion. That's trillion with a T, not billions. That's one to two years of output down the drain for the United States.

Three Solutions (Actually Four)

Torralba: We have talked a lot about the problems behind the financial crisis. Let's dive into your solution. I understand you have three recommendations.

Rosenblum: There are three steps—actually a fourth, but I rarely bring up the fourth one. The first thing I want to do is restrict the safety net to the banks. Save the payment system when all else fails. The banks are part of the payment system. The banks are where the safety net should be. That's why we have deposit insurance. It's why we have a Federal Reserve as a lender of last resort to the banking system.

The next thing I want to do is put everybody on notice that if you're doing business with XYZ bank—let's not give it a name—let's just say a very large, complex bank or bank holding company. If you're doing business with them, you know you've got deposit insurance up to a certain limit. But if you're doing business beyond that insurance limit, you're unprotected. If you're doing business with the derivatives entity of that bank holding company or the investment banking or the mortgage banking—whatever the entity is that's not directly a part of this narrow banking industry—you have to sign an agreement that says, "Yes, I get it. I can lose money."

Either the regulatory agencies can write that statement or the banks can compete on how to get it to the fewest words. But there ought to be a 100-word limit, something along those lines.

So you restrict the safety net. You get people to sign off that they understand. And then the government, in order to speed things up, needs to continue to encourage management—notice, I said management—to downsize, right-size, simplify their institutions, streamline.

If that banking entity gets into trouble, the government is not going to step in and bail it out. It will go through the normal process that a failed bank goes through. The FDIC is in on Friday and out on Monday. Over the weekend, that institution is sold to new management and new owners. Now, in the case of a giant institution with a footprint in 40 states, it may not be able to take place over a weekend. But it ought to be able to take place over a week. That assumes that it's only one giant bank getting into trouble. But if they break themselves up into enough smaller entities, some of those entities which get into trouble can be closed over a weekend.

Knowing that, people are going to change their behaviors. Knowing that the non-bank part of the entity is no longer protected, I think you will see the pricing of risk take place the way it's supposed to take place. Higher risk requires a higher price of funds.

I called this the Dallas Fed Plan. I set it up together with Richard Fisher. When we were working on it, we agreed to make it three points that everybody could understand.

Hidden in the background was a fourth point that I don't talk about too much. But I would like to see something set up whereby the non-bank entities cannot shift their problems to the bank entity within the same holding company. If the non-bank entity gets into trouble, it should not be able to shift bad assets and bad risks to the bank, where the safety net exists. So, I would like to see basically a rule set up whereby any assets that get transferred from the non-bank entity to the banking entity have to be done with advance notice. Every asset has to be listed out there on a website. There has to be absolute, complete transparency.

Torralba: Basically you're proposing break up the banks?

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Rosenblum: I want to be very careful because the first time Richard Fisher and I spoke out on the subject we did use the word "breakup." People thought, "Oh, these guys are the Texas chainsaw massacre." That we're going to cut these institutions into pieces. That was not what we intended.

We keep saying it's up to management to figure out how best to protect shareholder value by finding logical ways to streamline and right-size these institutions. It's management's job. They know their businesses. But they need to do this in a way that's shareholder-friendly. If the government comes in and says, "Oh, you have to spin this thing off, and you have to spin that thing off, and you got 30 days to do so"—I don't think it's going to be shareholder-friendly. It may destroy value.

I think a reasonable amount of time has to be given to managements to do that. You have to lay out the direction you want them to go. They do have to spin these off to their shareholders or sell them in the marketplace. Eventually, we would have some of these $2 trillion entities become seven or eight $200 billion entities that actually compete with one another, with a different shareholder base.

Torralba: Suppose you say no bank will be allowed to have assets of more than $250 billion. What, then, does it mean to be too-big-to-fail? Does it mean your proposal would ban banks from having more than that level of assets?

Rosenblum: I want to impose a condition here that says any bank that has deposit insurance has to be of an order of magnitude that if it has to be closed, its assets and liabilities can be transferred reasonably quickly to new owners and new management. Now, I don't know where that line is.

Torralba: But the thing is if you don't put a line, then we're back to the problem where, in times of crises, the government is going to bail you out because they're going to interpret that rule and say that these banking institutions are systemically important.

Rosenblum: The issue is getting these institutions down to the point where they are no longer labeled systemically important. Now, under the Dodd-Frank Act, there's a presumption that any institution that has assets of more than $50 billion is systemically important. I think that's the wrong place to draw the line. I would probably draw it five or six times higher than that.

The issue is really not just size. It's systemic footprint. What activities are you engaged in? How transparent are those activities? What are your interconnections with other institutions? If you ever had to go to bankruptcy court, would it be like Lehman, where it took five years to sort it out in bankruptcy court? Or would it be like some other institutions, where things can be sorted out in bankruptcy court in three months?

When you are part of the payment system your liabilities are somebody else's money. We don't want you sitting in bankruptcy for five years. The whole payment system would break down. What we have to worry about is that these bankruptcies don't happen one at a time in isolated circumstances. We end up with not just too-big-to-fail, but too-*many*-to-fail. This is where the secretary of the Treasury often has no other choice. It's not one institution that's being brought to his attention. It's five or six that could all go down at once. Our bankruptcy courts are just not prepared to handle five or six or 10 major bankruptcies at the same time, particularly if they're all going to be in the New York circuit.

But I don't think the market or the bankruptcy courts could have handled it very well when the nation's payment system was at risk. You can't pay your electric bill, and you can't get paid at work, and we end up with this wave of bankruptcies going on. The computers shut down. The economy shuts down. The stores can't even run their checkout systems these days without a computer and electricity.

