

THE SAFE BANKING ACT: A SUMMARY BACKGROUND AND FAQ

Americans for Financial Reform

April 22, 2010

Our financial system has become dominated by institutions that are “too big to fail.” Moreover, as FDIC Chairman Bill Isaac has said, they are “too big to manage, and too big to regulate.” MIT professor Simon Johnson and James Kwak, a researcher at Yale Law School, estimate in the past 15 years the six largest U.S. banks have grown in total assets from 17 to 63 percent of our overall GDP.

We must reduce this concentration of financial power if we are to end Too Big to Fail and the risk it poses to our economy. Trusting the same regulators who abdicated their responsibility in the lead-up to the financial crisis will leave us vulnerable to future financial crises. Despite the claims of the megabanks, there are no economies of scale that justify such massive banks, nor would U.S. multinational corporate needs go unmet by smaller (though still very large) U.S. global banks.

The prudent solution is to shrink these institutions to a manageable size at which they can actually be effectively regulated. The idea of size caps is supported by Thomas Hoenig, President of the Kansas City Fed; Paul Volcker, former Chairman of the Federal Reserve; Mervyn King, Governor of the Bank of England. Richard Fisher, president of the Dallas Fed; former IMF economist Simon Johnson; Dean Baker of the Center for Economic and Policy Research; financial bloggers Felix Salmon and Mike Konczal; and conservative commenter Arnold Kling of the *National Review*.

Accordingly, Senators Brown and Kaufman have introduced [legislation](#) that would impose sensible size and leverage constraints:

Size Limits on Our Largest Financial Institutions

- Imposes a strict 10% cap on any bank holding company’s or thrift holding company’s share of the total amount of deposits of insured depository institutions in the United States.
- Establishes limits on the liabilities of large banking and nonbanking financial institutions:
- A limit on the non-deposit liabilities (including off-balance-sheet ones) of a bank holding company or thrift holding company of 2% of GDP.
- A limit on the overall liabilities (including off-balance-sheet ones) of any non-bank financial institution - i.e. one that the proposed Financial Stability Oversight Council deems a risk to the financial system - regulated by the Federal Reserve of 3% of GDP.

Institute Statutory Leverage Ratio

- Codifies a 6% leverage limit for bank holding companies and selected nonbank financial institutions into law.

FAQs on Size and Leverage Limits on Banks and Other Financial Institutions

Q: What would this bill do?

It would place limits on the size and leverage of banks and large nonbank financial institutions.

Specifically, the bill would cap the concentration of deposits held by any one bank at 10 percent of the nation's deposits, or about \$750 billion. Only the three biggest banks would be affected by this limit.

The bill would also cap nondeposit liabilities at 2 percent of U.S. GDP - or about \$280 billion. This is slightly more than 10 percent of all nondeposit liabilities (\$268.1 billion) at federally insured banks. This aspect of the proposal would only affect the 9 or so largest bank holding companies. All in all, about 8,000 U.S. banks would remain untouched. But mammoth banks like Citigroup, Bank of America, and JPMorgan Chase would have to scale down by about 40 percent--from over \$2 trillion to about \$1.3 trillion. Investment banks in particular have benefitted significantly from their designation as "too big to fail" and the accompanying guarantee. To ensure that large nonbank financial institutions like investment banks don't evade this prudential limit, their overall liabilities will be limited to 3% of GDP - or about \$420 billion.

Finally, it would impose a statutory leverage requirement on banks and financial institutions that would require them to hold a minimum of 6% of capital as a percentage of their overall assets. This would be a 50% increase over the Fed's **current leverage requirement** for bank holding companies. This rule will largely affect the big banks because they tend to hold less capital than small banks. For the twenty largest institutions to meet the small banks' more conservative leverage ratios they would need to raise more than \$300 billion in new capital, shrink in size by \$5 trillion, or some combination of the two options.

Q: Why should we limit the size of banks and large financial institutions?

Our financial system has become dominated by institutions that are not only "too big to fail," but also, as FDIC Chairman Bill Isaac describes, "too big to manage, and too big to regulate." In the last few decades, the banking industry has become so concentrated that it no longer functions as a competitive market, leading to ever-higher levels of risk in the system. 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. Large banks with more than \$100 billion in assets are borrowing at interest rates 0.34 percentage points lower than the rest of the industry. **According to the Center for Economic and Policy Research**, the implicit guarantee that the government will bail out the 18 biggest banks amounts, through lower borrowing costs, to a government subsidy of \$34.1 billion a year.

