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Dodd Bill Fails to Fix "Too Big to Fail"

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Supporters of the Dodd financial regulatory bill list as one of its key virtues that it "solves" the problem of financial institutions that are seen as being "too big to fail." Unfortunately, this is not the case.

While the bill passed by the Senate Banking Committee includes a faulty mechanism for closing financial institutions whose failure could damage the entire financial system, it does nothing to reduce the systemic risk of today's "too big to fail" financial institutions or to prevent this risk in the future.

Simply Reiterating. The bill does create a new board of regulators aimed at controlling systemic risk and gives it and the Federal Reserve extraordinary powers to deal with financial institutions once there is a problem. However, the sections of the bill that deal with the board's ability to prevent the creation of new systemic risk are mainly a restatement of existing powers that the regulators have had for decades.

For instance, the financial regulators have explicitly had the power to increase the amount of capital a firm is required to have since the savings and loan crisis of the 1980s, but they have largely failed to use it. Similarly, they have also had the power to impose liquidity requirements and even prohibit or restrict certain risky activities, but that authority has not been used either.

Although the Dodd bill "requires" the regulators to take action on these issues, even the most minimal activity would satisfy that requirement. The presence of these powers failed to prevent the crisis of 2008, and there is no reason to have any confidence that they will be any more effective in the future.

It Is About More Than Size. The phrase "too big to fail" is misleading, since it implies that the size of a financial institution is responsible for the risk that its failure might impose on the overall financial system. If this were true, then the Dodd bill would only have to place a limit on the size of financial institutions to solve the problem. However, history shows that systemic risk is caused more by interconnections between financial institutions and the risk of a specific institution's portfolio—all that size limitations would do is limit the ability of U.S. banks to compete against equally large foreign banks.

Instead, the scope of a firm's investments, products, and its interconnectedness with other large global firms is far more important in determining the importance of the firm to the stability of the system as a whole and its potential risk if the firm runs into trouble. In addition, the firm's ratio of capital to its overall size and its liquidity are important as indicators of the firm's ability to withstand losses. None of these factors is simple to regulate, and the Dodd bill does not really attempt to do so. Instead, it passes the buck to the new Financial Stability Oversight Council and basically tells it to reduce systemic risk.

Although supporters of the bill imply that the council would be able to prevent the appearance of

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systemic risk in the future, this task is almost impossible. Systemic risk can be caused by a number of different factors, some of which may appear only in response to specific causes of stress in the financial system and may be present only in certain financial institutions. Thus, identifying systemic risk in advance is extremely difficult, and preventing it is even harder. The Dodd bill assumes that merely telling a council of regulators armed with existing powers to take care of the problem is sufficient. Unfortunately, certain details of the bill's approach are likely to create additional problems that will make preventing systemic risk even harder than it is now.

Creating More Fannies and Freddies. The Dodd bill creates a special class of large financial institutions that are almost certain to get special treatment in the credit markets. Under the bill, financial firms with assets of more than $50 billion that also meet certain other conditions would be regulated by the Federal Reserve. Unfortunately, being on this list of Fed-regulated financial institutions would send the signal that they are "too big to fail" and that the market is likely to price their debt and give them other competitive advantages.

As in the cases of Fannie Mae and Freddie Mac, repeated disclaimers that there was no government guarantee of their debt did nothing to counteract the market's assumption that such a guarantee existed. Just as that belief was a key factor in the government bailouts of both Fannie and Freddie, it would also make future bailouts of major financial services firms much more likely.

Open-Ended Power to Do the Wrong Thing. The Financial Stability Oversight Council is given virtually unlimited oversight, but the actual entity responsible for exercising new regulatory powers would be the Federal Reserve. The Dodd bill requires that the regulators take some action to improve capital standards, liquidity, risk management, etc., but the council has the power to only recommend action and has no power to compel any regulator to do anything.

As stated earlier, these are not new powers but simply a restatement of powers that the regulators have had for decades. Given that the way these powers have been exercised to date did little if anything to prevent the crisis of 2008, there is no reason to expect them to be any more effective in the future.

The new council could by a two-thirds vote bring any suspect and until then unregulated financial institution under the Fed's regulatory authority, and by the same vote, it could approve Fed decisions to force any larger financial institution that is deemed to pose a risk to the overall financial system to break itself up.

In practice, this is likely to mean that the council will focus its attention on new and innovative firms that are developing products that the regulators do not understand or cannot easily categorize. The council is almost certain to decide that it understands the risk imposed by more traditional firms and products and should concentrate its attention on new and unfamiliar products where the risk is uncertain.

But, as recent history shows, the regulators are very unlikely to recognize risk caused by variations of existing products or evolving relationships among traditional financial institutions. This approach to systemic risk is almost certain to fail and is one major reason why the whole notion of managing systemic risk is flawed.

How to Really Fix "Too Big to Fail." There are two relatively simple things Congress could do that would do much more to reduce systemic risk—at a much lower price—than would the gargantuan Dodd bill.

1. Strengthen Capital and Liquidity Requirements. One critical element to resolving "too big to fail" financial institutions is to reduce the risk that they pose to the overall financial system while they are still healthy. The most effective approach to reducing this risk—and one that is gaining support across the political spectrum—is through stronger capital and liquidity standards on larger financial institutions, regardless of whether they are banks or other types of institutions that might currently be exempt from such standards.[1]

Already, both U.S. and international regulators recognize that capital and liquidity standards

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need to be improved and are evaluating different approaches to do so. The regulators should continue to use their existing authority to impose such standards and tailor them to cover all systemically risky financial institutions.

However, Congress should give the regulators clear instruction to make necessary improvements to capital and liquidity standards so that they better reflect the diverse and highly complex structure and products of an ever-changing financial services industry and then follow up those instructions with regular oversight hearings that feature the assessment of outside experts on how well the regulators are meeting their responsibilities.

2. Create a Bankruptcy Procedure for Large Financial Firms. The Dodd bill would give the Federal Deposit Insurance Corporation (FDIC) the power to deal with failing "too big to fail" financial institutions through the ability to use a line of credit from the Treasury to repay all such a firm's creditors and to create a new government-owned entity to receive the assets of the old financial institutions. Congress should remove this flawed language and replace it with a process that is administered through the bankruptcy courts. This would ensure that regulators cannot revert to politically motivated bailouts or other forms of government intervention instead of closing poorly managed financial institutions and selling off the viable pieces to other firms.

Among the many virtues of a bankruptcy court–based method is that the creditors of failing firms would have to suffer losses unless the remaining assets are large enough to fully repay them. Faced with the potential for losses, creditors will do a better job of understanding and monitoring the riskiness of both financial institutions and their products.

Obamacare for Financial Institutions. If you liked what Obama and Congress did to health care, you will love what they plan to do to financial institutions. Although the press has focused on the creation of a consumer regulatory agency, that is only one part of a massive plan to create all-powerful regulators that could micromanage the financial industry. Despite protests to the contrary, the Dodd bill contains language that would make future bailouts of "too big to fail" firms inevitable but does nothing of consequence to reduce systemic risk.

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1. For more details see David C. John, "Using Bankruptcy and Capital Standards to Address Financial Institutions That Are 'Too Big to Fail,'" Heritage Foundation *Backgrounder* No. 2343, November 24, 2009, at *http://www.heritage.org/Research/Reports/2009/11/Using-Bankruptcy-and-Capital-Standards-to-Address-Financial-Institutions-That-Are-Too-Big-to-Fail.*