Dodd-Frank: Hope Over Experience

Torralba: Congress has pushed its own legislation to try to prevent this problem. The Dodd-Frank Act has an orderly liquidation authority provision that says the FDIC would wind down large firms that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard. Does this fix the problem?

Rosenblum: Dodd-Frank was well intentioned. It was the triumph of hope over experience to try to write a law that way. But getting that law passed was not easy. A lot of people used up an enormous amount of political capital to get a law passed that was supposed to "end" too-big-to-fail.

When the regulations were being written to come up with the orderly liquidation authority, a friend of mine was on leave from the Federal Reserve and working for the Treasury trying to write those regulations. I took my friend out to dinner one day when I was in Washington. I asked him to tell me about orderly liquidation authority. What's the key word: Is it liquidation? Is it orderly? Is it authority? I was hoping he would say liquidation. But liquidation was the third on the list. Orderly was the first word. Authority was the second word in importance. And liquidation was a distant, distant third.

So, it's not going to eliminate these companies when they fail. They're supposed to go through something like bankruptcy, but they're not going to go through something like bankruptcy. If you go through a bankruptcy and you want to reorganize the company, you have to have private capital come in, in the form of debtor-in-possession financing. The shareholders are wiped out. The debt holders are made shareholders. But there's a primary shareholder, the one who provided the capital to allow this thing to get the reorganization to take place.

Under Dodd-Frank, the debtor-in-possession financing is going to come from the FDIC, and they don't even have the funds in advance to do it, so it's coming from the taxpayers. That's not private capital coming in to reorganize the company to make it more efficient. It's a simulated bankruptcy, but it's simulated only. It's nationalization of the firm.

Torralba: One other alternative for handling too-big-to-fail is to raise capital requirements. Wouldn't this fix the problem?

Rosenblum: If you raise capital high enough, it will help address the problem. But you've got to do it in the right way. You have to have loss-absorbing capital, number one. And you can't have the risk weights that have been around since the late 1980s and early 1990s under the first Basel accord.

Sen. Brown and Sen. Vitter have a bill that would raise the capital-to-asset ratio of the largest banks to 15%. There's a belief on the part of many, including me, that that's about where it ought to be for the largest institutions. Of course, the banks are fighting that tooth and nail. If I were on the top management team of those institutions, I would be fighting it tooth and nail, as well.

Under the Dodd-Frank, the regulators are given leeway to readdress the funding needs. If a company is going to issue long-term debt—or if it is going to raise its leverage as opposed to overnight funding or one-week funding—when the market begins to have difficulties that funding can dry up in a heartbeat, and it did for many companies.

So, I think there are a couple things right with the Dodd-Frank Act—higher capital for the largest institutions, some kind of a capital surcharge, less leverage, and more use of longer-term debt funding, as opposed to overnight or short-term funding. I think those things could go a long way. Will it prevent failures entirely? No.

Torralba: We've talked about why too-big-to-fail is a problem for the level of risk that these banks assume in their balance sheets. We have talked that it's also unfair to the smaller banks. I'm thinking there is a third problem. Do these too-big-to-fail banks have too much influence on monetary policy?

Rosenblum: The Fed is inadvertently offering protection to these institutions through monetary policy and otherwise. A few years ago, back at the height of the financial crisis, Richard Fisher and I wrote a *Wall Street Journal* op-ed titled, "The Blob that Ate Monetary Policy." It had a science fiction theme. There was a movie out in the early 1950s called "The Blob," where this monster goes around gobbling up everything in its path.

In the financial crisis, the giant banks accounted for half the banking industry. They were the first to be crippled. When the giant banks became crippled, the economy became crippled, and it spread to the smaller banks. The smaller banks were pretty healthy going into the financial crisis. Sure, there were going to be some failures, but very manageable.

The giant banks when they are crippled don't lend and shrink their balance sheet. I have a rule of thumb that I like to put into simple English, and it goes back to the Texas banking crisis of the late 1980s and early 1990s:

Sick banks don't lend. That's what the largest banks were doing, and they accounted for half the banking system. In one fell swoop, the giant banks were sucking the life out of the U.S. economy.

Harvey Rosenblum

Sick banks don't lend. Sick banks are those that are unprofitable, undercapitalized, and are shrinking their balance sheets. They contract lending.

That's what the largest banks were doing, and they accounted for half the banking system. In one fell swoop, the giant banks were sucking the life out of the U.S. economy. Eventually, as the economy began to go into a downturn, it sucked the life out of the smaller banks as well. You had the banking industry fighting against the Fed's stimulative monetary policies. That was the blob that ate monetary policy.

It's no accident that when the New York Fed is trying to figure out what's going to work in their open market operations they consult with the primary dealers. Who are the biggest primary dealers? The largest banks. Not just in the United States, but globally.

So do big banks influence monetary policy?

Tangentially. I think the people who make monetary policy are thinking about what is the best thing for the U.S. economy and for 300 million American citizens. Of course, the Fed needs working banks and a working financial system. So, the Fed has to work with those institutions. We need them if the government is to remain open. If the government can't finance itself, think what's going to happen. They can't pay the Marines. The courts are going to shut down. A whole bunch of things are going to happen that are not good. Social Security checks are not going to go out.

The alternative would be the Treasury would try to go out and place trillions of dollars of debt around the world. I don't think the Treasury is prepared to do that kind of startup operation. That belongs in the private sector, where it is.

But the point is, that helps the economy. It helps it move forward, as opposed to where we were in 2009 and 2010, when banks were shrinking their balance sheet as a means to get their capital asset ratios where they needed to be. Shrinking balance sheet, deleveraging on the part of the banking system, shrinks the economy. It doesn't grow the economy.

The banking system was a headwind. Now, it's becoming a tailwind. And it's very, very important that it remain a tailwind if this recovery is going to continue. M

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