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The views expressed are those of the author and not necessarily those of the FDIC.

The United States is in its sixth year following the financial and economic crisis of 2008, and we are just about to start our fourth year since the enactment of the Dodd-Frank Act. Enormous energy has been expended in an attempt to implement a host of required reforms. The Volcker Rule has been implemented, and more recently a rule requiring foreign bank operations to establish U.S. holding companies has been adopted.

While these are important milestones, much remains undone and I suspect that 2014 will prove to be a critical juncture for determining the future of the banking industry and the role of regulators within that industry. The inertia around the status quo is a powerful force, and with the passage of time and fading memories, change becomes ever more difficult. There are any number of unresolved matters that require attention.

- This past July the regulatory authorities proposed a sensible supplemental capital requirement that is yet to be adopted. This single step would do much to strengthen the resiliency of the largest banks, since even today they hold proportionately as little as half the capital of the regional banks. The Global Capital Index points out that tangible capital to asset levels of the largest firms average only 4 percent.
- The largest banking firms carry an enormous volume of derivatives. The law directs that such activities be conducted away from the safety net, and we are still in the process of completing what is referred to as the push-out rules.
- Bankruptcy laws have not been amended to address the use of long-term assets to secure highly volatile short-term wholesale funding. This contributes to a sizable moral hazard risk among banks and shadow banks, as these instruments give the impression of being a source of liquidity when, in fact, they are highly unstable. The response so far has required that we develop ever-more complicated bank liquidity rules, which are costly to implement and enforce, and leave other firms free to rely on such volatile funding.
- Fannie Mae and Freddie Mac continue to operate under government conservatorship, and as such they dominate home mortgage financing in the United States.
- Finally, among the more notable and difficult pieces of the unfinished business is the assignment to assure that the largest, most complicated banks can be resolved through bankruptcy in an orderly fashion and without public aid. Congress gave the Federal Reserve and the FDIC, and the relevant banking companies, a tough assignment under the Title 1 provisions of the Dodd-Frank Act to solve this problem. It requires making difficult decisions now, or the die will be cast and the largest banking firms will be assured an advantage that few competitors will successfully overcome.¹

¹ Literature review of the too-big-to-fail subsidy. <http://www.fdic.gov/news/news/speeches/literature-review.pdf>

The Persistence of Too Big To Fail

I want to spend a few more minutes on this last topic, as it remains a critical step to a more sound financial system.

The chart titled Consolidation of the Credit Channel shows the trend in concentration of financial assets since 1984. The graph shows the distribution of assets for four groups of banks, ranging in size from less than \$100 million to more than \$10 billion. The chart shows that in 1984, the control of assets among the different bank groups was almost proportional. Also, within each group if a single bank failed, even the largest, it might shock the economy, but most likely would not bring it down. Today this distribution of assets is dramatically different. Banks controlling assets of more than \$10 billion have come to compose an overwhelming proportion of the economy, and those with more than a trillion dollars in assets have come to dominate this group. If even one of the largest five banks were to fail, it would devastate markets and the economy.

Title I of the Dodd-Frank Act is intended to address this issue by requiring these largest firms to map out a bankruptcy strategy. This is referred to as the Living Will. If bankruptcy fails to work, Title II of Dodd-Frank would have the government nationalize and ultimately liquidate a failing systemic firm.

While these mechanisms outline a path for resolution, success will be determined by how manageable large and complex firms are under bankruptcy and whether under any circumstance they can be resolved without major disruption to the economy. This is a daunting task, and increasing numbers of experts question whether it can be done given current industry structure.² Two impediments are most often highlighted to organizing an orderly bankruptcy or liquidation for these firms.

First, it is not possible for the private sector to provide the necessary liquidity through “debtor in possession” financing due to the size and complexity of the institutions and due to the speed at which crises occur. There simply would be too little confidence in bank assets and the lender’s ability to be repaid, and too little time to unwind these firms in an orderly fashion in a bankruptcy. Under the current system, it would have to be the government that provides the needed liquidity, it is argued, even in bankruptcy to avoid a broader financial meltdown.

