

A Failure to Communicate: The Pathology of Too Big to Fail

Harvey Rosenblum*

Many years ago, Paul Newman starred as Cool Hand Luke, an inmate on a Florida prison farm. The warden had many tough characters to deal with, so he established strict rules of behavior, with even stricter consequences. Following a series of infractions, Cool Hand Luke was required to spend the next night and day in solitary confinement, a small enclosed box about 30 inches square and six feet tall, in the hot Florida sun.

A Failure to Communicate

When the warden issued his ruling, he said “What we’ve got here is a failure to communicate.” In other words, actions have consequences, and failure to play by the rules had serious consequences.

Fast-forward to 2008. Instead of focusing on a movie from 1967, let’s review a cast of characters with corporate names such as Bear-Stearns, AIG, Citigroup, and Bank of America Corporation, to name a few. What they have in common is that extraordinary government assistance allowed them to avoid failures that would have wreaked havoc on the rest of the financial system and the economy – they were considered “too big to fail” (TBTF).

Thanks to governmental interventions, the owners, managers and creditors of these companies suffered drastically less severe consequences, relative to what the market might have doled out. A basic tenet of our capitalist economic system was violated; a series of serious business mistakes is supposed to lead to *failure*. But it did not.

Anybody who followed the 2008-09 Financial Crisis remembers the headlines, which often used the term “BAILOUT.” People act on their perceptions, beliefs and deeply held convictions. Five years later, one of the most deeply embedded convictions in the mindset of the public is that the owners and managers of the giant banking institutions were bailed out. The rest of American companies and households were left to fend for themselves, still paying the costs – through higher taxes, lower incomes and lost opportunities. A corollary of this story is the perception that creditors of very large banking companies received preferential treatment that was not available to uninsured and unsecured creditors

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of smaller banking institutions. These perceptions may not be correct. Nevertheless, *these perceptions have become the prevailing wisdom that conditions future behavior.*

The Explanation Matters – A Lot

In the midst of the financial crisis, Timothy Geithner, then President of the New York Fed, told journalist David Wessel: “the government had to get both the substance [i.e. the policy] and the theater [i.e. the explanation] right.”¹ Wessel explains that the Fed, but particularly the Treasury Department, muffed the theater, basically allowing journalists and other commentators to fill the information void with sometimes erroneous and biased interpretations of what actually happened, and what would likely happen in the future if policy makers were faced with another financial crisis.

Given the prevailing perception of future bailouts for giant banks and their creditors, is it any wonder that most people scoff at the notion that Dodd-Frank has ended Too Big to Fail (“TBTF”)? If ever there were a classic failure to communicate effectively, TBTF is likely the poster child of such miscommunication.

Improving Communication – the Fed’s Way

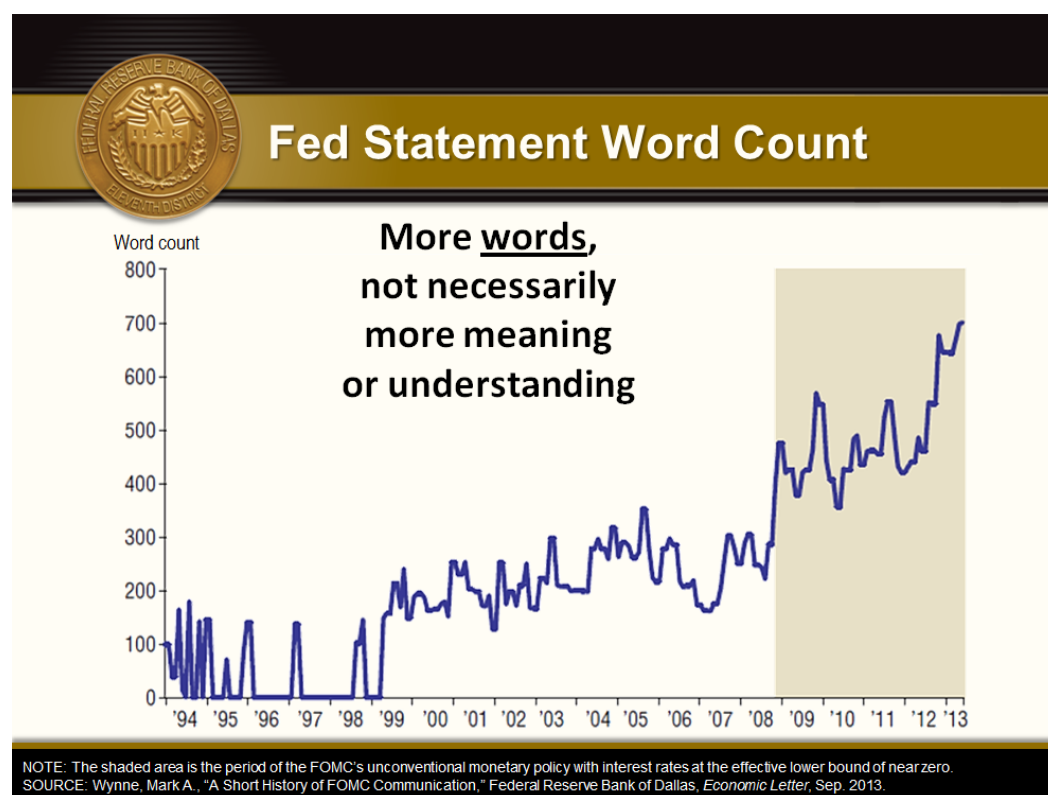
Today, after each of its meetings, the (FOMC) releases a detailed statement indicating its decision, even when there is no change in policy. It gives the rationale for the decision, as well as some indication of the direction of future policy.² Prior to 1994, the FOMC said little or nothing about its policy decision until many weeks later.

