Lessons from the Crisis: Ending Too Big to Fail

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Thank you, David, for that kind introduction. It is great to be back at the Brookings Institution. Before I begin, I just want to remind everyone that the views I express today are my own and not necessarily those of the Federal Open Market Committee or the Board of Governors, which sets supervision and regulatory policy for the Federal Reserve System.

Today I will offer my assessment of the current status and outlook for ending the problem of too big to fail (TBTF) banks.[2] I come at this problem from the perspective of a policymaker who was on the front line responding to the 2008 financial crisis. When Congress moved quickly to pass the Dodd-Frank Act (the Act) in 2010, I strongly supported the need for financial reform, but I wanted to see the Act implemented before I drew firm conclusions about whether it solved TBTF[3].

In the last six years my colleagues across the Federal Reserve System have worked diligently under the reform framework Congress established and are fully utilizing the available tools under the Act to address TBTF. While significant progress has been made to strengthen our financial system, I believe the Act did not go far enough. I believe the biggest banks are still too big to fail and continue to pose a significant, ongoing risk to our economy.

Enough time has passed that we better understand the causes of the crisis, and yet it is still fresh in our memories. Now is the right time for Congress to consider going further than Dodd-Frank with bold, transformational solutions to solve this problem once and for all. The Federal Reserve Bank of Minneapolis is launching a major initiative to develop an actionable plan to end TBTF, and we will deliver our plan to the public by the end of the year. Ultimately Congress must decide whether such a transformational restructuring of our financial system is justified in order to mitigate the ongoing risks posed by large banks.

Although TBTF banks were not the sole cause of the recent financial crisis and Great Recession, there is no question that their presence at the center of our financial system contributed significantly to the magnitude of the crisis and to the extensive damage it inflicted across the economy.

Given the scale of job losses, home foreclosures, lost savings and costs to taxpayers, there is widespread agreement among elected leaders, regulators and Main Street that we must solve the problem of TBTF. We know markets make mistakes; that is unavoidable in an innovative economy. But these mistakes cannot be allowed to endanger the rest of the country. When roughly 1,000 savings and loans failed in the late 1980s, there was no risk of an economic collapse. When the technology bubble burst in 2000, it was very painful for Silicon Valley and for technology investors, but it did not represent a systemic risk to

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[1] I thank Ron Feldman, Jim Lyon, Jenni Schoppers, Sam Schulhofer-Wohl, David Wargin and Niel Willardson for giving helpful feedback on this speech.

[2] I use "banks" in this talk to include banks, bank holding companies and other nonbank financial institutions.

[3] See Neel Kashkari's May 6, 2011, remarks at the 47th Annual Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago. https://www.minneapolisfed.org/~/media/files/news_events/pres/kashkari-remarks-conference-on-bank-structure-and-competition-05-06-2011.pdf

our economy. Large banks must similarly be able to make mistakes—even very big mistakes—without requiring taxpayer bailouts and without triggering widespread economic damage. That must be our goal.

Ongoing progress

Since 2008, legislators and regulators have worked hard to address the TBTF problem. My colleagues in the Federal Reserve System, working closely with other financial regulators, have implemented important tools and regulations that are making the financial system stronger. Regulators have forced large firms to hold more capital and have deeper, more resilient sources of liquidity. Our stress tests check whether the most systemically important institutions can withstand a serious shock to the economy. In some cases, institutions have responded to these higher regulatory requirements by reducing certain activities. Considerable progress has been made, and these are steps in the right direction.

But regulators know that despite these best efforts, banks will still sometimes make mistakes and run into trouble. To ensure that banks can fail without requiring taxpayer bailouts, regulators are using the living will review process to try to address the hurdles that make large banks so hard to resolve.[4] They are establishing a resolution approach intended to give regulators the ability to restructure large banks without massive spillovers.[5] And they have proposed requiring banks to issue debt that would help recapitalize the firm if necessary.[6] All of these measures are sensible. Policymakers are committed to seeing these important efforts through. The question is, should we be satisfied with this approach or should we do more?

Lessons from the crisis

The lessons I learned during the 2008 financial crisis strongly influence my assessment of new regulatory measures to address the TBTF problem.

I learned in the crisis that determining which firms are systemically important—which are TBTF—depends on economic and financial conditions. In a strong, stable economy, the failure of a given bank might not be systemic. The economy and financial firms and markets might be able to withstand a shock from such a failure without much harm to other institutions or to families and businesses. But in a weak economy with skittish markets, policymakers will be very worried about such a bank failure. After all, that failure might trigger contagion to other banks and cause a widespread downturn. Thus, although the size of a financial institution, its connections to other institutions and its importance to the plumbing of the financial system are all relevant in determining whether it is TBTF, there is no simple formula that defines what is systemic. I wish there were. It requires judgment from policymakers to assess conditions at the time. I know this is unsatisfactory to many people, but it is the truth today. Perhaps one day we will have better tools to make this determination analytically.

