The Problem Is Bigger Than Too Big to Fail

by Jesse Eisinger
ProPublica

Earlier this year, President Obama's new Treasury secretary, Jacob J. Lew, offered a financial reform litmus test: By the end of 2013, could we say with a straight face that we have solved the "too big to fail" problem?

Last week, Mr. Lew gave a sweeping overview of the efforts to overhaul financial regulation. It was a talk of a man who has been practicing his straight face in the mirror.

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About The Trade

In this column, co-published with New York Times' DealBook, I monitor the financial markets to hold companies, executives and government officials accountable for their actions. Tips? Praise? Contact me at jesse@propublica.org

To judge by his performance, one technique for remaining stoned-faced is to recite platitudes. Mr. Lew told the attendees: "Going forward, we cannot be afraid to ask tough questions, with an open mind and without preconceived judgments." That requires that "we must remain vigilant as emerging threats appear on the horizon." He reassured us that "we have made tough choices, and very significant progress toward reforming our financial system."

This is not the stuff of persuasion. Simply asserting that the financial system becomes safer as regulators complete Dodd-Frank rules does not make it so. To those who don't think those rules go far enough, the administration offers little. More important, the claim frames the issue in a discouragingly limited fashion.

In his speech, Mr. Lew claimed that his test had been passed. He said, more than once, that "Dodd-Frank ended 'too big to fail' as a matter of law." That may sound soothing, but it is empty of meaning. "Too big to fail" was never literally the law of the land. Therefore, it wasn't something that Dodd-Frank excised.

As long as there are gargantuan banks, Mr. Lew is left to make a faith-based argument that we can assume officials' pre-battle boasts of courage will hold true as the fight is engaged.

"Too big to fail" is a generally held assumption that some entities are so central and vital to our markets that they will be backstopped by the government. For

starters, it requires expecting that government officials will have the stomach to unwind a failing bank with a multitrillion-dollar balance sheet and impose losses on shareholders and, if required, bondholders and other creditors.

But that's only a first step. The government must also have the ability to safely unwind the institution and all of its international operations. And that's not even the most important aspect of "too big to fail." The government won't simply be able to unwind one failing giant financial institution and be done. Anything that is taking down JPMorgan Chase is highly likely to be also taking down Bank of America or Goldman Sachs — or both. What will the government do then? It's at this point that the straight face becomes a look of terror.

Grant for a moment Mr. Lew's argument that we've made progress on financial reform. I do. This week, the depressingly delayed Volcker Rule finally emerged from the regulatory cavern. And that rule is stronger than previous versions. But is it strong enough?

The process wasn't encouraging. It was only in the last couple of weeks that the loopholes were closed. Now we are left to trust the enforcement efforts from regulators who only weeks ago were arguing about how many and how extensive the loopholes should be. Now we need them to uniformly become true-believers in muscular Volcker enforcement.

The way to really solve "too big to fail" is not by tinkering with the existing system, which leaves the great and fundamental problem still with us. The economy has become overly "financialized."

Historically, finance's share of the economy has been at about 4 percent. Today, it's about twice that. And the peak occurred not in pre-bubble 2007, but in post-crash 2010, at just under 9 percent, according to research from Thomas Philippon of New York University. That represents a shift of more than $600 billion of wealth a year, as Wallace C. Turbeville, a former investment banker-turned-financial reformist, has pointed out.

Despite technological innovation, finance costs more than it used to, even though prices have fallen for things like trading stocks.

Research from Professor Philippon shows that financial activities have gone up in the deregulatory era, and now cost about the same as in 1900, the last Gilded Age. In other industries, like retail, technological innovation has led to lower prices and therefore decreased the size of the sector. In finance, the opposite happened.

Society isn't benefiting. Research by Jennie Bai, Professor Philippon and Alexi Savov shows that even as the differential between buying and selling stocks and bonds has fallen, prices aren't better. Prices have displayed the same ability to forecast corporate futures steadily for the last 50 years.

The regulator focus has been on reducing the chances and damage of financial crises, and that is certainly vital. But it's insufficient. Are we on the right path to fix the pathologies of our obese financial sector?

The financial sector has become a self-sustaining perpetual motion machine that extracts money from the rest of the economy. Shouldn't it be a goal of society — Mr. Lew's focus — to restore the financial industry to its traditional role as an intermediary between companies that need capital and savers who have it?

There are some modest signs in the right direction. Large banks are not as profitable as they were before the crisis. They clearly have more capital and less leverage, which makes them safer.

Regulators have incrementally raised the costs of risky activities, which may work to slow down the growth of finance.

"The effect of financial regulation is serendipitous," Mr. Turbeville notes. "They accidentally got partly the way there."

But part of the way isn't good enough.