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A Spirited Conversation Assessing the Risks and Benefits of Big Banks

Center for Banking and Finance

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I. INTRODUCTION

On November 8, 2011, the Center for Banking and Finance at the University of North Carolina School of Law hosted a debate on the risks and benefits of big banks, or too-big-to-fail, at The Palace Hotel in New York City. This event preceded The Clearing House's First Annual Business Meeting and Conference.[1] The Clearing House also provided generous financial support for the debate. Biographical information about the moderator, Paul Saltzman, and the panelists is set forth before the debate transcript begins.

Paul Saltzman has the dual responsibility of overseeing the legal, compliance, and litigation functions for the organization's payments business and driving the strategic agenda for the Association, a not-for-profit membership-based business league. The Association was recently described as providing "a whole new model of leadership in the commercial bank space . . . bringing data-driven research to their analysis of legislative and regulatory proposals."[2]

John C. Dugan is a partner at Covington & Burling's Washington, D.C. office where he chairs the firm's Financial Institutions Group. Prior to his position at Covington & Burling, he served as Comptroller of the Currency heading the agency that supervises over 1,500 national banks and federal branches of foreign banks. He also served on the board of directors of the Federal Deposit Insurance Corporation, the Basel Committee on Banking Supervision,

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1. The Clearing House is the oldest banking association and payments company in the United States, having been established in 1853. It is owned by the world's largest commercial banks. The Clearing House Payments Company L.L.C. provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer, and check-image payments made in the U.S. The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing the interests of its owner banks on a variety of important banking issues.

2. Joe Adler, *Who Speaks for the Big Banks? It's Not Always Clear*, AM. BANKER, Nov. 7, 2011.

and was chair of the Joint Forum (an international committee of banking, securities, and insurance regulators), through which he participated at meetings of the Financial Stability Board.

Phillip L. Swagel is a professor of international economic policy at the University of Maryland School of Public Policy. He previously served as Assistant Secretary for Economic Policy at the Treasury Department from December 2006 to January 2009.

Ingo Walter is the Seymour Milstein Professor of Finance, Corporate Governance and Ethics and Vice Dean of Faculty at the Stern School of Business at New York University. His principal areas of academic and consulting activity include international banking and corporate governance issues. At New York University, he has previously served a number of terms as Chairman of International Business and Chairman of Finance, as well as Director of the New York University Salomon Center for the Study of Financial Institutions from 1990 to 2003 and Director of the Stern Global Business Institute from 2003 to 2006.

Arthur E. Wilmarth, Jr. is Professor of Law at The George Washington University School of Law. He teaches courses in banking law, contracts, corporations, and American constitutional history, and also serves as executive director of the law school's Center for Law, Economics and Finance (C-LEAF). He is a member of the editorial board of the *Journal of Banking Regulation* and of the advisory board of the American Antitrust Institute.

The four panelists are identified in the transcript of the debate by their last names.

II. THE DEBATE

Saltzman: Before we begin, it's our pleasure to be sponsoring this event and working very closely with the Center for Banking and Finance, which has done a fantastic job of bringing thought and leadership to the banking space on both sides of varying issues. Thanks to our CEO, Jim Aramanda, for his leadership as well.

During the course of the debate and the academic literature that we review, there really does seem to be an underlying theme in connection with each of the various regulatory proposals that we're debating, whether it's the G-SIFI surcharge,[3] the Durbin Amendment,[4] the Volcker Rule,[5] the Lincoln push-out rules[6] – you name it – and there really does appear to be a bias against big banks. And the purpose of today's debate is to flesh that out and the propositions and themes that undergird regulatory policy in the hopes of debating and challenging that as a way to effectuate good public policy.

We have three basic tenets that we're going to debate. The first proposition is as follows:

Large, systemically important regulated financial holding companies caused the financial crisis by taking excessive risks that created negative societal or social externalities. This was, in part, the result of compensation structures that encouraged excessive risk-taking. Unnecessary government support provided to such firms created moral hazard, exacerbating risk-taking and enhanced market perceptions that some firms are too big to fail.

Arguing in favor of the proposition, Art, Ingo, all yours.

Walter: Actually, I could just as well take the other side of this argument. This is a very complicated story. It has to do with running the world twice, once the way it went and once the way things might have gone without the kinds of institutions that you have just described. This is what historians call the "counterfactual" – what would the world have looked like if things had been different? I'm not totally convinced that the world would have looked all that different in the absence of massive universal banks and financial conglomerates. Why? Because smaller and more specialized financial intermediaries could have made the same mistakes – warehousing what turned out to be toxic financial instruments instead of sticking to financial intermediation and pipelining them to end-investors. If you take a look at the damages to the intermediaries themselves, it's somewhere around $1.55 trillion so

3. G-SIFI means "Global Systemically Important Financial Institutions." For a list of G-SIFIs, see Financial Stability Board, *Policy Measures to Address Systemically Important Financial Institutions*, Nov. 4, 2011, http://www.financialstabilityboard.org/publications/r_111104bb.pdf.

4. 15 U.S.C. § 1693o–2 (Supp. IV 2010) (amending the Electronic Funds Transfer Act, 15 U.S.C. § 1693 *et seq.*).

5. 12 U.S.C. § 1851 (Supp. IV 2010).

6. 15 U.S.C. § 8305 (Supp. IV 2010).

far, according to IMF estimates, mainly due to warehousing.

The second allocation of losses was on the end investors, which the IMF currently estimates at roughly the same amount, so that's around $3 trillion in total financial losses associated with the toxic assets themselves and contagion to related asset classes.

If the real sector losses in the Great Recession are added things really begin to mount-up. Comparing the five previous recessions and their respective recovery rates – focusing on household wealth losses, capex erosion, and GDP undershooting – we estimate an additional $4 trillion or so in damage. So a back-of-the-envelope guesstimate is around $7 trillion in financial and economic wreckage associated with the financial architecture that collapsed in 2007-09.

That's very, very large. So if you believe your own study of remediation costs somewhere around $50 to $110 billion, that's really nothing in comparison to the damage inflicted. If you present-value both, some plausible estimate of the damage and then present-value the remediation costs, the remediation costs are de minimis.

It reminds me of the time I had to go down to Washington to talk to the ERISA people about eliminating self-dealing restrictions – if a firm is running ERISA pension money, it is prohibited from trading with its broker-dealer affiliate to prevent exploitation of an obvious conflict of interest. We did, I think, a very good study of the costs of that prohibition to pension beneficiaries, based on the fact that because the restriction eliminates one competitor if it cannot self-deal.

We came up with an annual cost to the investors of somewhere around $40 million or so. I went down to Washington to present that study, and that was probably the shortest meeting with regulators I ever had. The ERISA folks said, "Small price to pay." And thinking about it, they were probably right. Reducing risk is rarely free, and this was no exception. So, I think if you look at remediation issues such as higher capitalization and leverage limits against the damage avoided under stress conditions, whatever it is, it's likely to be a small price to pay.

In terms of the actual sources of the crisis, if you look at the financial architecture that led up to it, there are really no white hats. In retrospect, this becomes clear by considering the macro-policy drivers, the gaps in the regulatory overlay, the origination process, and lack of due diligence in what turned out to be toxic asset classes with respect to valuation, debt servicing in the mortgage sector, the actual loan booking, the securitization process, the sales and trading and structuring, the rating process and eventually the due diligence exercised by investors. If one simply draws a flow of funds diagram of the financial architecture and its functioning as opposed to focusing on the institutions involved, and then put a big black dot on where the failures were, it looks like smallpox. There were lots of failures in lots of financial functions. The failures had to do with information flows. They had to do with risk taking. They had to do with incentive systems – the role of fees and volume-dependent remuneration as opposed to results-dependent remuneration – and the like.

So one looks back at the prevailing financial architecture and its shortcomings prior to and during the financial crisis, what did the large, integrated universal banks actually add to the picture? I could argue that could have been relatively marginal. We could have easily had a structure which had the same results without them. Even assuming Glass-Steagall[7] had still been in force after 1999, and we had the same sort of confluence of factors, macro drivers, complexity, information gaps, market microstructures and the like, would the results have been very different? Maybe not. There have been plenty of financial panics in history without large banks. Regardless of structure, when everyone moves in the same direction at the same time, the results and the search for effective remedies can be daunting. The fact that large, complex, interconnected financial firms exist whose failure is unacceptable simply means that most efforts to improve systemic robustness by changing the rules of the game will necessarily focus on them.

Saltzman: Before we go to the other side, why do you think perception and reality is so different? Because if you talk to the man on the street, they wouldn't agree with you. They'd say, "Yeah, it's the big banks that caused the crisis. It's the big banks," and to a certain degree, whether it's true or not, that's fueling the populism that's driving a lot of regulatory reform. So, how do you explain that, and also your thoughts on the government's reaction and whether or not that, in fact,

7. Glass-Steagall Act, Pub. L. 73-66, 48 Stat. 162 (1933), *repealed by* Gramm-Leach-Bliley Act, Pub. L. 106-102, 113 Stat. 1338 (1999) (codified in scattered sections of U.S. Code).

exacerbated the moral hazard problem before we turn it over to these gentlemen.

