
2017

HOOVER INSTITUTION

# Summer Policy Boot Camp

## Director’s Awards Winners

# Revisiting "Too Big to Fail": A Better Approach for Regulating Systemic Risk

*By John McDonough, U.S. Treasury, Office of Financial Research*[1]

*Large US banks are currently subject to varying levels of enhanced regulatory requirements according to the size of their balance sheets. This sized-based trigger creates perverse incentives, imposes substantial barriers to entry on smaller firms, and fails to account for endogenous factors such as risk propensity, or exogenous factors like inflation. Congress should amend the Dodd-Frank Act to replace size-based regulation with a risk-based approach that reduces the regulatory burden for large banks with relatively lower risk profiles.*

## BACKGROUND

The recent financial crisis demonstrated the negative externalities that large financial institutions can pose on the economy as a whole. Banks, in particular, are vulnerable to macroeconomic shocks because of their fundamental business model of maturity and risk transformation. That, combined with low capital levels, high reliance on runnable liabilities from the short-term funding market, and increased risk taking in the mid-2000s, led to a financial panic when the housing bubble burst in 2007.

During the crisis, extraordinary measures were enacted in an attempt to contain the fallout. The Federal Reserve stepped in to serve as the Lender of Last Resort by providing bailouts to many banks. Additionally, Congress injected $426 billion into the financial sector as part of the Troubled Asset Relief Program (TARP).[2] These efforts were viewed by many economists as successful in stabilizing the fragile financial system, but not without great cost to the taxpayer.[3] It is worth noting, however, that those views are not universally shared.[4] Furthermore, the government's actions have also been criticized for promoting moral hazard by reducing the penalties associated with failure.[5] These banks that either received bailouts or were perceived as potentially eligible for future bailouts became known colloquially as "too big to fail."

In effort to address the "too big to fail" problem, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) created a framework for enhanced regulation of large financial institutions to internalize these negative externalities. Dodd-Frank chose a tiered, asset-based threshold approach for assigning various levels of stricter regulation for banks that exceed $1 billion, $10 billion, $50 billion, and $250 billion in assets.[6]Of those four thresholds, the most stringent regulatory ratchet occurs at the $50 billion level, where enhanced supervision, including being subject to the annual CCAR stress tests, kicks in.[7] Completing the stress test requires significant expenditures to hire substantially larger compliance staff, as well as technology costs for systems that can capture, model, and report the necessary financial data to the Federal Reserve. There are currently forty-four

US financial firms (or US subsidiaries of foreign banks) with greater than $50 billion in assets on their balance sheet (see Table 1).

**Table 1: US Financial Firms Above $50 Billion Threshold.**[8]

| Rank | Institution Name (RSSD ID) | Total Assets |
|---|---|---|
| 1 | JPMORGAN CHASE & CO. (1039502) | $2,546,290,000 |
| 2 | BANK OF AMERICA CORPORATION (1073757) | $2,249,046,000 |
| 3 | WELLS FARGO & COMPANY (1120754) | $1,951,564,000 |
| 4 | CITIGROUP INC. (1951350) | $1,821,635,000 |
| 5 | GOLDMAN SACHS GROUP, INC., THE (2380443) | $894,091,000 |
| 6 | MORGAN STANLEY (2162966) | $832,391,000 |
| 7 | U.S. BANCORP (1119794) | $449,522,000 |
| 8 | PNC FINANCIAL SERVICES GROUP, INC., THE (1069778) | $371,278,327 |
| 9 | TD GROUP US HOLDINGS LLC (3606542) | $353,617,381 |
| 10 | CAPITAL ONE FINANCIAL CORPORATION (2277860) | $348,549,339 |
| 11 | BANK OF NEW YORK MELLON CORPORATION, THE (3587146) | $337,536,000 |
| 12 | HSBC NORTH AMERICA HOLDINGS INC. (3232316) | $295,078,604 |
| 13 | TEACHERS INSURANCE & ANNUITY ASSOCIATION OF AMERICA (1607170) | $286,212,264 |
| 14 | STATE STREET CORPORATION (1111435) | $236,805,204 |
| 15 | CHARLES SCHWAB CORPORATION, THE (1026632) | $227,061,000 |
| 16 | CREDIT SUISSE HOLDINGS (USA), INC. (1574834) | $225,483,660 |
| 17 | BB&T CORPORATION (1074156) | $220,500,518 |
| 18 | SUNTRUST BANKS, INC. (1131787) | $205,949,928 |
| 19 | BARCLAYS US LLC (5006575) | $200,477,000 |
| 20 | DB USA CORPORATION (2816906) | $185,155,000 |
| 21 | ALLY FINANCIAL INC. (1562859) | $162,101,000 |
| 22 | AMERICAN EXPRESS COMPANY (1275216) | $161,378,000 |
| 23 | UNITED SERVICES AUTOMOBILE ASSOCIATION (1447376) | $152,252,002 |
| 24 | CITIZENS FINANCIAL GROUP, INC. (1132449) | $150,690,016 |
| 25 | STATE FARM MUTUAL AUTOMOBILE INSURANCE COMPANY (3840207) | $150,198,345 |
| 26 | MUFG AMERICAS HOLDINGS CORPORATION (1378434) | $149,684,076 |
| 27 | RBC USA HOLDCO CORPORATION (3226762) | $147,180,305 |
| 28 | UBS AMERICAS HOLDING LLC (4846998) | $140,367,771 |
| 29 | FIFTH THIRD BANCORP (1070345) | $140,199,626 |
| 30 | BNP PARIBAS USA, INC. (1575569) | $136,616,779 |
| 31 | SANTANDER HOLDINGS USA, INC. (3981856) | $135,109,476 |
| 32 | KEYCORP (1068025) | $134,972,587 |
| 33 | BMO FINANCIAL CORP. (1245415) | $127,696,829 |
| 34 | REGIONS FINANCIAL CORPORATION (3242838) | $124,739,162 |
| 35 | M&T BANK CORPORATION (1037003) | $123,223,251 |
| 36 | NORTHERN TRUST CORPORATION (1199611) | $121,488,675 |
| 37 | HUNTINGTON BANCSHARES INCORPORATED (1068191) | $100,045,506 |
| 38 | DISCOVER FINANCIAL SERVICES (3846375) | $94,795,139 |
| 39 | SYNCHRONY FINANCIAL (4504654) | $89,050,082 |
| 40 | BBVA COMPASS BANCSHARES, INC. (1078529) | $87,309,233 |
| 41 | COMERICA INCORPORATED (1199844) | $73,169,721 |
| 42 | ZIONS BANCORPORATION (1027004) | $65,462,677 |
| 43 | CIT GROUP INC. (1036967) | $63,094,385 |
| 44 | E*TRADE FINANCIAL CORPORATION (3412583) | $55,879,348 |

