Resolving Systemically Dangerous Financial Institutions

William K. Black, Associate Professor of Economics and Law
University of Missouri, Kansas City

October 19, 2009

The Obama administration is continuing the Bush administration policy of refusing to comply with the Prompt Corrective Action (PCA) law.[a] 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.

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 "systemically dangerous institutions" (SDIs). SDIs 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.

[a] http://www.pbs.org/moyers/journal/blog/2009/04/william_k_black_on_the_prompt.html
http://www.huffingtonpost.com/william-k-black/why-is-geithner-continuin_b_169234.html

SAFER
ECONOMISTS' COMMITTEE FOR STABLE, ACCOUNTABLE, FAIR AND EFFICIENT FINANCIAL REFORM
A PROJECT OF THE POLITICAL ECONOMY RESEARCH INSTITUTE ■ UNIVERSITY OF MASSACHUSETTS, AMHERST

SDIs 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. Be prohibited from any stock buy-backs;

6. Have limits on dividends;

7. Be subject to a requirement to follow "best practices" on executive compensation as specified by their primary federal regulator;

8. Be subject to a prohibition against growth and a requirement for phased shrinkage;

9. Be banned from 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 (effective in 18 months);

10. Be banned from lobbying any governmental entity;

11. Be required to consolidate of all affiliates, including SIVs, so that the SDI could not evade leverage or capital requirements;

12. Be subject toleverage limits;

13. Be subject to increased capital requirements;

14. Be banned from the purchase, sale, or guarantee of any new OTC financial derivative;

15. Be banned from all new speculative investments;

16. Be banned from so-called "dynamic hedging";

17. Be subject to a requirement to file criminal referrals meeting the standards set by the FBI;

18. Be subject to a requirement to establish "hot lines" encouraging whistleblowing;

19. Be required to appoint public interest directors on the SDI's board of directors; and

20. Be required by the primary federal regulator to appoint an ombudsman as a senior officer of the SDI with the mission to function like an Inspector General.