After *every* meeting since May 1999, the FOMC releases detailed statements with increasingly greater length (Figure 1). The FOMC’s first statement in February 1994 contained 99 words; it’s recent statement issued after the April 30 - May 1, 2013 meeting was 669 words. However, more verbiage does not necessarily equate to increased transparency and improved communication. Increased transparency is more than communicating the outcome of a policy decision in a timely manner. Best practice also encompasses *being understood* by a broad audience, not just policy wonks and bond market geeks. It is even more important to *not be misunderstood*. This is a critical part of “getting the theater right.”

¹ David Wessel, In Fed We Trust: Ben Bernanke’s War on the Great Panic, New York: Crown Business, 2009: 7-8.

² Mark A. Wynne, “A Short History of FOMC Communication,” Federal Reserve Bank of Dallas, *Economic Letter*, Sep. 2013.

Figure 1: Fed Statement Word Count

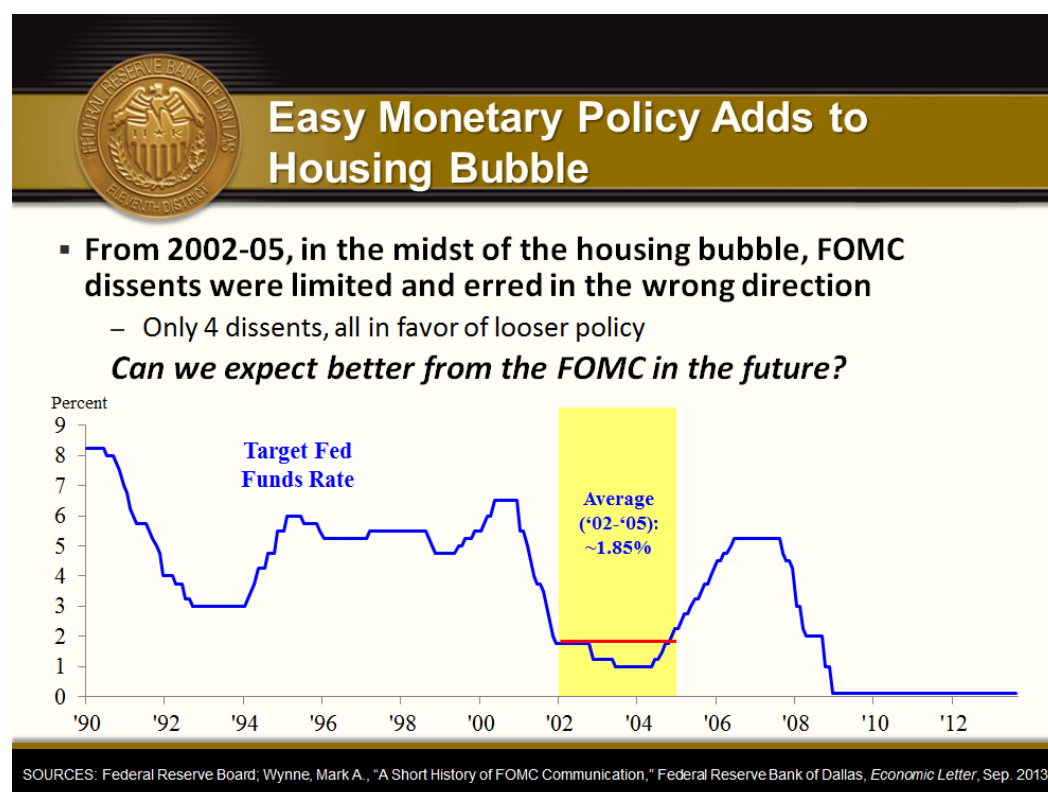


The issue of financial instability has been around since the Federal Reserve's inception a century ago. It was a widely held view that the goal of financial stability was part of the Fed's legal mandates prior to the 2008-09 Financial Crisis or the Dodd-Frank Act of 2010. Do prior decisions by the FOMC inspire public confidence in the Fed's ability to choose policies that reduce the likelihood of financial excesses, bubbles and crises?

The U.S. experienced a housing bubble between 2002 and 2006, with housing prices peaking around 2006.³ During this period, the FOMC's policy rate, the federal funds rate, was generally below 2 percent. Moreover, there were only four dissents from the otherwise unanimous monetary policy decisions reached by the FOMC (Figure 2). And *all* of these dissents were in favor of *easier* monetary policy. Admittedly, the overnight federal funds rate is not the best or most precise instrument for addressing reckless mortgage lending and borrowing behaviors. However, the implications for financial stability of extremely low interest rates "maintained for a considerable period" and "removed at a pace that is likely to be measured" should have been better understood.

³ Different indices of housing prices peak at different times owing to differences in their design and the sectors of the markets they cover. The CoreLogic housing price index peaked in April 2006; the Case-Schiller Index peaked in 2006.Q2. The FHFA purchase-only index did not peak until the first half of 2007.

Figure 2: Easy Monetary Policy Adds to Housing Bubble



I am not using the benefit of hindsight to criticize the FOMC for what turned out to be a too-accommodative monetary policy with less than fully understood consequences. I sat in almost every FOMC meeting over this period and never told anybody that the trajectory of monetary policy might reduce financial stability in the future. I too failed to connect the dots. Can our successors be expected to do a better job of using the Fed's broad range of policy tools to augment financial stability in the future? I can only hope so, but I cannot be sure. Adding more players to the financial stability team – for example, the 15-member Financial Stability Oversight Council – may not improve matters.

Timing is Everything: The Cost of Garbled and Incomplete Communications

The Fed's response to the unfolding crisis was relatively rapid, especially when contrasted with the incremental policy responses generally taken in both monetary and regulatory policies. Section 13(3) of the Federal Reserve Act permits the Fed to act quickly, boldly and innovatively in "unusual and exigent circumstances."⁴ During the crisis, the Fed demonstrated its sense of urgency in unprecedented and

⁴ Niel Willardson and LuAnne Pederson, "Federal Reserve Liquidity Programs: An Update," Federal Reserve Bank of Minneapolis, *The Region*, June 2010.

exemplary ways. On “the substance” and even the timing, many commentators have given the Fed a grade of an “A”, maybe even an “A+”. The grade for communication is another matter.