Wilmarth: Well, number one, the largest banks are extraordinarily visible. Number two, there is a widely-shared perception that they benefit from a government-sponsored safety net and are too big to fail. Government support for the largest banks during the crisis caused many citizens to conclude that the government followed an asymmetric policy that allowed Wall Street firms to socialize losses and privatize gains. The post-crisis reaction by many bankers has failed to acknowledge this reality. Many people I have talked with are resentful because they believe that top executives of major banks have learned absolutely nothing from the financial crisis. At the end of the day, you also have a widespread public perception that Wall Street is engaged in a rearguard action to prevent effective financial reform, and that Wall Street's efforts are likely to succeed. As a result, many critics of the largest banks have concluded that we're simply waiting for the next big shock to occur. That's the public perception of the largest Wall Street institutions as I have understood it. I'm not saying it's necessarily the reality as to what bankers intended.

Saltzman: No, I understand. Gentlemen, if you want to respond.

Dugan: Okay, well I'll lead off, and Phil may want to add a couple of points. I agree with some of the things Ingo said, but my take is a little bit different and I wanted to make three fundamental points. First, I think that large regulated bank holding companies were not the main the cause of the financial crisis. Indeed, I would say the crisis primarily began outside of commercial bank holding companies in companies that were either less regulated, less diversified, or much more vulnerable to loss of confidence and failure, especially where there was excessive reliance on wholesale short-term funding. So, I'm thinking now of the names that started the crisis – Countrywide, Bear Stearns, Fannie Mae and Freddie Mac, Lehman Brothers, AIG, Merrill Lynch, and WaMu. And yes, of course, there were exceptions, most notably Wachovia earlier on and then others later.

But in the vast majority of cases, large, diversified, and regulated bank holding companies fared better than others with the same business models that were far riskier. And the regulated bank holding companies often acted as shock absorbers during the crisis to dampen the effects of the crisis by acquiring other troubled financial institutions. So, I'm thinking now when J.P. Morgan acquired Bear Stearns and WaMu, Bank of America acquired Countrywide and Merrill Lynch, Wells Fargo acquired Wachovia, although obviously, in some cases, these acquisitions turned out to cause big problems later for the regulated bank holding company.

Also, some big nonbanks avoided even bigger problems by becoming regulated bank holding companies at the height of the crisis, reflecting the value of market confidence in regulation and stable funding structures, more stable funding structures. Just as an aside, because this comes up all the time, many of these stabilizing acquisitions and conversions could not have been accomplished if Glass-Steagall were still in effect. Rather than causing the financial crisis, as some have asserted, the Glass-Steagall Act repeal actually helped dampen its effects by allowing these combinations at a very critical moment. So, that's point one.

My second point is that the too-big-to-fail policy – as problematic as it was, and it really was – did not *cause* the financial crisis. Yes, the fact that some very large institutions were bailed out, while smaller institutions were not, was grossly unfair – and it created huge political and public relations damage for banks, which we're still living with.

And yes, since too-big-to-fail really has proven to be a reality, it has to be fixed because it has caused real moral hazard that needs to be dealt with in the future. But I don't think there's any persuasive evidence that the perception that the largest financial institutions were too big to fail actually caused the crisis. Their funding was not appreciably lower than the funding of other institutions leading up to the crisis. Funding was cheap for everybody, including for smaller institutions that were proportionally much bigger users of insured deposit funding. That's point two.

The third point I want to make is that while there were many causes of the financial crisis – including low levels of common equity, ridiculously loose mortgage underwriting standards, and terrible liquidity risk management – I would say the uneven regulation of our largest financial institutions was a much bigger cause of the financial crisis than too-big-to-fail. In particular, too much of our outdated regulatory regime focused on regulating commercial banks and too little of it focused on the big nonbank financial companies that were using their big new balance sheets to extend credit like banks, but were not regulated the same way. So, nonbanking companies like Bear Stearns, Lehman Brothers, and Merrill Lynch had much lower capital requirements, much more runnable wholesale funding, and much less on-site regulation and supervision than large, regulated bank holding companies – and that lack of supervision was similarly problematic for AIG.

These and similar nonbank companies were the most vulnerable to problems and this is where the crisis first mushroomed. Now, that's not to say that the larger commercial bank holding companies were free of problems, because they obviously were not, and one very big problem was that the nonbank trading subsidiaries of these companies were not subject to the same level of regulation as the bank. That was a deliberate design of federal policy, but it was a misguided federal policy.

Moreover, the more aggressive and riskier practices of large nonbanks put tremendous pressure on banks to loosen their standards to meet the competition because of this fragmented regulatory system – and they did loosen their standards in ways that caused damage later.

In sum, though, when it comes to the biggest institutions, the fundamental lesson of the financial crisis is *not* that the regulated bank holding companies engaged in the riskiest activities and presented the biggest risks to the financial system. Instead, it's first, that all large systemically important institutions that are engaged in similar activities need to be subjected to comparable, intensive bank-like supervision. Second, all these institutions need to play by the same rules when they engage in the same activities. And third, the rules applicable to all these institutions need to be stricter than they were leading up to the crisis, including: higher required levels of common equity and liquidity; increased transparency; minimum underwriting standards in certain cases; and reduced risk from derivatives activities.

Swagel: I'll add a few words agreeing with John and with much of what Ingo said, and then will disagree with the proposition. I've taught a course on the financial crisis along with a former colleague from Treasury, sort of the view of two people who saw it from the inside. One of the points that I make in the course, which I think is relevant for the proposition, is that the striking thing about this crisis is how many things failed. It's not like one thing failed and the system blew up as a result. It was from top to bottom – the asset managers who bought subprime MBS without knowing what was in it or asking for disclosure; the securitizers, the rating agencies, the bond insurers; the GSEs; everyone from top to bottom of the financial system, including, I would say, the home buyers who lied on their loan applications or signed on the dotted line, even if they didn't lie, for a home they could never really afford.

This doesn't excuse the mistakes made by the large financial firms, but it's striking at how many things went wrong. And the other observation is that of the items on my list of things that went wrong, it's striking how many of those are not fixed or are not addressed by Dodd-Frank.[8] That's what I think is too bad.

Saltzman: Art, do you want to respond?

Wilmarth: Yes. I have a few points. There's no question that the shadow banking system played a huge role, and that nonbanks played a huge role, but it is important to ask, who was funding those institutions? The nonbank institutions were, in very large part, being funded by the largest securities firms and the major bank holding companies. When the subprime problems began to emerge in late 2006 and early 2007, large banks and large securities firms immediately cut off their warehouse lines of credit and nonbank lenders like New Century Option One and Ameriquest promptly went out of business. As a practical matter, they were nothing more than conduits for producing the nonprime mortgages that large Wall Street securities firms and major banks wanted to securitize and distribute.

For example, if you look at the list of creditors for New Century, as shown in its bankruptcy filings, the largest banks and the biggest securities firms were among the largest creditors for New Century.[9] So, to say that the largest banks were not deeply involved in

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8. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of the U.S. Code).

9. *In re* New Century TRS Holdings Inc., No. 07-10416 (Bankr. D. Del. 2007).

the housing bubble through their warehouse lines of credit fails to allocate an important part of the responsibility where it's due.

You also have to look at the history of Citigroup. Citigroup has been in the center of every major crisis since the 1970s. For example, the dotcom-telecom bust in the early 2000s (including the Enron and WorldCom scandals) told us everything we needed to know about the risks of the new universal banking franchises. Most of the large, complex financial institutions that were involved in funding the housing boom were also implicated in the Enron and WorldCom debacles as well as the market-timing and other trading abuses involving bank-sponsored mutual funds. However, policymakers apparently didn't learn anything about those risks despite a very serious stock market crash which destroyed $8 trillion of investor gains. That stock market crash caused Fed Chairman Alan Greenspan to cut interest rates in order to pump up the housing market in an effort to make up for the loss of wealth from the dotcom-telecom bust.

We also should have learned from the collapse of Long-Term Capital Management during the Russian debt crisis of 1998. Instead, the Fed's response to that crisis, both in terms of flooding the market with liquidity and arranging a rescue of Long Term Capital Management, led many people to believe that large nonbank institutions were now within the scope of the too-big-to-fail doctrine. That assumption proved to be largely correct during the recent financial crisis. I think that's one reason why the failure of Lehman Brothers was such a shock. Lehman's bankruptcy was a shock to the financial system because most people thought (especially after the Fed's rescue of Bear Stearns) that the too-big-to-fail doctrine covered large securities firms as well as major banks. In my opinion, when you look at the history of Citigroup, Wachovia, National City, and Bank of America, you have to conclude that several of the largest, diversified, complex financial holding companies had major commercial banking units that were deeply implicated in both the housing bubble and the financial crisis.

Saltzman: Art, I want to clarify one thing. Bigger hospitals have more people die in them, so the reality of it is that larger financial intuitions, to the extent that they are performing their credit-intermediation function, will by definition have a larger role in any bubble. But that's not the point. The point is, is that role pernicious? Is it problematic?