² December 11, 2013 meeting of the FDIC Systemic Risk Advisory Committee.
<http://www.fdic.gov/about/srac/>

Second, when a mega banking firm goes into bankruptcy, capital markets and cross-border flows of money and capital most likely would seize up, intensifying the crisis, as happened following the failure of Lehman Brothers, for example. International cooperation is critical in such circumstances, and it would be ideal if creditors, bankers and governments acted calmly and rationally in a crisis. It would be ideal also if all contracts were honored and if collateral and capital were free to move across borders. But, experience suggests otherwise. Panic is about panic, and people and nations generally protect themselves and their wealth ahead of others. Moreover, there are no international bankruptcy laws to govern such matters and prevent the grabbing of assets, sometimes known as ring-fencing.

This raises the important question of whether firms must simplify themselves if we hope to place them into bankruptcy. This is no small question, and it must be addressed.

A further sense of the importance of these unresolved issues can be gained by working through the annual report of any one of these largest firms. These reports show that individual firms control assets close to the equivalent of nearly a quarter of U.S. GDP, and the five largest U.S. financial firms together have assets representing just over half of GDP. The reported composition of firm assets represents a further challenge in judging their resolvability, as it is opaque and the relationship among affiliate firms is sometimes unclear. A host of assets and risks are disclosed only in footnotes, although they often involve trillions of dollars of derivatives that are not shown on the balance sheet. Inter-company liabilities are in the hundreds of billions of dollars and if any one link fails, it can initiate a chain reaction of losses, failure and panic. And should crisis emerge, liquidity is sought through the insured bank, not through the provisions of bankruptcy. One failure means systemic consequences.

These conditions mean “too big to fail” remains a threat to economic stability. They necessarily put the economic system at risk should even one mega bank fail. And they allow these mega banks to operate beyond the constraints of economies of scale and scope, and provide the firms an enormous competitive advantage -- all of which is antithetical to capitalism.

Structural Change, Subsidiarization, and Capital

These observations are not new to the financial system, and they have sparked a broadening debate on what action might be taken to better assure that bankruptcy is the first option for resolution. Potential actions include some of the following:

First, simplify the corporate structure of the mega banks that now dominate the financial system. There is mounting evidence of the benefits that would flow from such an action. Market analysts and economists³ have pointed to increased value and greater economic stability

³ OECD research by Adrian Blundell-Wignall, Paul Atkinson and Caroline Roulet

<http://www.oecd.org/daf/fin/financial-markets/Bank-Separation-2013.pdf>

<http://www.oecd.org/daf/fin/financial-markets/Bank-Business-Models-Basel-2013.pdf>

“Break Up Banks: Show Me My Money,” Credit Agricole Securities - Mike Mayo. January 2013.

Hoenig and Morris: <http://www.fdic.gov/about/learn/board/hoenig/Restructuring-the-Banking-System,Hoenig,Morris,Nov.2013.pdf>

that would flow from such restructuring. Commercial banking is different than broker-dealer activities, and studies show that requiring banks and broker-dealers to operate independently would serve potentially to improve the pricing and allocation of capital, and to increase value.

Second, as the Federal Reserve recently required for foreign banks operating in the United States, governments should require global banking companies to establish separate operating subsidiaries within each country. This subsidarization would give greater clarity to where capital is lodged globally, and it would serve to assure that banks within each country have capital available at foreign affiliates to absorb losses on a basis comparable to that jurisdiction's domestic banks. Subsidarization also would lead to greater recognition of the risks on firms' balance sheets, causing more capital to be held globally and thus contributing to greater overall financial stability and availability of credit.