We have a saying in Texas: when you are standing in water up to your neck in alligators, there is no time to communicate. That was the situation the Fed faced in 2008 and 2009, as new catastrophes were unveiled and hurled at Fed officials at warp speed. In these circumstances, “getting the theater right” may not have been feasible. The media and the Congress turned against the Fed’s actions, spinning the stories for their own political, financial and ideological benefit.

Three examples are worth noting. Lehman declared bankruptcy on September 15, 2008. Roughly *three weeks later*, Chairman Bernanke provided the rationale for the Fed’s decision to not intervene in a speech to the National Association for Business Economics.⁵ A second example comes from one of the many successful special credit facilities the Fed put in place in the midst of the crisis. The Term Asset-Backed Securities Loan Facility (TALF) enabled a variety of lenders to access funding to make intermediate-term loans by issuing asset-backed securities collateralized by student loans, auto loans, credit cards and small business loans. The Fed’s convoluted description of the private-public partnerships needed to jump-start these markets gave the appearance of granting special favors to a select few.

The Troubled Asset Relief Program (TARP) was a \$700 billion Treasury program that met enormous resistance from the public, the banking industry and the Congress. The TARP finally won Congressional approval after Congress first voted it down, and stock market indices had dropped precipitously.

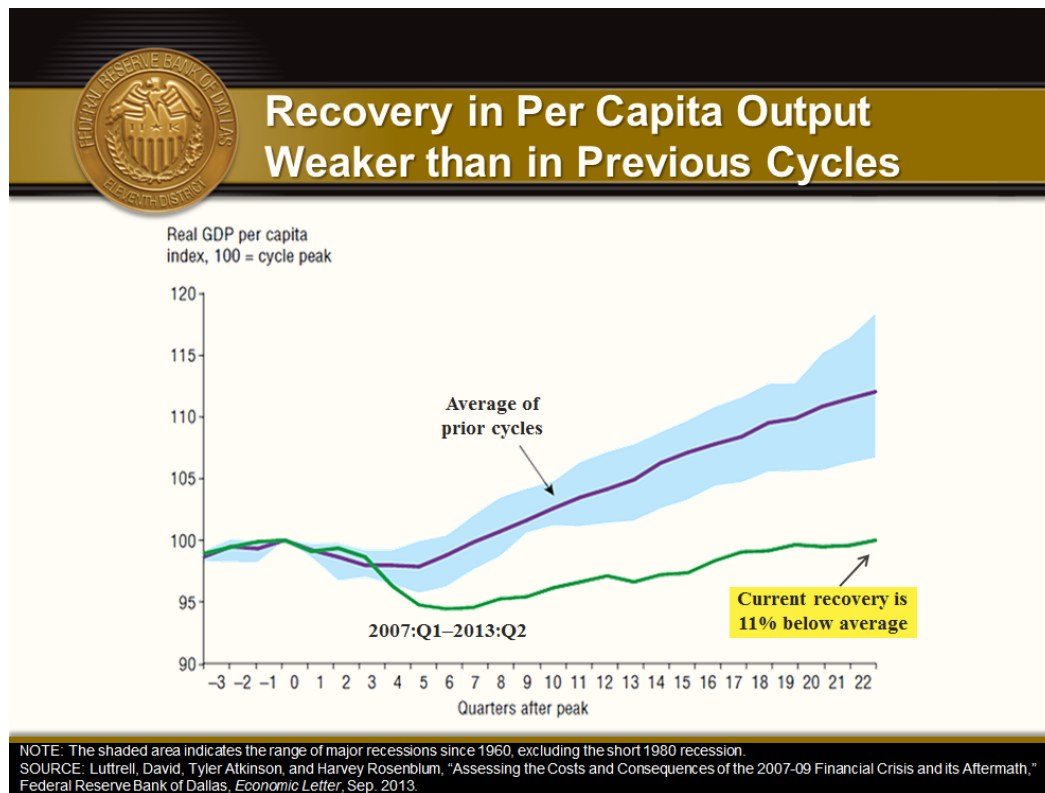
Think how much more the Treasury and the Fed could have done – at the time it was most urgent – to slow down and reverse the negative feedback loop that was underway in the autumn of 2008. ***If only a clear, concise and adequate explanation had been forthcoming***, the cost of the resulting financial crisis might have been a lot less than it was.

The Cost of the Financial Crisis

Since the end of World War II, the U.S. has experienced twelve recessions. The U.S. recession of 2007-09 was unlike any of its predecessors. In summer 2013, some four years after the recession supposedly ended, per capita income is still 11 percent below that of the average recovery (Figure 3).