Wilmarth: Let's look at the extraordinary assistance that was given to the largest banks. More than $200 billion of capital assistance was given to the nineteen largest financial institutions. Hundreds of billions of dollars of Federal Home Loan Bank advances were given to several of those banks. Trillions of dollars of liquidity assistance were given by the Federal Reserve System to most of those banks. More than $200 billion of debt guarantees were given to the nineteen largest banks by the FDIC. The largest banks received extraordinary assistance. We shouldn't be surprised that they didn't fail. They weren't allowed to fail. Without the assistance given through capital infusions, through liquidity provisions, through asset guarantees, we know that a number of those institutions would have failed, and we would be talking about them in the way that we now talk about Lehman, New Century or WaMu. When people say that the largest banks weren't at the center of this crisis, that claim is incompatible with the extraordinary assistance they received. Why was that assistance given? It was given so that they wouldn't fail. I don't know how much more candidly to put it than that.

Swagel: It's great to hear someone applaud the TARP,[10] to say the TARP worked.

Wilmarth: Oh, I'm not against TARP. I think it's regrettable that we got to the point we had to use it.

Dugan: Wait. I think you're missing one important point. You say they were given it as if it went away and never came back, but of course, all that money from the banks got paid back and in fact, the federal government made a profit on its TARP investments in banks.

Wilmarth: But all of that assistance amounted to catastrophe insurance, which was given by the government at a point during the crisis when those big institutions could not have gotten help from anyone else.

10. Troubled Asset Relief Program (TARP), Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (codified in scattered sections of the U.S. Code).

Dugan: I'm not denying that.

Wilmarth: If the government acts as catastrophe insurer for the largest financial institutions, that function creates an enormous moral hazard because the government is effectively saying, "when you get into deep, deep trouble and the market won't fund you, we will come in and give you literally trillions of dollars of funding to keep you alive until things are stabilized." And that extraordinary assistance also amounted to underpriced insurance.

Dugan: But of course, that's what governments do.

Wilmarth: Right.

Dugan: And that's what central banks do and that's why liquidity is provided to any modern financial system. Otherwise, we would have institutions operating with such high levels of capital and provide such little amount of liquidity to the system that you wouldn't have economic growth. So, no one's saying that the biggest regulated bank holding companies didn't have a significant part to play in the crisis. I'm just making the point that they were not the primary causes of this financial crisis, and while they in many places did things to help dampen the effect of it, it eventually came back to roost on its books and they had big problems, the whole world erupted and it wasn't just them, it was the entire financial system that was in stress at that point.

Saltzman: Art, go ahead.

Wilmarth: There were eighteen large complex financial institutions in the world that, in my view, were the primary private sector catalysts for this crisis. We had a debt boom, both in this country and abroad, that we've not seen since the 1920s. In this country, private sector debt went from $10 trillion in 1991 to $40 trillion in 2007. We quadrupled private sector debt in sixteen years. That was the same time period when you had this enormous uprush of securitization and you had this enormous distribution of highly-rated, high-yield securitized debt to investors who were misled as to the risks inherent in that debt.[11]

11. *See* Arthur E. Wilmarth, Jr., *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-to-Fail Problem*, 89 OR. L. REV. 951, 963-71 (2011).

Saltzman: Art, why isn't it just a public-policy macroeconomic failure?

Wilmarth: Oh, I agree. The regulators should have stopped it.

Saltzman: But why are you pinning it on the banks?

Wilmarth: Well, I'm not blaming the banks entirely. But who was generating that debt and securitizing it?

Saltzman: But that's their role and their function.

Wilmarth: The question I would ask is, if bankers felt (as they reportedly did) that they were originating this debt because they were going to package it up and sell it to investors and that debt was not going to come back to haunt them – in other words, they didn't really expect this debt to be repaid at maturity, but they expected it to be paid long enough to securitize and sell it – my view is that I would have hoped the industry would say, "That's not a model that makes any sense." The originate-to-distribute model for high-risk debt didn't make sense because it blew up credit markets around the world, and, eventually, the collapse of those markets came back to haunt the banks. As Ingo pointed out, banks weren't able to get all of the securitized debt out of their production pipelines even as it was. Unfortunately, bankers were tempted to use the originate-to-distribute model because it seemed to promise that banks could generate large fees, that banks could sell the securitized debt to investors, and it wouldn't come back to haunt them, but it was fundamentally an unsound business model.[12]

Now, I do blame the regulators for not acting – in my view, they must have seen the flaws in the model but they didn't stop it.

Saltzman: But the fact of the matter also is, when I was at the Bond Market Association, Alan Greenspan gave a speech on the virtues of securitization because it diversified risk. And so, again, with the benefit of hindsight, it's very easy to be critical of something. But at the time, as I think John said, securitization was viewed as a way to funnel liquidity to places where it couldn't otherwise go. Now,

12. *See id.* at 971-75.

obviously – again, with the benefit of hindsight – you're right, an originate-to-distribute model was a material factor. But at the time this was something that was supported by our country. It had bipartisan support. Republicans and Democrats supported it, so I go back once again to the premise: why is it that large banks are being singled out as an undue cause of the crisis to motivate a series of policy reforms that – at least it's debatable whether it's beneficial or not? So, that's really the question that I'd like to hear a little more about. Phil?

Swagel: To an economist, you look at both supply and demand, not supply or demand. And so, when people decry securitization, it's always puzzling to me because it seems like it's looking only at supply and people say that the supply side of credit caused the problem. And I say, "Well, I have to look at the demand side as well," since there are failures on both sides.

Wilmarth: Let me give you two very homespun examples. How many credit card solicitations were you getting in the mail during the bubble? How many are you getting now? I mean every day I would receive five or ten credit card solicitations. How many stories have you heard where subprime option ARM mortgages were literally pushed on people? And when the borrowers made statements like, "Well, I can't pay the full amortized rate," they were told, "Don't worry. We'll refinance you before the teaser rate runs out, and don't worry, home prices go up forever, so you can always refinance." In my view, that's not the way credit should be originated or sold to investors.

I agree that it's hard to maintain prudent lending and securities underwriting policies when other institutions are following a "devil take the hindmost" policy, but I believe the role of top executives of major banking institutions is to say, "We are not going to follow that model. That model leads to disaster. We're going to be the ones left standing when everybody else collapses." I agree that the regulators – and Greenspan is right at the top of my list – should have stopped the nonprime lending boom and clamped down on unsound lending and underwriting practices. But I think top banking executives should have said, "This is a model that makes no sense to me, and I'm not going to pursue it. I'm going to be the one left standing when my competitors have failed." Apparently, Jamie Dimon did take that approach.

Saltzman: One second. I'd like to get Ingo in, and then we'll go to John and then we'll move on to the next proposition.

Walter: Just a slightly different angle on this: I'm always impressed with the difference in performance of individual firms within your category of large, complex financial institutions during the crisis period. How do you explain J.P. Morgan versus Citi? How do you explain UBS versus Credit Suisse? How do you explain Royal Bank of Scotland versus Barclays? They were each subject to much the same market dynamics, much the same regulatory gaps and inconstancies, etc., that you were describing. And yet they performed vastly differently. So, one of the things we did, responding to one of the comments you made earlier, is simply to take a look at the deal-flow in terms of the actual market shares and compare that with the losses booked as a result of revaluing toxic asset holdings. And then we did a rank correlation of market shares against the write-downs at time intervals. The correlations are extremely low.

So, market shares and the volume of deal-flow fails to explain the difference in performance of the individual competing firms. Rather, the explanation of losses had to do with specific management decisions regarding pipelining and warehousing, and these decisions in turn were probably traceable to the board level decisions. It's very hard to take these institutions, lump them together as a unified group for better or for worse. They're not. They're very different and idiosyncratic. And besides the regulators, and I think the Congress, which has been very reluctant to take responsibility for any of this – even more so than the banks – has to bear a share of blame in terms of the government processes and institutions involved.

Saltzman: John?

Dugan: First of all, I do not think that the originate-to-distribute model is inherently a bad model. I mean, I think there are plenty of good things about securitization markets to this day that still fund credit in the United States in very responsible ways. There were particular problems that needed to be addressed, for sure, particularly with the structured credit markets. But to say that the whole originate-to-distribute model is faulty, I just fundamentally flatly disagree with that, number one.

Number two, on the mortgages, the worst mortgages in the system, the ones that had the worst characteristics – these were ones that really were made outside of the commercial banks, the regulated banks that were making loans with higher underwriting standards. I know at the OCC, for example, we put out policies and we really pushed the payment option mortgages out of the national banking system. The problem comes back to something I talked about earlier, which is that you had a very uneven set of rules that different players were playing by. And you had one old part of the system where there was more regulation and another part where there wasn't, and it wasn't working in a world that had become less about what banks did with traditional intermediation.

Saltzman: I'm going to ask one last question before we move on to the second proposition and violate a pretty core axiom, which is "Don't ask a question you don't know the answer to." But what's the current thinking with respect to the Canadian banking market? There you have five or six large banks, certainly on a relative basis – I think even exceeding the GDP relationship to the United States – yet they, at least the perception is, came out okay. Is it a regulatory situation? Is it just they bet the right way? What's the analysis in that regard?

Walter: The Canadians get very high marks, along with a few others. The normal answer you get is better regulation, more thoughtful assessment of the financial intermediation process, and these are large institutions with large businesses outside Canada as well. And basically, better governance and management.