Those who object to this concept suggest that such a requirement interferes with capital flows and would actually reduce available credit. However, subsidarization would require that capital be aligned with where assets reside, and it would identify for markets and authorities the capital available to absorb losses should it be needed. It provides far more transparency than the current structure. Such transparency would encourage a more responsible use and allocation of capital and resources. It ends the charade that markets are open and safe, only to see them suddenly shut down and ring fenced, with devastating effect, when the inevitable crisis occurs.

Conclusion

It is fundamental to capitalism that markets be allowed to clear in an open, fair manner and that all participants play by the same rules. A situation whereby oligopolies that evolve into institutions that are too big to fail, and are so significant and complex that should they fail the economy fails, is not market economics. To ignore these circumstances is to invite crisis.

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Global Capital Index

Capitalization Ratios for Global Systemically Important Banks (GSIBs)

Data as of second quarter 2013

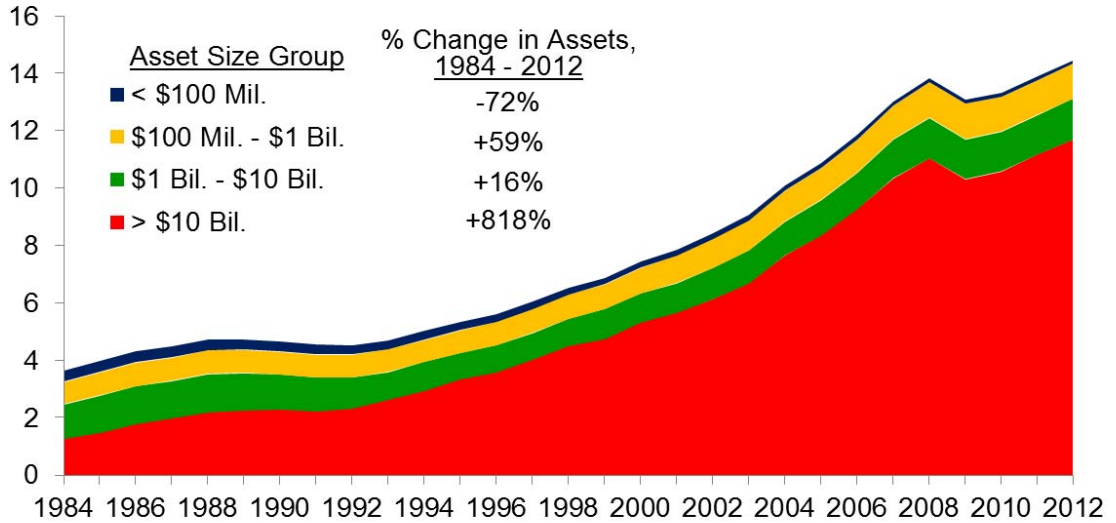
Institution	Basel Risk-Based Capital			Self-Reported Basel III Leverage Ratio (Percent)	Tangible Capital				Components of Capital			Price-to-Book	
	Tier 1 Capital ¹ (\$Billions)	Risk-Weighted Assets (\$Billions)	Tier 1 Capital Ratio ² (Percent)		GAAP		IFRS ESTIMATE ³		Total Equity ⁴ (\$Billions)	Goodwill and Other Intangibles (\$Billions)	Deferred Tax Assets (\$Billions)	Price-to-Book Ratio ⁵ (Percent)	Price-to-Adjusted Tangible Book Ratio ⁶ (Percent)
					Total Assets (\$Billions)	Leverage Ratio ⁷ (Percent)	Total Assets (\$Billions)	Leverage Ratio ⁸ (Percent)					
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	
U.S. G-SIBs													
Bank of America	157	1,288	12.16	4.90	2,128	5.73	3,092	3.87	231	82	34	0.84	
Bank of New York Mellon	17	115	14.82	...	361	3.94	378	3.75	36	23	0	0.94	
Citigroup	144	1,084	13.24	4.90	1,884	6.01	2,680	4.15	196	33	56	0.76	
Goldman Sachs	71	457	15.55	...	939	7.35	1,547	4.44	78	4	5	1.00	
JPMorgan Chase	164	1,410	11.63	4.70	2,439	5.81	3,715	3.78	209	59	12	1.01	
Morgan Stanley	57	403	14.07	4.20	803	5.85	1,549	3.00	63	10	7	0.78	
State Street	14	82	16.63	...	227	5.37	233	5.24	20	8	0	1.49	