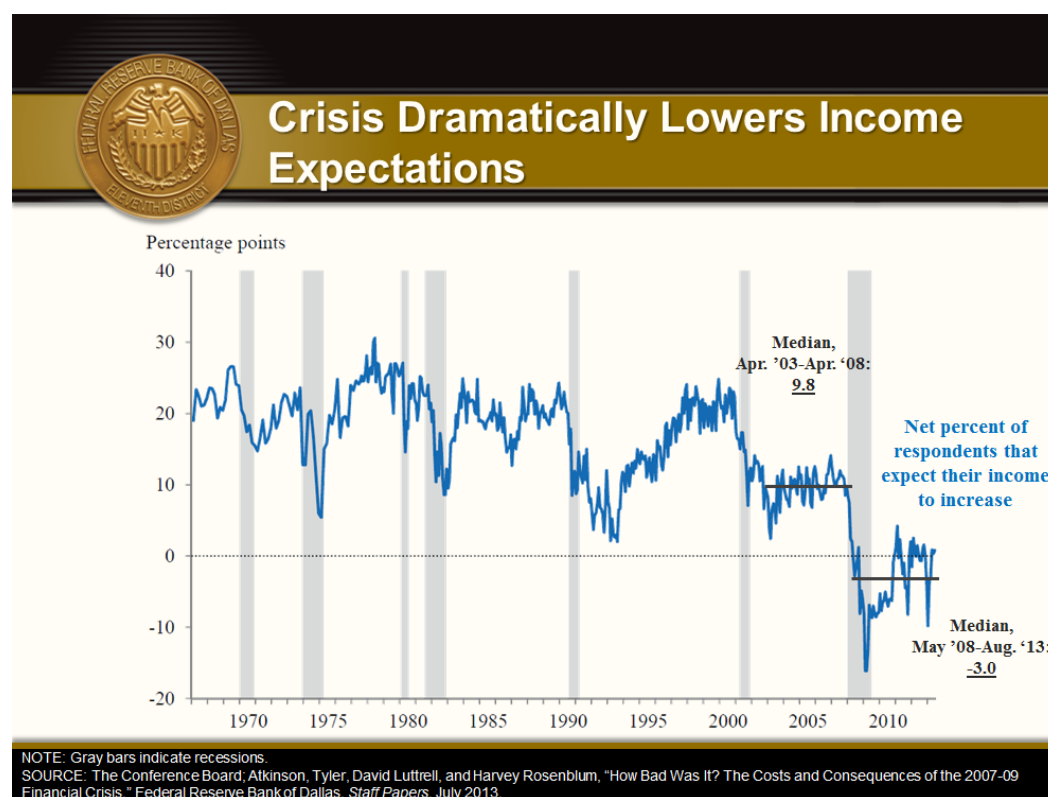
⁵ Benjamin S. Bernanke, “Current Economic and Financial Conditions,” Speech, National Association for Business Economics 50th Annual Meeting, Washington, DC, 7 Oct. 2008.

Figure 3: Recovery in Per Capita Output Weaker than in Previous Cycles



The financial crisis and its aftermath destroyed America's perceptions of economic opportunity and sense of well-being. On the whole, Americans now expect a future of lower incomes, not higher incomes (Figure 4).

Figure 4: Crisis Dramatically Lowers Income Expectations



This is likely the first instance of such a dismal future outlook since the Great Depression of 1930s.

In terms of foregone income – the income we would have earned as a nation had we grown at roughly trend but without the crisis – the cost totals between \$6 trillion and \$14 trillion.⁶ To put it in conservative and understandable terms, the cost is around \$50,000 to \$120,000 for every U.S. household. As shown in Figure 4, the perceptions regarding future income prospects have plummeted since the crisis, and household consumption has downshifted accordingly. Based on this lower consumption trajectory, the cost of the crisis is in the range of \$15 trillion to \$30 trillion. When we include some of the difficult-to-quantify economic and psychological costs, the crisis has easily cost at least an entire year's output, and perhaps double that. Better communication could have reduced these costs.

Can a cost like this be avoided in the future? Probably not. The TBTF problem that was at the heart and center of the 2007-08 crisis has not disappeared. The largest financial institutions remain "a dagger

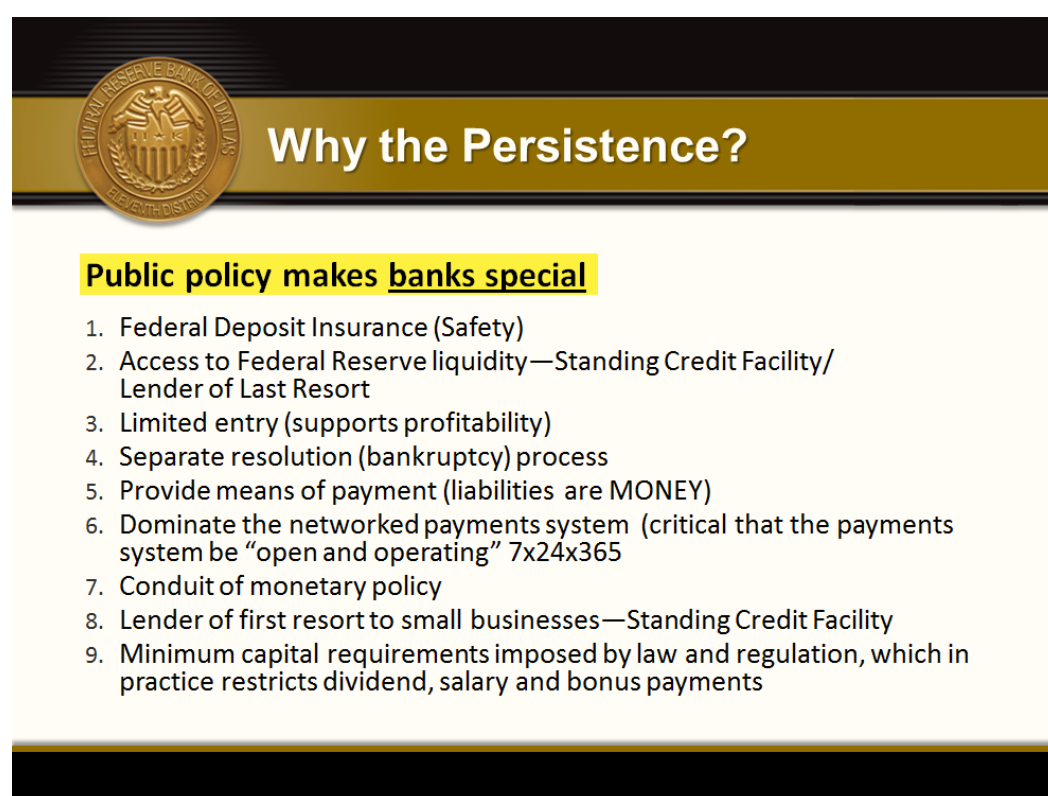
⁶ David Luttrell, Tyler Atkinson, and Harvey Rosenblum, "Assessing the Costs and Consequences of the 2007-09 Financial Crisis and Its Aftermath," Federal Reserve Bank of Dallas, *Economic Letter*, Sep. 2013.

pointed at the heart of our economy.”⁷ The TBTF banking institutions remain an ever-present threat as long as the key stakeholders in the megabanking institutions believe they are immune from failure and prosecution. Given the experience of the management and creditors of these institutions during the 2008-09 crisis and in the period since, it would be difficult for them to believe otherwise.