Somebody in Toronto in a meeting corrected me and they said, "No, it's an oligopoly." So you have five firms, by the way, who had proposed mergers, so there would have been three if the merger hadn't been rejected – when was that, about ten years ago or more? That basically what you do is you have very, very fat margins, intermediation margins, that allows you to have adequate capital and adequate profitability, and if we hadn't had this oligopoly here in Canada effectively screwing the end user, we would have had the same problem as the Canadians.

Saltzman: But we need a rebuttal on that quickly. Quick, John, help me out.

Dugan: Yes. Well, one is, I don't think that they were as central to the nontraditional funding in capital markets in New York and around the world as some of the other firms that we've talked about. So, that's point one. But I think a big thing that is really quite interesting and where they were much more successful is their residential mortgage market. The fundamental difference is that, unlike in Canada, in the United States we are obsessed with the thirty-year fixed-rate no prepayment penalty mortgage, and banks do not want to hold that on their balance sheet. It is uneconomic. It is so difficult to hedge. It's not considered a bankable asset. Whereas in Canada, they don't have that model.

They have shorter fixed-rate periods, they have prepayment penalties, they do have some government involvement through an insurer that guarantees part of the risk and that sets common minimum underwriting standards across the board. But as a result of the way their system is structured, their banks love to hold mortgages on their books. It's extremely profitable, not just for the biggest banks, but for the thousands of credit unions that operate in Canada. And it is a model that we ought to be looking to as a country as we try to figure out how we're going to get out of this because as long as we cling to a thirty-year fixed-rate no-prepayment-penalty mortgage, you have to have institutions like Fannie Mae and Freddie Mac to help provide the kind of funding structures that make that work.

Saltzman: Let's go to the second proposition. Whether or not it's true is obviously debatable, but, certainly, there's the perception that large financial intuitions are too big to fail. The proposition before the panel is as follows.

The Dodd-Frank Act ended too-big-to-fail and successfully mitigated or reduced the probability of failure of large banks and nonbanks.

So we'll go to Professor Swagel first.

Swagel: Thanks very much. I'll talk for a few minutes and then turn it over to John. I'm going to agree in part and disagree in part. Dodd-Frank did not end too-big-to-fail, so there's the disagreement, but there are some provisions in the legislation that certainly will be helpful for avoiding future problems, for detecting the future problems, and then especially for dealing with them as they arise. As we all know, there are many aspects to the legislation. I'm not going to talk about them all, but instead just highlight a few.

In terms of avoiding the problem, the additional capital and liquidity requirements in the legislation and through the Basel III process will both help. I don't think that another couple percentage points of capital and then Lehman and Bear Stearns wouldn't have failed. This is not enough to say it will never again happen. But obviously, better capital and more robust access to liquidity will help firms survive and bolster confidence in them.

Within the Dodd-Frank legislation, I'd say that the crown jewel of Dodd-Frank is the FSOC, the Financial Stability Oversight Council,[13] which will help authorities detect building problems in ways that were not done previously. Even though it's the same group of regulators, giving them a charge, will help avoid the AIG problem where really no one was in charge of the financial products activities that were taking place in London.

The OFR, the Office of Financial Research,[14] could also be helpful. It's hard to know how exactly that will work and one could imagine the OFR asking for too much information and being somewhat burdensome just as a natural response to not having existed before, but, hopefully, that pendulum will swing and they'll find the right place. The derivatives piece of the Dodd-Frank legislation could help as well by increasing transparency. John will talk more about derivatives.

Let me talk about the resolution authority, which will help dealing with a failure of a large financial institution and somewhat get at the too-big-to-fail problem. I have a couple of big picture observations. One is that I think it's one-hundred percent certain that the resolution authority in Dodd-Frank will be used. If a large financial institution gets into trouble, say if the state attorneys general, "succeed," inadvertently so to speak, whichever firm gets in trouble will be put into resolution. I think there's not going to be another TARP in the lifetime of anyone in this room or possibly in our children's lifetimes, and the

13. *See* 12 U.S.C. § 5321 (Supp. IV 2010) (establishing the Financial Stability Oversight Council).

14. *See* 12 U.S.C. § 5342 (Supp. IV 2010) (establishing the Office of Financial Research within the Department of the Treasury).

Fed is not going to do a Bear Stearns-like transaction. Obviously, the legislation itself seeks to avoid that. But even if it didn't, they wouldn't.

Saltzman: Phil, let me interrupt you there, because now I don't understand. You started off your discussion by saying Dodd-Frank did not end too-big-to-fail.

Swagel: I'll get there.

Saltzman: Then for the next ten minutes, you gave all sorts of reasons why you think it will.

Swagel: I'm getting there. Don't worry.

Saltzman: I love playing professor with all the professors, to get back from that D-minus I got in . . .

Swagel: We're available for bar mitzvahs and weddings.

Saltzman: Right.

Swagel: Okay, so that's number one. Number two is that the authority would have been used if it had been available for Lehman and that's both good and bad. I think anyone who reads the James Stewart article in *The New Yorker* from a few years ago[15] would immediately come away seeing that it would have been used and there was considerable talk within the Treasury between Bear Stearns in March and September with Lehman about would it be possible to get some sort of authority, and obviously, the realization was that, no, it wouldn't be.

But I do worry about the problems with the resolution authority, and very briefly, the problems are that the authority is so broad for the federal government to put money in to a firm and have the bondholders of the financial institution on the hook for any costs through the retroactive clawback provisions.

I look at what's going on with the GSEs, where there is an effort by the government to use the GSEs to pay for policy steps knowing that

15. James B. Stewart, *Eight Days: The Battle to Save the American Financial System*, THE NEW YORKER, Sept. 21, 2009.

the Treasury will pay back that money to the GSEs, and so it's really a fiscal action. I have the same worries with the resolution authority, that the regulator, perhaps well intentioned, will see the firm in resolution as an opportunity to put into place policy steps knowing that they'll be paid for by the bondholders.

Saltzman: So is your main point that there are structural flaws in Title II or that, when the time comes, we won't have the political will to follow it through?

Swagel: When there's a blank check in front of the person at the head of the agency, I think it's going to be really tough for her or for him to avoid using that blank check.

Saltzman: John?

Dugan: So, I agree with the basic thought that Dodd-Frank and Basel committee reforms have significantly reduced the probability of failure of a really big firm, primarily through much higher common equity capital requirements and liquidity. I think over time, there will be – it's been controversial, but I think the movement of derivatives to clearinghouses and exchanges will result in less risk being taken by big banks, and I think that will also reduce the probability of failure. And I think the living will process will cause some simplifying reforms that will reduce the risk of failure as well.

But on the bigger question, I think the more fundamental question is did it end too-big-to-fail? It's my take that it made some very big strides to address too-big-to-fail. It eliminated financial assistance for open institutions. If you want to use Title II of Dodd-Frank, you have to close the institution. Secondly, the taxpayers cannot by law be made to pay for the losses of a big firm. They have to be borne by either the shareholders or the creditors, or in extraordinary situations, other SIFIs[16] through after the fact assessments.

I think there are new tools provided to the FDIC to make a

16. Dodd Frank Wall Street Reform and Consumer Protection Act § 204(a)(1), 12 U.S.C. § 5384(a)(1) (Supp. IV 2010) ("creditors and shareholders will bear the losses of the financial company"); Dodd Frank Wall Street Reform and Consumer Protection Act § 210(o), 12 U.S.C. § 5390(o) (Supp. IV 2010) (empowering FDIC to collect "risk-based assessments" from SIFIs to repay loans incurred in liquidating a covered financial company).

resolution more orderly. There is a fighting chance that it can be done in a way that would be much less likely to cause the kind of contagion we saw with Lehman Brothers. And in particular, there is new ability, it's not very well popularized, but it's something that the industry and the FDIC have been working a lot on. There's new ability to do in the resolution setting in a closed bank something that looks a lot like a prepackaged Chapter 11 debt for equity reorganization, with two fundamental differences. One, because of the awesome Title II powers that Phil referred to that make people nervous, the FDIC can do this a lot faster than it could be done under the Bankruptcy Code – and speed is critical for financial companies that have short-term funding and depend critically on the swift restoration of confidence. And number two, because financial intuitions, when they get into trouble, it is so critical that they get funding, the bill does provide for emergency funding from the Treasury Department, which essentially allows the prepackaged reorganization to go forward until market confidence and market funding return.

I also think there's a lot more flexibility than people realize to protect short-term creditors in a problem situation, the kinds of creditors that would not only run from that institution, but would trigger other kinds of runs by similarly situated creditors in other institutions.

So, I think all of those things do make it much more likely that we will see an institution closed rather than bailed out, and that it can be done in a more orderly way, particularly if it's a one-off situation involving a single firm that gets into trouble.

Saltzman: Do either of you believe MF Global is a case in point to support the proposition that we have now accepted a big-firm failure as simply a normal part of capitalism?

Dugan: I don't.

Saltzman: Or is it not big enough?

Dugan: Not big enough.

Saltzman: CIT came closer, I would say.

Dugan: Yeah. Not big enough.

Swagel: Yeah. I voted for the TARP capital injection into CIT. That was a mistake.