The biggest banks know that there is no way the government will let them fail, because of how failure would hurt the real economy, so they can take more and more risks. The markets then bet on subsidies

and bailouts, instead of good performance. Economists Volz and Wedow found as much as a 1 point distortion in the CDS market for institutions perceived as “too big to fail.” As the *New York Times* just reported, Hedge Fund Manager David Tepper made 4 billion dollars last year when he “wagered that the government would not let the big banks fail.”

Ultimately, if we don't want another crisis like last year, we need to limit bank size. Banks with over a trillion dollars in liabilities are enormously risky, and threaten our entire economy. These enormous banks are likely to be bailed out by government, and they know that the government won't let them fail, so they take even riskier bets, at taxpayer expense.

The cost is staggering--as much as \$33,000 for every single taxpayer since 2007. Federal agencies have disbursed \$4.6 trillion dollars to support the financial sector since the meltdown in 2007-2008; that's at least four times what has been spent in the wars in Iraq and Afghanistan since 2001. Others put the cost of all government programs - including those run by Treasury and the Fed--at \$14.4 trillion. The Special Inspector General of the TARP Program calculated the potential cost of all government support related to the crisis at **\$23.7 trillion**. And none of these projections include the cost of the 7 million jobs and the 6 million homes lost since the crisis began. It's simply too expensive to allow banks that are too big to fail to continue to exist.

Q: Who supports size caps?

The idea of size caps is supported by Thomas Hoenig, President of the Kansas City Fed; Paul Volcker, former Chairman of the Federal Reserve; Mervyn King, Governor of the Bank of England. Richard Fisher, president of the Dallas Fed says:

“The existing rules and oversight are not up to the acute regulatory challenge imposed by the biggest banks. Because of their deep and wide connections to other banks and financial institutions, a few really big banks can send tidal waves of troubles through the financial system if they falter.”

Other supporters of size caps include former IMF economist Simon Johnson, financial bloggers Felix Salmon and Mike Konczal, and conservative commenter Arnold Kling of the *National Review*.

While big bankers for obvious self-serving reasons have claimed that size caps are foolish, “several privately [say] that size, by default, increases risk” (Dealbook, Feb. 2, 2010). Former Fed Chairman Alan Greenspan has not endorsed size caps specifically, but has said that, “If they're too big to fail, they're too big.”

Q: Why not give regulators the greater powers and responsibilities? Why are statutory limits necessary?

The truth is that regulators have long had powers to restrict the size and leverage of these banks. As Moody's states, “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.” The 1970 Bank Holding Company Act Amendments **gave the Fed the power** to terminate a company's authority to engage in non-banking activities if it finds such action is necessary to prevent undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices. The Financial Institutions Reform, Recovery and Enforcement Act also **gave** regulators the power to restrict an institution's growth and limit its size.

Unfortunately, as evidenced by the runaway leverage and growth of the megabanks in the run-up to the crisis, the regulators failed to exercise their powers sufficiently. The Basel II Capital Accord, with its reliance on the ratings of credit rating agencies and the banks' own internal models, reflected the degree to which the regulators couldn't comprehend institutions as complex and large as these. Instead of relying upon regulators, this bill would institute sensible size and leverage limits in statute.

Q: Isn't there already a 10% cap on deposits?

While the Riegle-Neal Banking of Act of 1994, which established a 10% cap nationally on any particular bank's share of federally-insured deposits, should have been a barrier for at least some of these mergers, holes in the law and regulatory forbearance permitted them to go through anyway. For example, the deposits of an acquired thrift do not count towards the cap, a loophole that allowed Bank of America to acquire Countrywide even though the overall deposits of the combined institutions far exceeded the cap. The law also allows banks to exceed the cap through organic growth and provides great flexibility to regulators to find ways around the limit. By establishing a hard 10% cap on the overall holding company, this legislation would close the loopholes and obviate regulatory forbearance.

Q: Why limit size through a cap on nondeposit liabilities?