Megabanks are Super-Special

To understand the persistence of the TBTF mentality, we need to recognize that public policy makes all banks “special,”⁸ (i.e., different from other private-sector companies) (Figure 5).

Figure 5: Banks are Special



But more importantly, during the financial crisis public policy placed the megabank institutions in an entirely new category of being *super-special* (Figure 6).

⁷ Fisher, Richard W. and Harvey Rosenblum, “Why we must downsize banking behemoths into ‘too small to save’ entities,” *Dallas Morning News*, 12 Sep. 2013.

⁸ For a discussion of the “specialness” of banks, see Mark W. Olson, “Are Banks Still Special?” Speech, Annual Washington Conference of the Institute of International Bankers, Washington, DC, 13 Mar. 2006.

Figure 6: Megabanks are Super-Special



Why the Persistence?

Since 2008, public policy makes megabanks super-special

1. Triage regime: Giant banks first to be “saved” by first responders
2. Escape hatch: After their “Lehman Moment,” Goldman Sachs and Morgan Stanley chose to become bank holding companies
3. SIFIs: Label codifies the “systemic importance” of certain financial institutions

They were the first to be saved by the first responders – the Fed and the U.S. Treasury.

Dodd-Frank Promises More That It Can Deliver

The Dodd-Frank Act’s preamble declares it to be “an act to end too big to fail.” Outside of the corridors of Washington, D.C., however, there seems to be few observers of the banking industry in 2013 who believe this assertion. Consequently, the TBTF banks as well as their holding company affiliates enjoy a sizeable subsidy in the form of a lower funding cost than their smaller banking institution competitors.⁹

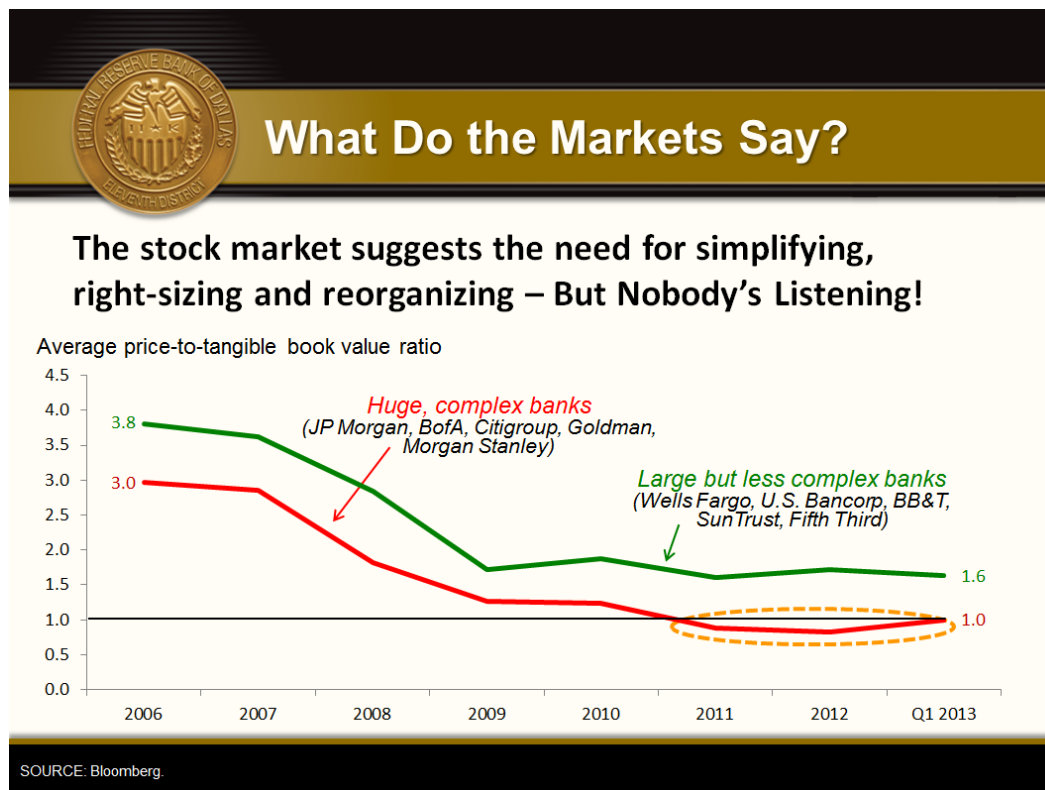
Dodd-Frank attempts to reduce the TBTF subsidy through smarter regulations – for example, by imposing higher capital and liquidity standards on the largest and most complex institutions, those designated as Systemically Important Financial Institutions (SIFIs). In many ways, these supposedly tougher regulations are a distraction from the fundamental fact that the behaviors of firms that believe

⁹ This TBTF subsidy is sizeable, being somewhere in the vicinity of \$50–\$100 billion annually. See Bloomberg View, “Why Should Taxpayers Give Big Banks \$83 Billion a Year?” *Bloomberg*, 20 Feb. 2013; Andrew Haldane, “On Being the Right Size,” Speech, Institute of Economic Affairs’ 22nd Annual Series, The 2012 Beesley Lectures, London, UK, 25 Oct. 2012; and Bank for International Settlements, *BIS Annual Report 2011/12*, p. 75–6. Professor Cornelius Hurley (Boston University) with his Subsidy Reserve Plan, and Professor Simon Johnson (MIT) with his series of columns and blog-posts, have done a great deal to publicize the persistence, size of, and the inequities stemming from, the TBTF subsidy.

they are invincible, will never change. Indeed, higher capital standards may offer a false sense of security, and will likely induce customers and other stakeholders in the megabanking firms to continue believing they remain unassailable, thereby enabling the TBTF institutions to become more powerful and unmanageable. In this sense, smarter regulation is a worthy goal that, in practice, will prove difficult to achieve. Like most other subsidies, the TBTF subsidy is nearly impossible to remove and is self-perpetuating in the sense that it enables the giants to grow faster than their smaller competitors.