Dugan: But having separately said, if you have a wave where there are a bunch of institutions getting hit at once, I think it's a different thought. And there are still tools to do programmatic things of the kind that Art was criticizing a minute ago to inject liquidity into the system, to prop up the system, or programmatic capital – liquidity funding programs that the Fed can do. But I think it is quite dangerous that Dodd-Frank said that the FDIC cannot guarantee the new debt of healthy firms in a crisis without getting Congressional approval, because I think it's going to be very hard to get that – and that was a critical step that was taken in October of 2008, not just in the United States, but by governments around the world. That new constraint really does make me nervous.

I also think there are still very significant problems with the lack of compatible resolution regimes in other countries; so a cross-border failure is still a problem. The FSB, the Financial Stability Board, knows this, is committed to addressing it, and I think we can make progress on it. But we're not there yet. And so, until we do, we're not going to really address that problem.

Saltzman: Ingo? Art? Your thoughts?

Wilmarth: I think there's a fair bit of agreement on this issue. I agree that Dodd-Frank did a number of good things, in terms of enhancing supervision, improving procedures for coordinating supervision, trying to avoid the falling between the stools problem that we had before, and getting a better overall sense of what the risks are. And I think the orderly liquidation authority is an improvement over what we had before, but I don't think that it comes close to ending too-big-to-fail. John and Phil have pointed out some of the remaining problems.

One major issue is the too-many-to-fail problem, a term which is not my coinage. The problem is that when one of these very large institutions gets into trouble it's almost always a systemic episode. As Ingo has pointed out, some institutions get into worse trouble than others, but usually when one of these very large diversified institutions gets into trouble, its problems are shared by several others, whether because of a herd mentality or otherwise. Many analysts have really struggled to see how the government could put several of these very large institutions into an orderly liquidation process and turn them into what Fannie and Freddie have become, essentially extended hospitalization cases.

I agree with John that the prepackaged bridge-bank approach under Dodd-Frank is a much better resolution procedure than we've had before for large financial holding companies. However, the bridge-bank concept tends to encourage the government to protect all of the short-term creditors instead of making short-term creditors take haircuts. What that approach will do, in my opinion, is to repeat what happened during the financial crisis. In other words, as institutions get into more and more trouble, their long-term creditors won't roll over their credit and the institutions' liabilities will become shorter and shorter term. In fact, the FDIC has already said in its recent orderly liquidation rules that nobody with liabilities having a maturity of more than 360 days will be protected under the orderly liquidation authority against a haircut. Accordingly, if creditors think a major bank is in trouble, creditors are only going to buy their 90-day or 180-day commercial paper or their short-term repos. Creditors will not buy their long-term liabilities. As a result, the orderly liquidation rules will tend to make the big troubled institutions even more fragile and more vulnerable to liquidity runs.[17]

In addition, there are still major sources of assistance available to the largest institutions. The Federal Home Loan Bank System can still provide lender of next-to-last-resort help through its advances. The Fed can still use its discount window to provide liquidity assistance to individual institutions. Previously, there was always a stigma attached to use of the discount window,[18] but if it's the only source of assistance available to individual institutions, I don't think stigma is going to stop large troubled institutions from seeking discount window loans during the next crisis. In addition, as John pointed out, if multiple large institutions are in danger, the Fed can create a systemic liquidity assistance program under amended Section 13(3) of the Federal Reserve

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17. *See* Wilmarth, *supra* note 11, at 997-99.

18. For a discussion of this stigma, see Amantier et al., *Stigma in Financial Markets: Evidence from Liquidity Auctions and Discount Window Borrowing During the Crisis* (Fed. Reserve Bank of N.Y. Staff Reports, Staff Report No. 483, Jan. 2011), *available at* http://www.newyorkfed.org/research/staff_reports/sr483.pdf.

Act.[19] For example, the Fed could say, "we think all primary dealers need help, and we're therefore going to create a Primary Dealer Credit Facility like we did during the last crisis." So, if enough big institutions or a really huge institution gets into trouble, I do not believe that regulators will choose to break up those institutions in a manner similar to Chapter 11 of the Federal Bankruptcy Code.[20]

I would point to two recent episodes that indicate the continuing strength of the too-big-to-fail policy. First, when Dexia got into trouble, the first thing the French and the Belgians did was to make sure that no depositors and no bondholders would lose any money. The Europeans were determined to prevent such losses in order to avoid any broader panic, because they knew that Dexia was not the only large European bank in deep trouble. Second, why did the Fed allow Bank of America to transfer all of its derivatives into its subsidiary bank, which greatly increases the risk to the Deposit Insurance Fund (and taxpayers), but at the same time gives Bank of America tremendous advantages in terms of a lower cost of funding for those derivatives and lower collateral requirements? The derivatives transfer by Bank of America shows me that the too-big-to-fail policy is still alive and well in this country. Regulators allowed a large body of exposures to move from a securities subsidiary that is more insulated from taxpayer-funded bailouts to a bank subsidiary that presents a much more direct threat to taxpayers. So, even in the current day, we're seeing regulatory actions indicating that, unfortunately, the too-big-to-fail policy is still a reality when we're in a crisis and large institutions are weak.

Swagel: Can I just ask as a factual question, didn't the FDIC approve that?

Wilmarth: That's an interesting issue.

Swagel: That's part of the Dodd-Frank legislation; the FDIC is required to approve it.

Wilmarth: I've heard that the provision of Dodd-Frank requiring FDIC approval hasn't taken effect yet. However, if the FDIC

19. *See* Federal Reserve Act of 1913, 12 U.S.C. § 343 (Supp. IV 2010); Wilmarth, *supra* note 11, at 1001-05.

20. 11 U.S.C. § 1101 *et seq.*

did approve the transfer by Bank of America, I have to believe that the FDIC acted under considerable duress. If the FDIC felt compelled to approve the transfer in order to help Bank of America, it doesn't give me much comfort as a taxpayer.

Dugan: But let us be clear, the taxpayer is not exposed under Dodd-Frank because you can't have the taxpayers paying for it, by law. And I think we learned in the crisis, when you get to this stage, the distinction between the bank and the holding company is not really a big one. And so, I think there is a whole question about the funding model derivatives that have always been provided by banks. It's been a bank-centric business since its beginning. The derivatives that were funded by derivatives dealers in the banking system, as opposed to the AIG's one-sided bets, actually performed quite well during the crisis, and, generally, did not cause big problems or risks in the banks.

Saltzman: Art, let me just ask you a question to move the conversation along. What do you believe needs to happen to end too-big-to-fail?

Wilmarth: I have proposed a "narrow bank" approach that is quite similar to the "ring-fencing" concept proposed by the Vickers Commission (Independent Commission on Banking) in its recent report to the U.K. government.[21] Under the Vickers Report, you would rigorously separate the utility side of banking, including the payments system, the deposit taking, and the small business lending, from more risky activities related to the capital markets. You would create an absolute firewall that would segment off all of the capital markets activities, including derivatives. Only the utility side of the banking organization would be protected by deposit insurance.

Saltzman: Wait; let me interrupt because that dialogue I do want to save for the third proposition. So, your answer is that we can't and that, therefore, we've got to mandate structural changes that mitigate the impact?

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21. INDEPENDENT COMMISSION ON BANKING, *Final Report Recommendations*, Sept. 2011, http://bankingcommission.s3.amazonaws.com/wp-content/uploads/2010/07/ICB-Final-Report.pdf [hereinafter *Final Report*].

Wilmarth: We need reforms that will make creditors believe that the government has made a binding and credible commitment to impose haircuts on all creditors (except for depositors) if a major financial institution fails.

Saltzman: So you are of the view that too-big-to-fail just cannot be changed statutorily, or politically, and that structural change really is required? Do you guys agree with that?

Dugan: No, I don't agree with that. And I will tell you what was interesting to me in the crisis, people talked about Citigroup, and I don't like to talk about individual firms, but this is sort of a historical piece of it. What happened to Citigroup and how it got out of the crisis was a slow motion version of the type of recapitalization or reorganization that the FDIC now has the power to do much more swiftly under Dodd-Frank. Essentially, in Citi's case, it diluted the shareholders dramatically, and the stakeholders that were above them in the capital chain were forced to become equity holders, and it was a very precarious long-term process, but it was a capital reorganization that occurred. And there's no reason why you couldn't do that in a much more systematic way under Title II in [a] way that will haircut creditors. But it doesn't have to be the international calamity that Lehman Brothers was.

And let's not forget, when WaMu failed, although not everybody agrees with this, it was not as complicated. They did have subordinated debt-holders that took haircuts and a lot of people think that that was not the end of the world. So, there were institutions that failed during this crisis that inflicted haircuts on creditors, absolutely.

Saltzman: Let's move into the third proposition and sort of mix it all up:

Large, systemically important commercial banks are inherently too large, and too complex, and too interdependent to resolve and also do not provide any meaningful benefits to society. Therefore, firms should be forcibly broken up by government into smaller entities or ring-fenced into entities that are less complex, less interdependent, and less universal.

And I'd also like the panelists to debate not just the stark remedy of ring-fencing or breakup, but the more subtle "death by a thousand cuts," which is essentially an undergirding policy—whether it's SIFI surcharges, FDIC premiums, each individual, siloed regulatory form—that has the effect of crunching down asset size, reducing balance sheet, and effectively disincentivizing asset growth. So the proposition itself is stark, but the reality of what's happening is something more subtle. Ingo, you're kicking us off on that one.