These megabanks rely heavily on short-term financing like repos and commercial paper to finance to finance their own inventories of securities, as well as their own book of repurchase agreements, which they provide to hedge funds through their prime brokerage business. The growth of those funding markets in the run-up to the crisis was staggering. 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. Incredibly, the size was more than \$5 trillion more than the total value of domestic bank deposits at that time, which was less than \$7 trillion.

The overreliance on such wholesale financing made the entire financial system vulnerable to a classic bank run, the type that we had before we instituted a system of deposit insurance and strong bank supervision. Remarkably, while there is a prudential cap on the amount of deposits a bank can have (even though deposits are already federally insured), there is no limit of any kind on liabilities like repos that need to be rolled over every day. This legislation would correct that problem by placing restrictions on these liabilities at both bank and nonbank financial institutions.

It is particularly critical that we institute such a limit on these liabilities now that the federal safety net has been expanded to cover not just traditional commercial banking franchises, but also investment banks engaged primarily in speculative activities. Prior to the financial crisis, investment banks, by gorging upon wholesale liabilities like repurchase agreements and commercial paper, were able to leverage a small base of capital over 40 times into asset holdings that, in some cases, exceeded \$1 trillion. With the purchase of Bear Stearns by J.P. Morgan Chase (with financial support from the government), the purchase of Merrill Lynch by Bank of America (allegedly under pressure from the federal government), and the special dispensations that Goldman Sachs and Morgan Stanley received from the Federal Reserve, all of the main Wall Street firms are either part of bank holding companies or have become ones themselves. Financial institutions that have the benefit of being financed by insured deposits and of having permanent access to the Fed window should be primarily engaged in the business of banking. To limit the amount of speculative and non-core financial activities within a bank holding

company, this legislation would place a strict limit on the amount of non-deposit liabilities the institution may have.

Q: Will these changes reduce the availability of credit for consumers and businesses?

No. According to the FDIC's Quarterly Banking Profile for the fourth quarter of 2009, the number of federally-insured banks fell by 293 last year, including 179 mergers. Having fewer and bigger banks has not meant more lending. Instead, over the last year, banks have been decreasing their consumer and small business lending, including SBA loans (the three biggest banks reduced their 7(a) lending by 86% from 2008 to 2009), while increasing their investments in securities by almost 23 percent. We need a system where banks' lending will fuel the rest of the economy. Having more banks will create competition and increase the volume of lending, and proper incentives will entice banks to lend the right way again.

Moreover, there are several years of research showing that the biggest banks do not provide better services, or the same services at lower costs, than the medium sized bank or community bank. [For example](#), in the second quarter of 2009 the top four banks raised fees related to deposits by an average of 8 percent. To compete with the big banks, smaller banks lowered their fees by an average of 12 percent over the same period.

Though there is some disagreement, the evidence suggests that economies of scale exhaust somewhere between \$200 million and \$500 million in assets. At that point there is no difference in services for bank customers; the bigger banks greater profitability appears to come from software developments. Moreover, as Nassim Taleb and Charles Tapiero of NYU have shown, "size and economies of scale have commensurate risks that mitigate the advantages of size."

Q: Don't we need large megabanks to compete against foreign giants and to provide "financial solutions" to large and global customers?

In the most recent crisis, other countries have also had to address the problem of "too big to fail" financial institutions. Many nations in Europe and the rest of the world had to bail out their megabanks. Given that the *Wall Street Journal* reports that German and French banks carry more than \$900 billion in exposures to Greece and other vulnerable Euro countries, it remains to be seen whether more bailouts will be necessary. The problem of "too big to fail" banks is indeed a global one and other nations will have to chart their own paths. Their decisions, whatever they may be, do not obviate the need for decisive action on the part of our nation.

There is no reason why a large, multinational company could not have its financing needs met by a variety of financial companies. When underwriting equity and bond offerings and providing large loans, banks use syndication as a means of to spread risk. This process benefits the customer since it is apt to get better pricing by having a large number of firms sell its securities through a wide variety of distribution channels. The financial system is also safer by not having large concentrations of proprietary positions in different loans and securities on the balance sheets of banks that are supposed to be acting as intermediaries instead of speculators, which is why this proposal is complementary to the one to restrict proprietary trading.