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September 10, 2009

The Obama administration is continuing the Bush administration policy of refusing to comply with the Prompt Corrective Action (PCA) law.[1] Both administrations twisted a deeply flawed doctrine – "too big to fail" – into a policy enshrining crony capitalism.

Historically, "too big to fail" was a misnomer – large, insolvent banks and S&Ls were placed in receivership and their "risk capital" (shareholders and subordinated debtholders) received nothing. That treatment is fair, minimizes the costs to the taxpayers, and minimizes "moral hazard." "Too big to fail" meant only that they were not placed in liquidating receiverships (akin to a Chapter 7 "liquidating" bankruptcy). In this crisis, however, regulators have twisted the term into immunity. Massive insolvent banks are not placed in receivership, their senior managers are left in place, and the taxpayers secretly subsidize their risk capital. This policy is indefensible. It is also unlawful. It violates the Prompt Corrective Action law. If it is continued it will cause future crises and recurrent scandals.

On October 16, 2006, Chairman Bernanke delivered a speech explaining why regulators must not allow banks with inadequate capital to remain open.
http://federalreserve.gov/newsevents/speech/bernanke20061016a.htm

> Capital regulation is the cornerstone of bank regulators' efforts to maintain a safe and sound banking system, a critical element of overall financial stability. For example, supervisory policies regarding prompt corrective action are linked to a bank's leverage and risk-based capital ratios. Moreover, a strong capital base significantly reduces the moral hazard risks associated with the extension of the federal safety net.

The Treasury has fundamentally mischaracterized the nature of institutions it deems "too big to fail." These institutions are not massive because greater size brings efficiency. They are massive because size brings market and political power. Their size makes them inefficient and dangerous.

Under the current regulatory system banks that are too big to fail pose a clear and present danger to the economy. They are not national assets. A bank that is too big to fail is too big to operate safely and too big to regulate. It poses a systemic risk. These banks are not "systemically important", they are "systemically dangerous." They are ticking time bombs – except that many of them have already exploded.

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[1] [Add links to Huff Post article and Bill Moyer supplement]

We need to comply with the Prompt Corrective Action law. Any institution that the administration deems "too big to fail" should be placed on a public list of "banks posing systemic risk" (BPSRs). Such banks should be subject to regulatory and tax incentives to shrink to a size where they are no longer too big to fail, manage, and regulate. No single financial entity should be permitted to become, or remain, so large that it poses a systemic risk.

BPSRs should:

1. Not be permitted to acquire other firms
2. Not be permitted to grow
3. Be subject to a premium federal corporate income tax rate that increases with asset size
4. Be subject to comprehensive federal and state regulation, including:
    a. Annual, full-scope examinations by their primary federal regulator
    b. Annual examination by the systemic risk regulator
    c. Annual tax audits by the IRS
    d. An annual forensic (anti-fraud) audit by a firm chosen by their primary federal regulator
    e. An annual audit by a firm chosen by their primary federal regulator
    f. SEC review of every securities filing
5. A prohibition on any stock buy-backs
6. Limits on dividends
7. A requirement to follow "best practices" on executive compensation as specified by their primary federal regulator
8. A prohibition against growth and a requirement for phased shrinkage
9. A ban (which becomes effective in 18 months) on having an equity interest in any affiliate that is headquartered in or doing business in any tax haven (designated by the IRS) or engaging in any transaction with an entity located in any tax haven
10. A ban on lobbying any governmental entity
11. Consolidation of all affiliates, including SIVs, so that the BPSR could not evade leverage or capital requirements
12. Leverage limits
13. Increased capital requirements
14. A ban on the purchase, sale, or guarantee of any new OTC financial derivative
15. A ban on all new speculative investments
16. A ban on so-called "dynamic hedging"
17. A requirement to file criminal referrals meeting the standards set by the FBI
18. A requirement to establish "hot lines" encouraging whistleblowing
19. The appointment of public interest directors on the BPSR's board of directors
20. The appointment by the primary federal regulator of an ombudsman as a senior officer of the BPSR with the mission to function like an Inspector General