Walter: Well, I still have some shares in a number of these firms. I keep them only for sentimental purposes, and also, so that I can give my lectures and tell the students that I have personal exposure to the industry. But my shares haven't done all that well. Right now, if you take the population of SIFIs, basically they're trading at half of book value. You don't see that very often in any industry. And if you take one [of] the big global players that dominate world wholesale finance and add up their market values, they are trading at maybe fifty-eight percent of book value. Shareholders have suffered enormous punishment over the period, and bank investors won't soon forget how badly they have been hurt. So in terms of punishing the correct people, owners of financial firms at the center of the hurricane, then many of the correct people were in fact punished, and this should demand a clean sweep of the senior management and board members involved. Has this happened? Only in part.

If you look next at this population of large, complex financial firms in terms of their EVA – which is basically return on equity minus cost of capital – it is currently running at -5.32% per year. So, it's currently a tremendously value-destructive industry. In fact, among the large industries in the U.S. classified at the sector level, this one is the worst. So, it's a terrible industry to invest in at this point in time.

Still, there are some good industrial economics as to why such organizations should exist. One classic argument is economies of scale, and economies of scale do exist in financial services. Problem is, we have great difficulty pinning down exactly what those scale economies are because they tend to occur at a product line level, and from an academic perspective we don't have product line data because these are proprietary to a firm and not publicly available. So, we try to estimate economies of scale from overall cost functions of firms engaged in a particular activity such as commercial banking, and we can derive certain results from that.

Then we have the whole issue of economies of scope. First question relating to scale is, "is bigger better?" The question relating to scope is, "is broader better?" Here again there is conflicting evidence. There are possible cost economies of scope because you may be able to use the same platforms to manufacture or distribute different financial products and services. But this may come at a cost, since the more things you do, the more complex you get, and the more difficult it is to oversee the entire organization – as well as possible conflicts of interest that exist within the organization.

On the revenue side, scope has to do with cross-selling products. One can easily draw a matrix that says, "Here are all the things we do on this axis, and here are all the things we do on the other axis." Using such a grid allows a firm to locate where possible cross-selling or revenue generation possibilities might exist, and there are plenty of them if it is possible to convince clients of the benefits by reducing their transactions costs or information costs. The problem is not that cross-selling opportunities rarely exist; the problem is that in many cases it's very hard to bring them to the surface because you have to have effective internal remuneration and contracting structures that actually brings both sides of a cross-sell into effective play.

So overall, you could say there are definitely scale and scope economies associated with large, complex financial firms, but, in general, they are very hard to document and measure in a credible way.

Secondly, we've already mentioned that such firms tend to be more stable than more specialized financial intermediaries. We know that there are low correlations across earnings financial firms' flows – for example, between private banking and investment banking, or between these and the credit card business. So, a large complex institution tends to have more stable earnings spread across clients and markets and products that are not perfectly correlated. So, bankruptcy risk goes down, and that's very good.

On the other hand, such firms also suffer from a conglomerate discount. If I invest in Citigroup stock, I'm getting about nine or ten different businesses, just like if I invest in General Electric stock. I'm basically getting a closed-end mutual fund managed by the people who manage Citi or GE.

As we all know, and the data is absolutely clear, that conglomerates trade at a significant discount to the individual value of their businesses, just like closed-end funds trade at a discount to the value of the constituent holdings. In the financial services industry, that's about twenty to twenty-two percent below breakup value.

So, the complexity of financial firms has a good side and a bad side. The good side is, it's more stable, and this should reduce failure risk and the cost of capital. On the bad side, the investor is paying for this in terms of getting a significant discount from the value of the individual businesses.

Of course, the fact is that these large, complex financial institutions do exist in the financial architecture. On the whole, therefore, the benefits must have exceeded the costs. One possible reason would be an unpriced externality in the form of a subsidy from the taxpayer, and here we get into the too-big-to-fail issues. Economists often argue that large and complex financial institutions "manufacture" negative externalities by virtue of the too-big-to-fail characteristic. That leads to the ability of firms to use an unpriced resource and benefit from a lower cost of capital, which in turn effectively supports this kind of a structure. So, the argument goes, the existence of large, complex financial institutions is not, in fact, a natural result of the economics of financial intermediation, but rather is heavily influenced by public policy towards large institution[s]. If that's the case, then all we need to do is correctly price that externality and then let the economics of financial intermediation take its course. If bigger and broader is better, then we will see large and broad institutions. If not, we won't.

It's a little bit like a steel company that pollutes the air. It is in effect using that resource – ambient air quality – for free. What public policy does is cap the allowable pollution or we tax it. Then the steel people decide what to do in response. They may change the production process. They may change the line of products they produce, or whatever, and pass the remaining costs on to customers or shareholders who in turn decide how to adjust in steel consumption or capital investment in the steel industry. Once the externality is priced correctly, market forces will bring about the necessary adjustment throughout the economy.

In this case, we have Dodd-Frank as something concrete on the table that contains a range of measures intended to help internalize systemic risk and encourage an industry response to achieve that – by the way, I would give it a B-plus, better than your grade, which was B-minus, I think – in terms of its complex way of causing that pricing and neutralization of the externality to occur. Now it's up to the financial institutions subject to this new policy environment to draw the necessary conclusions. One might be that certain activities don't really belong as part of the business under the new rules, and our shareholders would be better off if we spun that activity off to the shareholders. They in turn are able to continue owning that piece of business if they want to. Or maybe not. At least the investor has a choice, which he or she doesn't have if the business is part of a financial conglomerate.

That, to me, as an economist, is a lot more efficient, to use the price mechanism to bring about structural change within these institutions than to forcibly break them up. Of course, it may not work. In that case, the next big crisis may well force a structural solution to the financial conglomerate issue.

Saltzman: But how do you quantify the negative externality?

Dugan: But aren't you saying the SIFI surcharge is like a pollution tax?

Wilmarth: It's exactly like that.

Saltzman: So you're supportive of Tarullo's perspective, which is supporting the G-SIFI-surcharge as a macroprudential tool that prices in the negative externalities that the firm decides they want?[22]

Walter: But then, you let the bankers decide how to respond to that. You're not an expert as a regulator or as a politician or as an academic in the specifics of managing profitable, safe, and sound financial institution. Let them operate under the new conditions for a while and they will try to do what's best for their own shareholders. This may well lead to significant structural changes.

22. *See Continued Oversight of the Implementation of the Wall Street Reform Act: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs*, 112th Cong. 5-6 (2011) (statement of Daniel K. Tarullo, Member, Bd. of Governors of the Fed. Reserve Sys.), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=7cd931a5-69d2-4070-8576-21b046691a4d.

Swagel: I just want to pick up on something Ingo said, which I thought is really interesting and why this all matters. He's talking about the large banks' trading below book. It's as if the U.S. economy now is trading below book and the financial sector has got to be part of it. And so I think, "What's our book value?" We have this incredible potential – all the things that are great about the U.S.: our markets, the rule of law, democracy, freedom, meritocracy. We've got good demographics. If we wanted even better demographics, we could easily do that with a change in immigration law. So we have all these things that a country like Japan, which has had a crisis for a decade or more, doesn't have.

To me, it's striking that several years after the crisis manifested, and even more after the housing bubble burst, we're still in this situation where we're, as an economy, trading below book. And that's why I think this matters. We're going to agree and disagree, but getting these questions right and getting the financial system back to doing its role in society – that's what it is all about. So that's a bit of a diversion.

The role of large banks – going back to the question – I agree with Ingo. I think it's clear that large banks provide economies of scope and of scale and benefits. I'm on the academic advisory committee of The Clearing House Association, and I can mention some of the results of the study that the Association has just put out. I didn't write this study, but I participated in some conference calls and have read the paper, and everyone can read the paper on their own.[23]

The paper says big banks are necessary for certain large transactions. It's a fact of life that there are large, multinational corporations that need large, multinational banks to do business with. You can tick through trade finance, lending, cash management. And of course, smaller banks or co-ops can do this, but it's not the same. You can do the same things on the capital markets side, and derivatives seem like the most important area, and that's what makes me question some of the components of the Dodd-Frank legislation, like the Lincoln Amendment, as possibly the opposite of a useful feature.

In my mind, the existence of the large banks is not a problem; it's a fact of life. It's not something to solve, but it's something to understand that will be with us, and, if we didn't have them, that would take away some of the benefits. I think I'll stop there.

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23. THE CLEARING HOUSE ASS'N L.L.C., UNDERSTANDING THE ECONOMICS OF LARGE BANKS (2011), *available at* http://www.theclearinghouse.org/index.html?f=073071.

Dugan: I certainly agree that there are economies of scale and scope for big financial firms. There are certain things that only big institutions can do with respect to big clients. But more to the point, without commenting on the sort of subtler notion of should you do a pollution type tax on them and have them restructure, I just want to respond to the larger part of the question of should we make them smaller and simpler so that they are not too big to fail.

I think it is truly naïve and ostrich-like to believe that we can simply eliminate complex large institutions in the United States. I mean, how small and simple would they have to be? For example, given today's crisis in Europe and the problems that I think all of us watch and worry about spreading to the United States, perhaps through the banking system, would that mean that firms couldn't lend to European firms? Or to European countries? That can't be right. Should we say that U.S. firms shouldn't be in a position to provide huge multibillion dollar financing deals to big global companies? If we do that, foreign banks will get that business, and we would be unilaterally taking away the competitive and comparative advantages that have caused U.S. firms to be leaders in global finance for more than a century.