An ironic twist in this story comes from the fact that stockholders in the biggest, most complex, and difficult-to-manage banking behemoths have been trying to tell the management of these companies that shareholder value could be improved by simplifying and downsizing. The shares of giant, complex banking companies in recent years have traded at a discount to book value, while their smaller and less complex competitors enjoy a sizeable and persistent premium over book value (Figure 7).

Figure 7: What Do the Markets Say?



Part of the reason is that public policy has essentially limited, and perhaps actually eliminated, the market for corporate control of the largest financial institutions. Unlike in other industries, the idea of a hostile takeover of a megabanking institution is just not a reality.

Dodd-Frank entrenches rather than eliminates the TBTF pathology. Since Dodd-Frank's enactment, the giants have gotten bigger and the profitability of the community and regional banks that might have posed more meaningful competition has been undermined by the regulatory burdens and complexity of the 849-page act and the over-14,000 pages of implementing regulations written thus far.

Dodd-Frank Ignores Community Banks' Record of Safety

Dodd-Frank's undermining of community bank profitability and viability is all the more disturbing in light of the record of community banks' service to their customers' needs.

In general, the community banking model focuses on sustaining long-term relationships rather than simply booking short-term gains. Small banks with stronger ties to the local community better understand the risks involved in lending to any particular customer. As a result, during the crisis, they faced fewer problems with loan quality across loan types than the larger banks did. Additionally, lacking significant trading desks, they tended to stick to more "plain-vanilla" non-lending investment activities and suffered less asset impairment than their larger counterparts. Community banks also dedicate a larger portion of their available funds to lending to businesses, in particular smaller ones, and proved to be a more stable source of business loans during the last crisis than were bigger banks.¹⁰

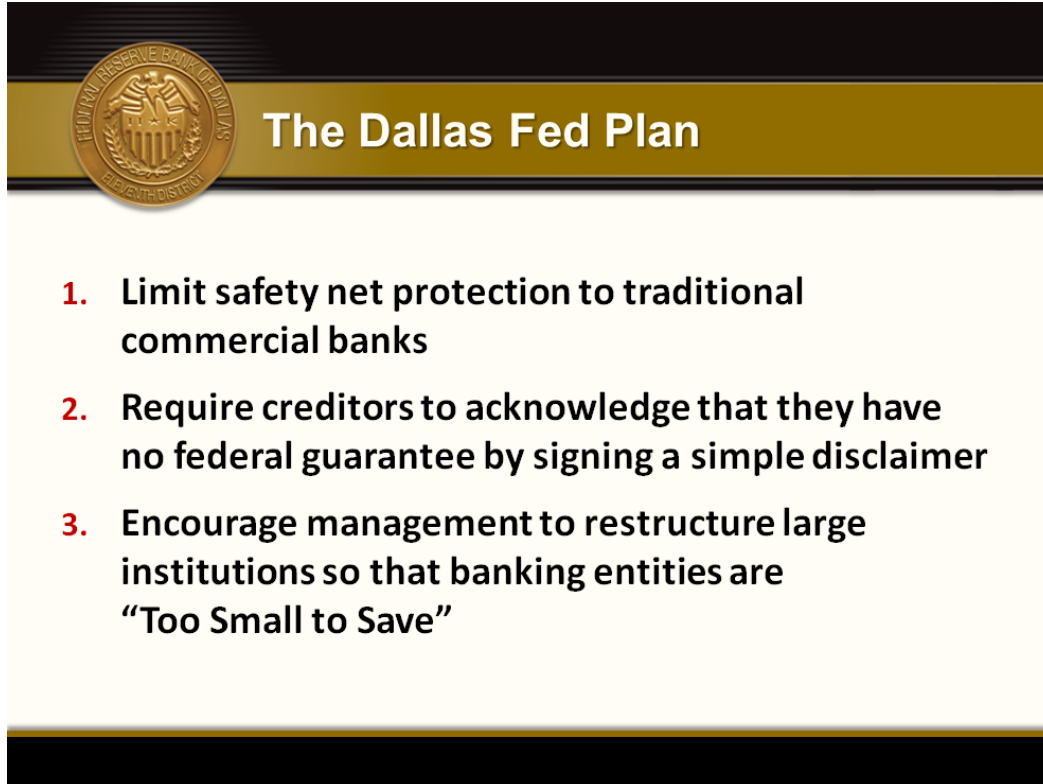
The Dallas Fed Financial Reform Plan: A Simpler and Better Way

To address the shortcomings and the inequities of Dodd-Frank, the Dallas Fed has proposed (Figure 8) confining access to the federal safety net – the Federal Reserve's discount window and federal deposit insurance protection – to traditional commercial banks.¹¹ Further, the plan advocates that customers and creditors of companies affiliated with commercial banks sign a disclaimer acknowledging their understanding that there is no federal guarantee underpinning their relationship with these nonbank units or with the parent of any banking company. We believe these two steps would reduce the perverse incentives stemming from the implicit – but widely recognized – creditor protection offered to TBTF institutions. These two changes would help realign incentives to better resemble those faced by customers of smaller banks whose unsecured creditors and equity shareholders are exposed to losses. In short, our proposal would revive the inhibited forces of market discipline.

¹⁰ For a more detailed discussion of the merits of the community banking model, see the "Special Report" essays of the Dallas Fed's *2012 Annual Report*.

¹¹ Richard W. Fisher and Harvey Rosenblum, "Vanquishing Too Big to Fail," Federal Reserve Bank of Dallas, *2012 Annual Report*.

Figure 8: The Dallas Fed Plan



Unfortunately, established customer relationships are slow to change. To accelerate the transition to a more competitive financial system, our proposal has a third element to help level the playing field. Specifically, our plan recommends that the largest financial institutions be restructured, by their management and boards of directors, so that every one of their corporate entities is subject to a speedy bankruptcy process, and in the case of banking entities, that each be of a size that is "too small to save." This last step gets both the incentives and the structure right, neither of which is accomplished by relying on Dodd-Frank. The aim of our three-step proposal is to underscore to customers and creditors that a credible regime shift has taken place, and the reign of TBTF policies is over.