A second lesson for me from the 2008 crisis is that almost by definition, we won't see the next crisis coming, and it won't look like what we might be expecting. If we, or markets, recognized an imbalance

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[4] Information on living wills can be found at federalreserve.gov/bankinforeg/resolution-plans.htm.
[5] Information on new approaches to resolution can be found at fdic.gov/news/news/press/2013/pr13112.html.
[6] Information on proposals to require banks to issue long-term debt can be found at federalreserve.gov/newsevents/press/bcreg/20151030a.htm and federalreserve.gov/newsevents/press/bcreg/20160129b.htm.

in the economy, market participants would likely take action to protect themselves. When I first went to Treasury in 2006, Treasury Secretary Henry Paulson directed his staff to work with financial regulators at the Federal Reserve and the Securities and Exchange Commission to look for what might trigger the next crisis. Based on his experience, we were due for a crisis because markets had been stable for several years. We looked at a number of scenarios, including an individual large bank running into trouble or a hedge fund suffering large losses, among others. We didn't consider a nationwide housing downturn. It seems so obvious now, but we didn't see it, and we were looking. We must assume that policymakers will not foresee future crises, either.

A third lesson from the crisis is that the externalities of large bank failures can be massive. I am not talking about just the fiscal costs of bailouts. Even with the 2008 bailouts, the costs to society from the financial crisis in terms of lost jobs, lost income and lost wealth were staggering—many trillions of dollars and devastation for millions of families. Failures of large financial institutions pose massively asymmetric risks to society that policymakers must consider. We had a choice in 2008: Spend taxpayer money to stabilize large banks, or don't, and potentially trigger many trillions of additional costs to society.

A very crude analogy is that of a nuclear reactor. The cost to society of letting a reactor melt down is astronomical. Given that cost, governments will do whatever they can to stabilize the reactor before they lose control.

My assessment of where we are

Regulatory reforms since the crisis have focused both on making banks safer so they are less likely to fail, and on creating tools to resolve troubled banks by imposing losses on creditors without destabilizing the economy. Based on lessons from the recent crisis, I evaluate these restructuring tools by asking the following questions: Would policymakers responding to a future crisis actually use them? And how likely are they to be effective?

To answer these questions, I consider two simplified scenarios:

1) An individual large bank runs into trouble, while the economy and financial system are otherwise healthy and stable, and
2) One or more large banks run into trouble while there is broader weakness and risks in the global economy.

My assessment of these tools under the first scenario is that they do have the potential to deal with the failure of a single large financial institution without requiring a bailout or triggering widespread economic damage. But we don't know that for certain, and the work on these tools is incomplete and slow moving. For example, reviews of the largest banks' living wills find that they have significant shortcomings, with the government requiring the banks to try once again to make themselves able to fail without massive fallout. Until this work is complete, which could be years from now, we must acknowledge that the largest banks are still too big to fail. And even then, we won't know how effective these tools are until we have actually used them.

Unfortunately, I am far more skeptical that these tools will be useful to policymakers in the second scenario of a stressed economic environment. Given the massive externalities on Main Street of large bank failures in terms of lost jobs, lost income and lost wealth, no rational policymaker would risk restructuring large firms and forcing losses on creditors and counterparties using the new tools in a risky environment, let alone in a crisis environment like we experienced in 2008. They will be forced to bail out failing institutions—as we were. We were even forced to support large bank mergers, which helped stabilize the immediate crisis, but that we knew would make TBTF worse in the long term. The risks to the U.S. economy and the American people were simply too great not to do whatever we could to prevent a financial collapse.

Going forward

I believe we need to complete the important work that my colleagues are doing so that, at a minimum, we are as prepared as we can be to deal with an individual large bank failure. But given the enormous costs that would be associated with another financial crisis and the lack of certainty about whether these new tools would be effective in dealing with one, I believe we must seriously consider bolder, transformational options. Some other Federal Reserve policymakers have noted the potential benefits to considering more transformational measures.[7] I believe we must begin this work now and give serious consideration to a range of options, including the following:

- Breaking up large banks into smaller, less connected, less important entities.

- Turning large banks into public utilities by forcing them to hold so much capital that they virtually can't fail (with regulation akin to that of a nuclear power plant).

- Taxing leverage throughout the financial system to reduce systemic risks wherever they lie.

Options such as these have been mentioned before, but in my view, policymakers and legislators have not yet seriously considered the need to implement them in the near term. They are transformational—which can be unsettling. The financial sector has lobbied hard to preserve its current structure and thrown up endless objections to fundamental change. And in the immediate aftermath of the crisis, when the Dodd-Frank Act was passed, the economic outlook was perhaps too uncertain to take truly bold action. But the economy is stronger now, and the time has come to move past parochial interests and solve this problem. The risks of not doing so are just too great.