We can't eliminate big customers and their complex financial needs, and we won't solve the problem by pushing out this business to unregulated nonbanks, because if we did that, it would eventually cause problems there that would spill back to the banking system – which is one of the critical lessons from the financial crisis. I think it's just unrealistic to think that we can keep systemic risk at bay by making the regulated banks smaller and more regulated while hoping that other risks stay outside the banking system and can be dealt with by the marketplace. I just think that's exactly what went wrong in the financial crisis, that risk outside the banking system became bigger than risk inside the system with regulators hamstrung in their ability to address this outside risk, and that that outside risk eventually spilled back to the banking system in a much bigger way than it needed to, in part because we didn't have an orderly resolution mechanism.

So, rather than thinking this thought that we're going to bust them up and make them really small and go back to a simpler Rousseau-like world,[24] I think it's far better to recognize that financial systems will always be able to generate systemic risk, and to address those problems head-on by treating anybody that engages in those activities the same – intensively regulating them, whether they're a bank or not a bank, with significant, strong, common equity capital rules and liquidity requirements, transparency, common rules for common activities, and limits on excessive risk taking.

Saltzman: Art? I'm sure you have something to say.

Wilmarth: The ring-fencing idea, as proposed in the Vickers Report,[25] is not intended to force an involuntary breakup of financial conglomerates. Instead, the Report proposes that large, complex financial institutions should be compelled to clearly separate the subsidized utility operations of the bank from capital markets activities that the government is not going to subsidize. If large, diversified financial institutions are so efficient and create all these wonderful benefits, then we ought to subject them to a true market test. Let's see what the market determines after all government subsidies have been removed. Right now, big financial conglomerates have a forty basis point funding advantage over smaller banks. That's an enormous funding advantage in a situation where interest rates are close to zero. So, there's an enormous subsidy built into the funding costs for the largest banks. If we don't separate the utility and capital markets operations of major banks – for example, if we allow financial conglomerates to move their derivatives activities into their subsidiary banks – we will continue to allow large financial conglomerates to benefit unfairly from their subsidized, federally-insured funding advantage.

After the banking crisis of the 1980s, there was an enormous surge in mergers and acquisitions among large banks. Ed Kane of Boston College hypothesized that large banks had figured out there was a too-big-to-fail policy in place after Continental Illinois, and they should get even bigger to make sure they would receive the full benefit of that policy.[26] Not surprisingly, large banks began to merge and get

24. *See, e.g.*, JEAN-JACQUES ROUSSEAU, ROUSSEAU: 'THE DISCOURSES' AND OTHER EARLY POLITICAL WRITINGS (Victor Gourevich ed., Cambridge U.P. 1997).

25. *See Final Report*, *supra* note 21, at 10-14.

26. Edward J. Kane, *Incentives for Banking Megamergers: What Motives Might*

even bigger. In fact, many executives of those banks said, "We're merging to survive. We're going to be a survivor." Some even said, "We're going to make sure we're too big to fail." Jagtiani and Brewer did a study a few years ago, which showed that mergers that put the acquiring banks over the $100 billion asset threshold generated much bigger stock premiums than mergers that didn't.[27] In response to the most recent crisis, the federal government's apparent response has been to say, "Let's get these guys to merge and grow even bigger."

Paradoxically, everyone is concerned about the too-big-to-fail problem, but we're creating larger and more complex institutions that are even more likely to be considered too big to fail and not resolvable under whatever rules we apply.

In contrast, if the government said, "Look, if you're doing deposit taking, small business lending, and other traditional credit intermediation activities, those activities can be conducted within a bank that is fully protected by deposit insurance and other elements of the federal safety net. However, if you're doing capital markets activities, including derivatives (except for derivatives that actually hedge what the retail bank is doing), all those activities must be conducted within separate subsidiaries, and there must be an absolute firewall between those subsidiaries and the bank. You will not be permitted to make any funds transfers except for paying dividends out of profits up to the parent holding company and receiving capital infusions into the bank from the holding company. The whole purpose of the firewall will be to prevent cross-funding advantages."[28]

When the Vickers Commission proposed this ring-fencing concept in England, the big banks cried out and said, "No, you don't understand. We can't operate under this model. We need that cross-funding so badly, we can't operate without that advantage." To me, that argument was Exhibit A in favor of my conclusion that financial conglomerates rely on government subsidies to attempt to make their business model work.

Regulators Infer from Event-Study Evidence?, 32 J. MONEY, CREDIT & BANKING 671 (2000).

27. Elijah Brewer III & Julapa Jagtiani, *How Much Did Banks Pay to Become Too-Big-to-Fail and to Become Systemically Important?* (The Fed. Reserve Bank of Philadelphia, Working Paper No. 11-37, Sept. 2, 2011), *available at* http://www.philadelphiafed.org/research-and-data/publications/working-papers/2011/wp11-37.pdf.

28. *See* Wilmarth, *supra* note 11, at 1037-47.

As Ingo points out, the long-term stock market returns for large financial conglomerates are very poor, on the whole, even with all the subsidies those institutions receive. I wonder what would happen without the subsidies? During the 1980s and 1990s, many of the industrial conglomerates were broken up by market forces because investors made the decision that Ingo has mentioned. In essence, investors decided, "We would rather be the portfolio manager of the stocks of many different (and more focused) companies instead of investing in one big diversified company." As a result, many of the industrial conglomerates got broken up by market forces.

Dugan: But wait. Those kinds of conglomerates were in completely different businesses. I mean I think the thought is that financial businesses are strategically aligned in related businesses. It's a different thought than the Beatrices of the world.[29]

Walter: What's the relatedness between growing a credit card network and an M&A advisory business?

Dugan: I didn't say every single one is uniquely aligned, but I think there are big synergies between corporate funding and advising on M&A.

Saltzman: Shared services, technology.

Dugan: There are tons of different things that actually do overlap.

Saltzman: Art, can I just ask a question? Is it firms are too big to fail, in that size is problematic? Is it that they're too complex to fail? Or is it just "Let's get back Glass-Steagall, regardless of size or complexity, and separate out the subsidized functions from the unsubsidized?" Which of the three, or all three, is it?

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29. Referring to Beatrice Foods Company, which was the target of a leveraged-buyout in 1986 by LBO specialist KKR and was sold off, division by division, in the years thereafter. *See* NEIL R. GAZEL, BEATRICE: FROM BUILDUP THROUGH BREAKUP (U. of Ill. P. 1990).

Wilmarth: I agree with the Basel Committee's approach regarding the factors that will lead to G-SIB surcharges. Size is obviously very important in determining the potential for systemic risk. I don't think anyone would deny that. I think complexity is also important for the reasons Ingo listed. If anybody has really successfully managed one of these large financial conglomerates for a long period of time – that will be an interesting story. J.P. Morgan Chase might be such a case, but I think it is one of the few cases where such a large conglomeration of different businesses has been successfully managed with adequate risk controls. So, in terms of capital surcharges for G-SIBs, I think size and complexity matter.

Again, my fundamental point is that FDIC insured funding and discount window funding should not be provided to institutions except for those engaged in traditional banking activities like deposit taking, payments processing, and traditional credit intermediation. Trading activities and other speculative activities in the capital markets should not be protected. We should move capital markets activities into ring-fenced subsidiaries so that they don't get insured subsidized funding, and they don't automatically get discount window help.

If we followed the ring-fencing approach, people buying the bonds of the ring-fenced capital markets subsidiaries would be likely to say, "How much of an interest rate do I need to earn on this bond in order to offset the risk that I will suffer a haircut if the subsidiary or its parent company fails?"

I expect that creditors will charge a much higher interest rate for liabilities issued by ring-fenced capital markets subsidiaries if they are doubtful about their degree of protection, compared to what they will charge if they believe they are buying bonds in a too-big-to-fail institution whose creditors will be fully protected when the next crisis occurs.

III. QUESTIONS FROM THE AUDIENCE

Saltzman: We can debate these issues probably all night. But I think we want to afford the audience time to ask some questions of our panelists.

Audience member: In the context of this debate, you often hear Glass-Steagall bandied about, pro and con, and I'm sort of curious what the panelists' views are? In hindsight, do you think it was a mistake to do away with Glass-Steagall, and do you think it in any way contributed to the financial crisis?

Dugan: I'll start.

I absolutely do not, as I said in my earlier remarks. I mean, actually, the fact that Glass-Steagall was repealed allowed us to take steps to dampen the crisis in ways that prevented it from getting much worse. And interestingly, the parts of the system in the capital markets that were most at risk were the ones that didn't have big banks and trading houses that were together. It happened at the trading houses that were funding themselves short, very short and did not have the structured diversified funding sources of a bank. Where the problems really started during the run on the system happened there first, not on the banking side. And it was the absence of Glass-Steagall that allowed the banks to team up with those troubled trading firms to make the losses far less than otherwise would have been the case.

If you had had to fail Merrill Lynch the way you did Lehman Brothers in the middle of that crisis at that time, it would have been disastrous. And I don't think the activities that are prohibited by Glass-Steagall were the ones that caused the crisis to begin with.