Rightsizing: Proceeding at a Snail's Pace

In the midst of the Financial Crisis, several of the largest TBTF banking institutions absorbed some competitors that were on the brink of failure. These already TBTF banking institutions were the only ones capable of such acquisitions. The U.S. banking system became more highly concentrated, less competitive and the megabanks became more complex and unmanageable.

More recently, some megabanking institutions have recognized their bloated structures and have taken small steps to downsize and simplify their business models.

For example, Citi is shedding some “alternative assets,” Bank of America is closing out its ownership stake in China Construction Bank; and General Electric (GE) is in the process of divesting some of its credit card businesses. Advising General Electric on how best to accomplish this downsizing, refocusing and redeployment of the proceeds are two other TBTF institutions, JP Morgan Chase and Goldman Sachs. These institutions should begin to practice what they preach, that is, create improved value for their own shareholders by rightsizing and refocusing their own businesses.

Most recently, perhaps due, in part, to growing public and regulatory pressures, some banks have begun exiting businesses that are “reputationally or ethically problematic.”¹² In the context of financial stability, the importance of banking institutions reputational risks cannot be underestimated. Financial stability requires not just good regulatory policies, but banking, monetary and price stability as well.

Roughly 90 percent of our money supply is held within the banking system. The U.S. dollar is a “faith-based currency” and remains the international reserve currency of the world. A loss of confidence in the health and safety of the U.S. banking system would translate into a loss of confidence in the U.S. dollar and the U.S. economic system.

Dallas Fed Plan: Not Radical

Compared to the alternatives, the Dallas Fed Plan is not all that radical. It seeks to enhance and protect the stability of our monetary system.

For those TBTF banking institutions that have enjoyed a sustained and enormous TBTF subsidy, the cost of reorganizing and streamlining their companies must seem substantial. But that cost must be weighed against the social and economic costs of suffering through another financial crisis. The last crisis cost at least one year of output, a staggering cost relative to the costs of re-distributing the ownership of roughly a dozen megabanking institutions with all subsidiary companies remaining in private hands and with the buying, selling and exchange of assets directed by the managements and directors of these companies acting in the interests of their shareholders.

Over the last several years, the authors of the Dallas Fed Plan (Richard W. Fisher and Harvey Rosenblum) have strived to find smaller adjustments that would accomplish the same end – that is, that would

¹² Patrick Jenkins, “HSBC mindful of sharp edges on its ‘sword of Damocles,’” *Financial Times*, 16 Sep. 2013.

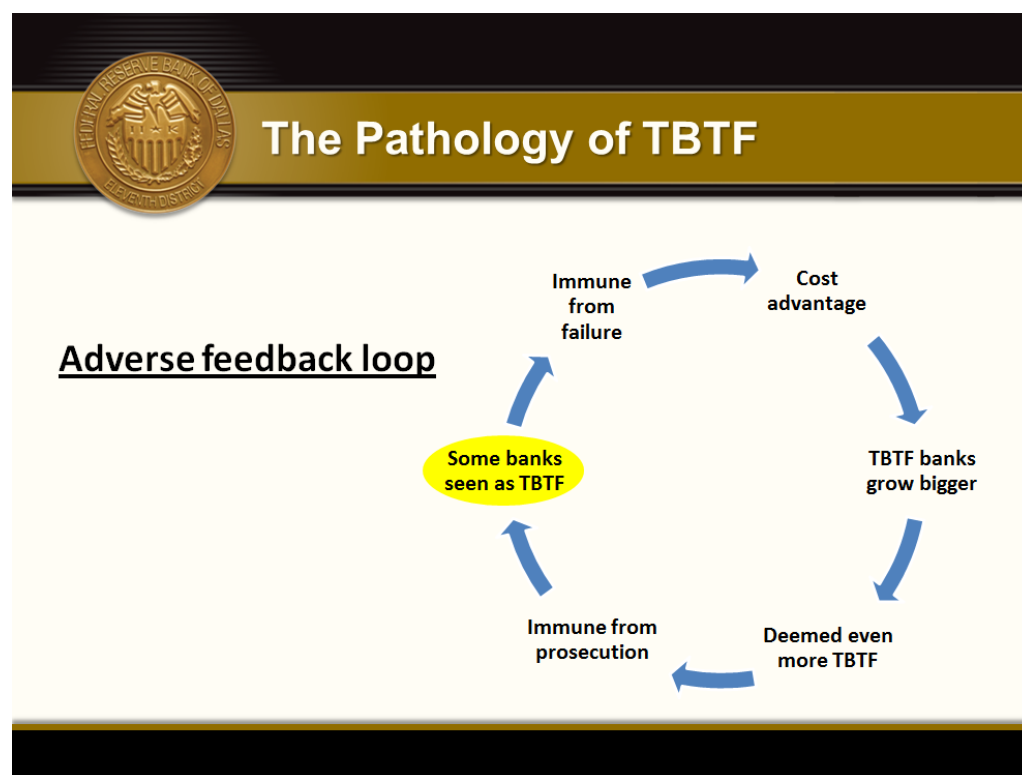
effectively end TBTF. We have determined that half measures will not work, because they will not produce a credible regime shift that the American public would find believable. The stock market prices of the giant, complex banking institutions underscore the need for the Dallas Fed Plan – in recent years the parts were often worth more than the whole. In the next crisis, the most likely alternative would be to quasi-nationalize many banks, just like what happened in 2008-09. The nationalization of private-sector financial institutions seems far more radical than the Dallas Fed Plan.