Although proponents argue that the enhanced regulatory requirements have reduced risk in the banking sector, there are three fundamental flaws with the current size-based threshold approach.

First and foremost, asset-size thresholds distort incentives for growth and risk taking. Each threshold acts as a tax on growth that banks pay upon passing the threshold. The “tax” occurs in the form of additional compliance costs that banks must pay to conform with the stricter regulations. While some aspects of the higher regulatory burden may be variable, the primary cost (compliance staff and higher capital requirements) is fixed.  As a result, banks are incentivized to limit their natural growth as they approach a threshold, then accelerate their growth once they have passed it in order to spread the fixed-compliance costs over a larger asset base. This acceleration occurs through reach-for-yield behavior, as banks pursue higher returns to maintain return-on-capital ratios, as well as increased leverage to support acquisitions of other banks. The ultimate effect is that it distorts the natural growth rate of financial firms and, ironically, leads to larger and riskier banks.

Second, asset-size thresholds fail to account for variation in risk profiles and business models among banks of similar sizes. To illustrate, consider a hypothetical bank that holds $51 billion in risk-free US Government Bonds on its balance sheet (but nothing else). Under the existing framework, that bank would be subject to a greater regulatory burden than a bank with exactly $49 billion in assets that are entirely comprised of high-risk derivative positions. From an efficiency and risk-management perspective, this framework does a poor job of allocating regulatory burden to riskier firms.

Finally, these thresholds ignore the long-run impact of inflation. The thresholds set forth by Congress are fixed to nominal values and thus are unable to adapt over time to movements in the price level. Even if intrinsic risk remains constant, the $50 billion trigger will slowly capture more and more firms as inflation raises the nominal value of assets on bank balance sheets. The recent low levels of inflation notwithstanding, the lack of an inflation peg in the statute demonstrates Congress' short-term thinking in writing the Dodd-Frank Act.

**Moving to a Risk-Based Approach**

To address these shortcomings in the existing framework for enhanced regulation of banks, Congress should amend the Dodd-Frank Act to repeal the asset-size threshold and replace it with a risk-based approach. Although this would represent a significant shift in how small and medium-size banks are treated, regulators already have the tools to implement a risk-based framework.

A small subset of the largest banks, referred to as "global systemically important banks" (G-SIBs) are already identified for the highest level of regulatory oversight by a multifactor approach that incorporates size, interconnectedness, complexity, global activity, substitutability, cross-jurisdictional activity, and short-term wholesale funding .[9] This enhanced methodology was created by the Basel Committee on Banking Supervision (BCBS) to better identify systemic risk and is used by regulators around the world.[10] While this balanced framework, with its focus on additional factors besides size, currently applies only to eight US banks designated as G-SIBs, it could be extended to small- and medium-sized banks in place of the asset-size thresholds.

**Implementation**

The weights of each risk indicator, as well as the enhanced regulatory requirements that are triggered, should be calibrated by the Federal Reserve according to a statutory mandate that prioritizes efficient allocation of the regulatory burden to riskier firms. Threshold effects would still exist in a risk-based framework, but they would better align banks' incentives with the financial stability goals of the macro-prudential authorities, and it would discourage excessive risk-taking by banks after crossing a threshold.