Many of the arguments against adoption of a more transformational solution to the problem of TBTF are that the societal benefits of such financial giants somehow justify the exposure to another financial crisis. I find such arguments unpersuasive.

- Finance lobbyists argue that multinational corporations do business in many countries and therefore need global banks. But these corporations manage thousands of suppliers around the world—can't they manage a few more banking relationships?

[7] For a discussion of the potential benefits to considering a size cap on banks, see Daniel K. Tarullo's Oct. 10, 2012, speech at the Distinguished Jurist Lecture, University of Pennsylvania, Philadelphia, federalreserve.gov/newsevents/speech/tarullo20121010a.htm, and for potential conditions under which the breakup of large banks might be considered, see William C. Dudley's Oct. 20, 2014, remarks at the Workshop on Reforming Culture and Behavior in the Financial Services Industry, Federal Reserve Bank of New York, newyorkfed.org/newsevents/speeches/2014/dud141020a.

- Many argue that large banks benefit society by creating economies of scope and scale. No doubt this is true—but cost/benefit analyses require understanding costs, too. I don't see the benefits of scale of large banks outweighing the massive externalities of a widespread economic collapse.

- Some argue that if we limited U.S. banks in size or scope, they would be at a disadvantage relative to banks in countries with looser regulations. If other countries want to take extreme risks with their financial systems, we can't stop them—but the United States should do what is right for our economy and establish one set of rules for those who want to do business here.

Given the complexity of this issue, any bold plan will be imperfect, and there will be unanswered questions that skeptical experts can point to as a reason for inaction: How can we precisely define which firms are dangerous and need to change? How can our plan adapt and endure as the financial system evolves over decades? What if strictly regulating some firms just pushes risk onto other, less regulated firms? How will new rules impact families' and businesses' ability to make important investments, and what will that mean for employment and economic growth?

Experts also correctly point out that there is always the possibility that an economic shock could hit us in the future that is so large, or so different from anything we have considered, that it overwhelms all of our efforts. In that scenario, only the balance sheet of the federal government would be strong enough to stabilize the financial system, as was required in 2008.

These are all important considerations, and there are many more. We must work to address them. But if we are serious about solving TBTF, we cannot let them paralyze us. Any plan that we come up with will be imperfect. Those *potential* shortcomings must be weighed against the *actual* risks and costs that we know exist today. Perfect cannot be the standard that we must meet before we act. Better and safer are reasons enough to act. Otherwise we will be left on the default path of incrementalism and the risk that we will someday face another financial crisis without having done all that we could to protect the economy and the American people.

Next steps

The Federal Reserve Bank of Minneapolis has been at the forefront of understanding the risks and challenges posed by large banks and moral hazard for a long time. Our work on these topics goes back to the 1970s, with specific work on TBTF beginning in the 1990s. In fact, my colleague Ron Feldman and one of my predecessors, Gary Stern, both of whom are here today, authored the original book on this topic, *Too Big to Fail,* arguing in 2004 that policymakers would not stick to their no-bailout pledges.[8] They were right.

Building on this important work, and the work done since the crisis, the Federal Reserve Bank of Minneapolis is launching a major initiative to consider transformational options and develop an actionable plan to end TBTF.

Starting in the spring, we will hold a series of policy symposiums to explore various options from expert researchers around the country. We will also invite leaders from policy and regulatory institutions and, yes, the financial industry to offer their views and to test one another's assumptions. We will consider

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[8] Gary H. Stern and Ron J. Feldman. 2004. *Too Big to Fail: The Hazards of Bank Bailouts*. Washington, D.C.: Brookings Institution Press. www.minneapolisfed.org/endingTBTF

the likely benefits, costs, risks and implementation challenges of these options. We will invite the media to these symposiums and livestream them so that the public can follow along and learn with us.

Following the symposiums, we will publish a series of policy briefs summarizing our key take-aways on each issue, so that all can provide feedback. And feedback can start now. We have established a website where anyone can share with us their ideas on solving TBTF. If you are a researcher—if you work in the financial sector—if you just have a good idea for solving TBTF, wherever you are, please share it with us at minneapolisfed.org.

We will use all of this work to inform our plan to end TBTF, which we will release by year-end for legislators, policymakers and the public to consider.

Congress created the Federal Reserve System to help prevent financial crises from inflicting widespread damage to the U.S. economy. Doing everything we can to address the systemic risks posed by large banks will be an important step to fulfilling that mission. Seven years after the crisis, I believe it is now time to move forward and end TBTF.

Thank you.