Can Dodd-Frank do a better-job of ending TBTF than the Dallas Fed Plan? Put simply, the answer is **“NO.”** As stated in the Dallas Fed’s *2011 Annual Report*, the “guiding principle” for navigating the legislative and regulatory morass of Dodd-Frank regulations should be to “codify and clarify, quickly.”¹³

In the intervening year and a half, thousands of additional pages have been added to regulations that are years away from being completed, let alone being understood. Unwritten rules cannot be followed or enforced. As a result, TBTF remains entrenched.

The persistence and pathology of TBTF can be represented as an adverse feedback loop (Figure 9).

Figure 9: The Pathology of TBTF



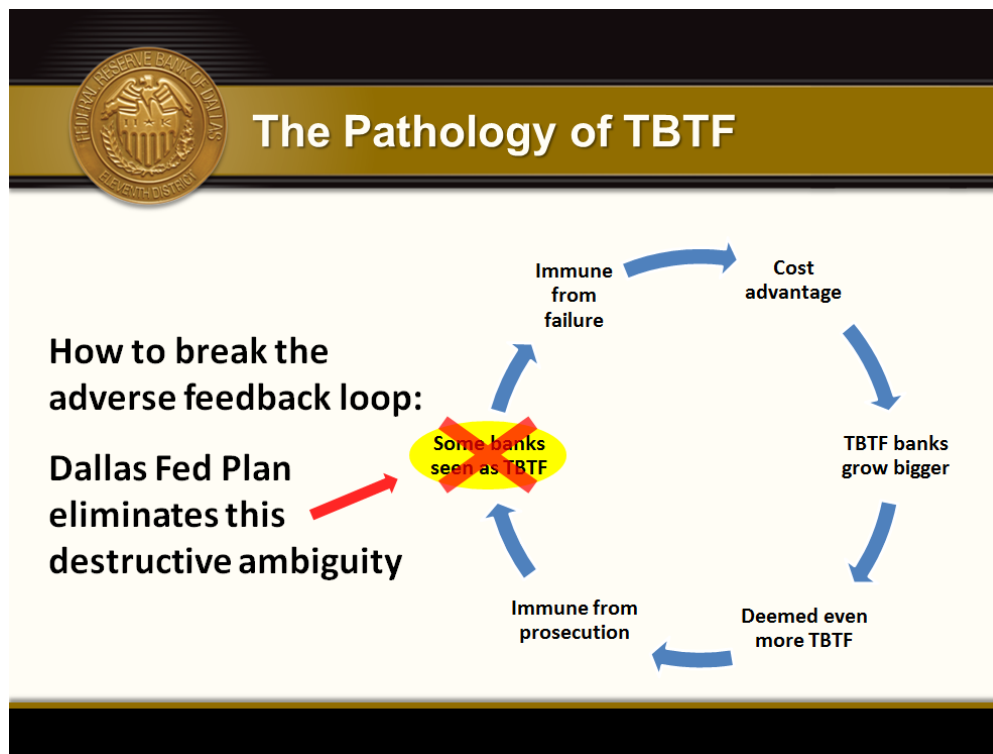
¹³ Harvey Rosenblum, “Choosing the Road to Prosperity: Why We Must End Too Big to Fail—Now,” Federal Reserve Bank of Dallas, *2011 Annual Report*.

As long as enough banking customers view their giant banks as being TBTF, these banks will grow faster, getting larger and more complex, thereby reinforcing the perception of their TBTF status.

People act on their perceptions. The experience of 2008-09 reinforced the perception that the giant banks are TBTF. Dodd-Frank may say otherwise. But with only a rudimentary and incomplete structure put in place to enforce it, Dodd-Frank is unlikely to convince the public that their perceptions on TBTF are erroneous. The term “destructive ambiguity” describes behavior based on strongly-held but perhaps incorrect perceptions.¹⁴

Under the Dallas Fed plan, the management of TBTF banking institutions would be incented to reorganize their companies so that no bank remained of a size, complexity, and systemic footprint such that it would be construed to be TBTF. All banks would be “Too Small to Save” (Figure 10).

Figure 10: The Pathology of TBTF



This is the only credible regime shift that would return the U.S. to the path of financial stability.

¹⁴ In the context of TBTF, there are two types of ambiguity. “Constructive ambiguity” minimizes moral hazard by allowing for the possibility of governmental financial assistance *only* in rare, necessary instances. Such interventions are so unpredictable that no company can justifiably presume that it will be rescued if it gets into trouble (see Harvey Rosenblum, et.al., “Fed Intervention: Managing Moral Hazard in Financial Crises,” Federal Reserve Bank of Dallas, *Economic Letter*, Oct. 2008). “Destructive ambiguity” refers to people acting on “wrong” perceptions. Creditors of megabanking institutions may be acting on the belief that they will be made whole should the institution get into trouble. The remaining uncertainty over Dodd-Frank’s large-institution resolution procedures has so far been “destructive,” reinforcing the view that regulators would likely resort to old “bailout” habits in a future crisis.

Concluding Comments

The cost of the last financial crisis, at least one year's output down the drain, is simply staggering. Ways to truly avoid a repeat episode must be found.

Dodd-Frank is an ineffectual remedy. It will not work unless simplified and codified quickly. Three years after its passage, Dodd-Frank is getting more complex and further from completion as the clock keeps ticking. Unless this situation is reversed, quasi-nationalization of many of our largest banking institutions will likely become the default decision in the next crisis.

Meanwhile, community banks, which contribute to the vitality of the American economic and financial systems, are being dragged under by the weight of Dodd-Frank's regulatory compliance burdens. At the same time, TBTF banking institutions, which undermine the rule of equal treatment under the law, keep getting bigger and more dangerous.

Fewer than a dozen TBTF banking institutions are the 800 pound gorillas in the room that most people want to ignore. What's wrong with this picture?

Saying that TBTF has ended is NOT the same as ending it. In dealing with children, parents learn the importance of credibility – doing what you say you are going to do. Consistent and predictable follow-through must reinforce the words and promises. Cool Hand Luke learned this the hard way.

The Dallas Fed Plan cuts through this fog of unnecessary ambiguity. The time to consider an alternative to Dodd-Frank is now – while there is still time.

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