As a result of this proposal, the overall number of banks subject to enhanced prudential regulation will change and likely will decrease depending on the exact calibration. Critics will undoubtedly complain that removing the asset thresholds will result in less oversight, possibly leading to greater risk in the financial system. However, in amending the statute, Congress should not be swayed by those arguments for the following reasons: first, those criticisms don't address the fundamental flaws in the existing tiered system; and second, banks are still subject to regulation and supervision even if the new risk-based framework exempts them from enhanced standards.

Conversely, some smaller banks that are not currently subject to enhanced regulatory supervision may find themselves facing stricter oversight due to their risk profile or unique role in the financial system. One example of the BCBS multifactor methodology emphasizing uniqueness and risk over pure size is as follows: the risk-based approach identifies Bank of New York (BNY) Mellon as systemically important, despite several larger banks (Capital One, PNC, US Bancorp, and TD Group) avoiding being designated as G-SIBs. This prioritization of risk profile over a pure size measure is sensible because BNY Mellon plays a critical role as the only bank to clear US government securities following J.P. Morgan's departure from that market.[11] Affected firms would likely exert political pressure and lobby to avoid changes, which should be ignored to every extent possible. A risk-based approach better aligns regulatory compliance costs with risk, leading to a more efficient outcome.

**Conclusion**

The current approach for subjecting banks to enhanced regulatory standards is inadequate because it distorts incentives for growth and risk-taking, inefficiently allocates the regulatory burden without regard to risk, and fails to adjust over time to the price level. Congress should amend the Dodd-Frank Act to adopt a risk-based approach, similar to the one already used to identify G-SIBs. This shift in policy would address all three of the aforementioned problems with the status quo.

---

[1] *Disclaimer: The views expressed in this paper are those of the author and do not reflect the views of the Office of Financial Research or the U.S. Department of the Treasury.*

[2] Ryan Tracy, Julie Steinberg, and Telis Demos, "Bank Bailouts Approach a Final Reckoning," *Wall Street Journal*, December 28, 2014, accessed February 13, 2018, https://www.wsj.com/articles/ally-financial-exits-tarp-as-treasury-sells-remaining-stake-1419000430.

[3] Alan S. Blinder and Mark Zandi, "The Financial Crisis: Lessons for the Next One," Center on Budget and Policy Priorities, October 15, 2015, accessed February 13, 2018, https://www.cbpp.org/research/economy/the-financial-crisis-lessons-for-the-next-one.

[4] "Market Interventions During the Financial Crisis: How Effective and How to Disengage?" chap. 3 in "Global Financial Stability Report: Navigating the Financial Challenges Ahead," International Monetary Fund, October 2009, accessed February 13, 2018, https://www.imf.org/en/Publications/GFSR/Issues/2016/12/31/~/media/Websites/IMF/imported-flagship-issues/external/pubs/ft/GFSR/2009/02/pdf/_textpdf.ashx.

[5] John Taylor, *Getting Off Track: How Government Actions and Interventions Caused, Prolonged, and Worsened the Financial Crisis* (Stanford, CA: Hoover Institution Press, 2009).

[6] Daniel K. Tarullo, "Application of Enhanced Prudential Standards to Bank Holding Companies," testimony before the US Senate Committee on Banking, Housing, and Urban Affairs, March 19, 2015, accessed February 13, 2018, https://www.federalreserve.gov/newsevents/testimony/tarullo20150319a.htm.

[7] Tarullo, "Application of Enhanced Prudential Standards to Bank Holding Companies."

[8] Source: FFIEC. Federal Financial Institutions Examination Council, "Holding Companies with Assets Greater Than $10 Billion," accessed February 13, 2018, https://www.ffiec.gov/nicpubweb/nicweb/HCSGreaterThan10B.aspx. Total Assets as of Q1 2017. Green denotes Global Systemically Important Bank subject to heightened prudential standards. Light green denotes non-G-SIB with greater than $250 billion in assets and subject to advanced approach regulatory capital requirements. Light blue denotes greater than $50 billion in assets and subject to annual Comprehensive Capital Analysis and Review (CCAR) stress tests.

[9] Meraj Allahrakha, Paul Glasserman, and H. Peyton Young, "Systemic Importance Indicators for 33 U.S. Bank Holding Companies: An Overview of Recent Data," Office of Financial Research, February 12, 2015, accessed February 13, 2018, https://www.financialresearch.gov/briefs/files/2015-02-12-systemic-importance-indicators-for-us-bank-holding-companies.pdf.

[10] Basel Committee on Banking Supervision, "Global Systemically Important Banks: Updated Assessment Methodology and the Higher Loss Absorbency Requirement," July 2013, accessed February 13, 2018, https://www.bis.org/publ/bcbs255.pdf.

[11] Katy Burne, "JPMorgan to Exit Part of its Government Securities Business," *Wall Street Journal*, July 21, 2016, accessed February 13, 2018, www.wsj.com/articles/j-p-morgan-to-exit-part-of-its-government-securities-business-1469135462.