Wells Fargo	133	1,097	12.12	...	1,441	8.23	1,499	7.92	162	48	0	1.47	
Average U.S. G-SIBs	756	5,938	12.73	...	10,219	6.28	14,693	4.30	996	287	113	0.97	
Foreign G-SIBs													
Banco Santander (Spain)	82	684	12.00	...	...	...	1,599	2.94	106	35	26	0.74
Bank of China Limited (China)	136	1,469	9.28	...	...	...	2,136	6.44	143	2	3	0.83
Barclays (UK)	80	595	13.46	2.30	...	...	2,354	2.73	83	12	7	0.70
BBVA (Spain)	49	433	11.34	...	...	...	785	5.13	80	9	12	1.27
BNP Paribas (France)	100	738	13.63	3.40	...	...	2,433	3.85	113	17	10	0.86
BPCE Group (France)	61	511	11.84	3.00	...	...	1,516	3.60	65	7	1	...
Crédit Agricole Group (France)	79	664	11.91	3.50	...	...	2,541	3.11	99	20	...	...
Deutsche Bank (Germany)	71	411	17.26	3.00	...	...	2,497	1.93	75	19	8	0.97
HSBC (UK)	150	1,105	13.58	4.10	...	...	2,645	5.62	182	29	7	1.10
ING Bank (Netherlands)	52	363	14.28	...	...	...	1,085	3.98	46	2	2	...
Nordea bank (Sweden)	31	277	11.26	...	...	...	813	3.95	36	4	0	1.41
Royal Bank of Scotland (UK)	89	670	13.28	3.10	...	...	1,808	3.92	99	22	6	0.44
Société Générale (France)	52	410	12.70	3.00	...	...	1,839	4.25	70	0	...	0.45
Standard Chartered (UK)	42	324	12.97	4.60	...	...	650	5.00	43	6	1	1.17
UBS (Switzerland)	42	258	16.24	...	...	...	1,199	2.91	50	7	9	1.29
UniCredit (Italy)	64	537	11.93	...	...	...	1,163	3.89	85	20	24	0.34
Average Foreign IFRS	1,180	9,445	12.48	...	...	...	28,927	3.89	1,359	212	120	0.74
Other Foreign G-SIBs													
Credit Suisse (Switzerland; CHF, U.S. GAAP)	49	308	15.97	...	959	3.37	...	...	47	8	7	...
Mitsubishi UFJ FG (Japan; JPY, Local GAAP)	119	912	13.02	...	2,292	5.46	...	...	139	11	3	0.70
Mizuho FG (Japan; JPY, Local GAAP)	68	599	11.42	...	1,727	4.03	...	...	78	5	3	0.90
Sumitomo Mitsui FG (Japan; JPY, Local GAAP)	74	638	11.63	...	1,474	5.45	...	...	89	8	1	0.94
Average All Foreign G-SIBs	1,450	11,902	12.62	...	33,325	4.04	...	...	1,712	244	136	0.75
Average U.S. BHC by Size Group													
U.S. G-SIBs	756	5,938	12.73	...	10,219	6.28	14,693	4.30	996	287	113	0.97	
Ten Largest Non-G-SIBs	179	1,525	11.74	...	1,891	8.40	1,899	8.37	230	71	7	1.07	
Ten Largest Less Than \$50 Billion ¹⁰	28	205	12.67	...	294	7.47	294	7.47	34	10	3	1.25	
Ten Largest Less Than \$1 Billion ¹⁰	1	7	12.71	...	10	8.27	10	8.27	1	0	0	...	

Source: Bankscope (Data updated as of September 9, 2013), Bloomberg LP, Federal Reserve Y-9C Reports, International Monetary Fund, and 10-Q reports.