Walter: Well, I'm a big fan of Glass-Steagall; I've become impressed by its unintended consequences – not the bad ones but the good ones. Most historians today will admit that Glass-Steagall was probably a mistake – structural reform that was done for the wrong reasons. A lot of the things that the banking industry as it then existed was accused of doing in the 1927-29 period never actually happened. But in the fog of war in 1933 and under extreme political pressure reflected in the Pecora Hearings,[30] you do what you can and in the end put in place this functional wall.

The question is, what happened after that, compared to how the world would have evolved in the absence of Glass-Steagall?

For one thing, we ended up with a thriving, highly innovative investment banking industry with a franchise that continued to exist, at

30. *See generally* MICHAEL PERINO, THE HELLHOUND OF WALL STREET: HOW FERDINAND PECORA'S INVESTIGATION OF THE GREAT CRASH FOREVER CHANGED AMERICAN FINANCE (2010) (recounting the Senate Committee on Banking and Currency inquiry on the causes of the Wall Street Crash of 1929).

least de jure, for sixty-six years. During those decades, many of the innovations in the U.S. financial architecture occurred on the non-banking side of the wall. Commercial paper, fixed-income instruments, convertibles, money market mutual funds, all those new approaches to financial intermediation developed on the nonbank side, busily trying to steal business from the commercial banks and building up their businesses within a relatively protected environment. Then they went and rolled all of this out globally so that by the mid-2000s something like seventy percent of all capital raising and investment banking activities [in] Europe were led by U.S. investment banks. So, we ended up with an unintended consequence of Glass-Steagall – an enormously different financial architecture than we might have had if Glass-Steagall had continued to exist.

If you were a big commercial bank with a universal franchise during these decades, it's unlikely that you're going to innovate commercial paper, money market mutual funds, etc., because you're likely to cannibalize your own commercial banking business. That is exactly what happened in Europe, lagging well behind the Americans in financial innovation for decades. Naturally, the banks then wanted to punch through into that side of the sandbox, and they started in the mid-1980s or so to undermine the Glass-Steagall wall, eventually got Section 20 subsidiaries and other liberalization and eventually ended up with the Gramm-Leach-Bliley Act.[31]

So, then the question is, what now? Now, we have universal banks again just like in the 1920s. So the question again arises, what is the likely impact of that and what are the likely unintended consequences? In the 1980s, I was very much in favor of the repeal of Glass-Steagall to try to create a fairly level playing field for all kinds of competitors, and I was really surprised that two years after Gramm-Leach-Bliley, every major U.S. commercial bank that developed an investment banking franchise was up to its ears in the biggest spate of U.S. financial scandals in memory – including engineering transactions and financial structures with no commercial value, basically designed to obfuscate the financial condition of companies, running off-balance-sheet entities and off-market transactions the people still remember during 2001-2002. I never expected this. I expected market discipline

31. Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified in scattered sections of U.S. Code).

and sound corporate governance with a sharp eye toward reputational risk and shareholder value to effectively block such behavior. So, maybe market discipline has its limits in the real world, and destructive behavior needs to be directly, as opposed to indirectly, controlled as a second-best alternative.

Audience member: But do you think it caused the crisis, the repeal of Glass-Steagall?

Walter: No. I don't think it did.

Saltzman: Any other questions?

Audience member: My question is for John. Part of at least the underpinning of your argument against the first proposal seemed to me that large regulated firms, by virtue of the regulatory supervision that they undergo, were better off against the crisis than others were.

Dugan: Yes.

Audience member: And just to pick on an example that you cited in the case of Wachovia and option ARM mortgages, how culpable are the regulators in terms of acting fast and in a timely fashion, albeit that they may have caught on to the after effects, but it doesn't seem to me that they acted in as timely a fashion across the board, and that's just one example of many that we could cite.

Dugan: Sure. Well, we definitely made big mistakes, there's no doubt about that. But the Wachovia example is an interesting one. So, Wachovia, as a national bank, did not engage in payment option mortgages. As I said, we put out our guidance in 2005, and we enforced that guidance, and it went out of the national banking system. Then Wachovia went out and bought Golden West – a thrift, not a national bank – in a transaction that the OCC couldn't see until it was completed. It was done through the Federal Reserve as a holding company acquisition, and that brought Golden West into the system to Wachovia and those Golden West loans were the ones that created the confidence stigma for Wachovia. By the way, it was a stigma that we always thought far more exaggerated than what the reality was in terms of the whole franchise of the company. In fact, we couldn't believe it was causing a liquidity problem like it did at the height of the crisis.

But we did not have the power to stop that transaction from occurring. It's just one example of the fragmented system that we have, that we would have a policy in one part of the system that we successfully put in place and then it comes back in to cause problems by another door. And by the way, in the end, Wells Fargo ended up acquiring Wachovia without government assistance, which has turned out to be a very profitable acquisition for the company over time.

But again, to me, the thing I think we missed as a regulatory community on the bank side was no-documentation mortgages. I became a big believer by the end of my term that there should be minimum mortgage underwriting standards, that somehow as a country, through all the pressure that we had from different parts of the system, we completely lost our way. The notion that we would have no-down-payment, no-documentation mortgages, and that they would become the norm is unthinkable. When I stood up in international bodies after the crisis and said, "It's really important that you never do this," people looked at me like I was crazy. They said, "Well, of course we'd never do that. We'd always have down payments. Of course you'd verify it."

I think we lost our way partly because, through the securitization system, there were things going on outside the system that began putting pressure back on the banking system. It's why we need absolutely, as I said, common rules for common activities. It's the one thing I really like about the CFPB, the Consumer Financial Protection Bureau: when it applies a rule, anybody who engages in that activity is subject to the same rule. The fact that we didn't have that commonality for mortgages before the crisis turned out to be a real problem.

Wilmarth: Let me give you another example that has perplexed me. This follows up on Ingo's point that the dotcom-telecom bust (which included Enron and WorldCom, because Enron was really a dotcom company and WorldCom was a telecom), gave us a window into the conflicts of interest and the fee-generating mania among large, complex financial institutions that drove that stock market bubble and inflicted great harm on investors. In 2003, FASB's response to the Enron scandal was to say that unless a company made true sales to off-balance-sheet entities and retained no residual risk, the sales would not be recognized and the assets would remain on the company's consolidated balance sheet. A lot of the major banks went to their regulators and said, "No, wait. We have these asset-backed commercial paper conduits and they're really important because we park a lot of our securitized assets there. And those conduits won't be able to buy our securitized assets unless we give liquidity puts that allow them to sell short-term, highly-rated commercial paper to investors. And we can't afford to have all those securitized assets consolidated with our other assets for purposes of regulatory capital requirements." In 2004, the regulators said, "Well, okay. It's true that FASB would consolidate this stuff. But for regulatory capital purposes, as long as your liquidity puts have terms of less than one year (which, of course [] can be rolled over), you only have to comply with a capital charge that is ten percent of the normal capital requirement. So, instead of putting up eight percent of capital for the assets held in off-balance-sheet conduits, you only have to put up 0.8%." And those conduits ultimately grew to over a trillion dollars and played a large role in triggering the financial crisis in 2007.[32]

Dugan: But they weren't consolidated under GAAP. They changed that rule last year to make sure they were consolidated. They were not consolidated.

Wilmarth: In any case, bankers made clear to the regulators that, "we are parking assets in large amounts off our balance sheets," in the same way that Enron did, and the banks retained exposures through their liquidity puts, and the regulators' answer was, to give the securitized assets parked in conduits only a ten percent risk weight for regulatory capital purposes. The asset-backed commercial paper conduits were, in many ways, a canary in the coal mine. If you go back and see what really broke the crisis open and made it virulent, it was the collapse of the asset-backed commercial paper conduits, which Ingo has written about.

Dugan: I agree with that.

32. *See* Wilmarth, *supra* note 11, at 973-75.

Wilmarth: Why did the regulators allow that very lenient regulatory capital treatment? I don't frankly know, exactly that the banks were telling them, "We need this more lenient capital treatment to make this securitization process work."

Saltzman: One more question?

Audience member: A lot of this discussion has been premised on the notion that we have universal banks, but I think that's the one corporate structure that still is prohibited by U.S. legal barriers. The system of functional regulation established by Gramm-Leach-Bliley is weakened but still intact. There are still a lot of restrictions on what legal entity can do what and what kind of funding can flow among the different entities. I'm interested in the reaction of the panel to the notion that perhaps true universal banking that put everything in one legal entity and eliminated the restrictions on cross-funding, but also put all the regulators of all the different activities onto that one legal entity, might not resolve some of the issues that we've been talking about, particularly now that with the Volcker Rule, that entity could not be used to finance leveraged proprietary trading.

Swagel: I just wanted to mention that essentially that's the proposal that the Paulson Treasury put out in March of 2008, the so-called blueprint for regulatory reform, which obviously would have gone much further than Dodd-Frank, but the general idea was to have different regulators for different purposes, with one of them for each purpose.

IV. CONCLUDING REMARKS

The debate concluded, and Professor Lissa Broome, Director of the Center for Banking and Finance, thanked the panelists and moderator for their participation, The Clearing House for its financial support, and the audience for its attention. She invited all to a reception for continued conversation.