Consolidation of the Credit Channel

Change in Assets by Bank Size Groups (1984-2012)

Total Assets of Institutions in Size Group, Dollars in Trillions



Source: FDIC. Reflects the aggregation of total assets of FDIC-insured institutions by bank holding company and also includes charter-level assets for banks with no holding company.

Notes:

¹Global systemically important banks (G-SIBs) are defined by the Financial Stability Board and include eight U.S. bank holding companies (BHC). Foreign G-SIBs report in local currencies, which are converted

into U.S. dollars using IMF International Financial Statistics exchange rates.

²Tier 1 Capital is equity capital less unrealized gains on available-for-sale debt securities, unrealized losses on available-for-sale equity securities, disallowed preferred stock, disallowed goodwill, disallowed

servicing assets, disallowed deferred tax assets, and other tier 1 capital components.

³Tier 1 capital ratios and underlying data are calculated and reported under the Capital Rules for Commercial Banks for the Bank of China, under Basel I capital standards for U.S. Banks, under Basel II for

Banco Santander, BBVA, ING Bank, Nordea Bank, Standard Chartered, and Unicredit, under Basel 2.5 for Barclays, BNP Paribas, BPCE Group, Credit Agricole, Deutsche Bank, HSBC, Royal Bank of Scotland,

and Societe Generale, and under Basel 3 for Credit Suisse, Mitsubishi UFJ, Mizuho FG, Sumitomo Mitsui, and UBS.

⁴Basel III leverage ratios are self-reported by institutions in published financial statements and presentations. They have not been reviewed for accuracy.

⁵Differences in accounting requirements for netting and offsetting of assets and liabilities result in significant differences in banks' total assets. The ability to offset under International Financial Reporting Standards (IFRS)

is limited in comparison with Generally Accepted Accounting Principles (GAAP), especially for derivatives traded with the same counterparty under an International Swaps and Derivatives Association (ISDA) Master

Netting Agreement. U.S. GAAP permits the netting of derivative receivables and payables, and the related cash collateral received and paid when a legally enforceable master netting agreement exists between a firm

and a derivative counterparty. U.S. GAAP discloses gross derivative assets and liabilities and the offset amount applied to derivatives in the notes to the consolidated financial statements rather than in the consolidated

balance sheet. To narrow the difference in total assets between IFRS and U.S. GAAP reporting institutions, the U.S. G-SIBs IFRS estimates follow the methodology used by ISDA in its Netting and Offsetting

Report (May 2012, <http://www2.isda.org/functional-areas/research/studies/>) and adds the disclosed offsetting amount applied to derivatives back to total assets in order to calculate total assets. Total assets are as

reported in the consolidated balance sheet while the offset applied to derivatives is as reported in the notes to the consolidated financial statements on derivatives in each firm's 10-Q report.

⁶The Leverage Ratio is the ratio of adjusted tangible equity to adjusted tangible assets. Adjusted tangible equity, adjusted tangible assets, and adjusted tangible book subtract goodwill, other intangibles, and deferred tax assets.

⁷Equity Capital is the basic GAAP measure of net worth, defined as total assets minus total liabilities.

⁸Median price-to-book ratios and price-to-adjusted tangible book ratios are used instead of averages for subgroups and for U.S. BHC size groups. Data are not available for six bank holding companies with assets

less than \$1 billion, as well as for BPCE Group, Credit Agricole Group, and ING Bank.

⁹Bank holding companies that are owned by a foreign parent or reported a net loss in second quarter 2013, and thrift holding companies that did not file a full FRY-9C report as of second quarter 2013 were excluded.

¹⁰The ten largest U.S. bank holding companies with assets less than \$50 billion and the ten largest U.S. bank holding companies with assets less than \$1 billion reported de minimis derivative exposures.

We assume that total assets and the adjusted tangible equity to adjusted tangible assets ratio are essentially the same under U.S. GAAP and the IFRS estimate.