THE DODD-FRANK ACT AND THE PERSISTENCE OF "TOO BIG TO FAIL"

The Dodd-Frank Act, the Persistence of "Too Big to Fail," and the Institutionalization of Government Bailouts

Of all the claims made by the proponents of the Dodd-Frank Act, the most important are these: that the Dodd-Frank Act ends "too big to fail" and that it protects the American taxpayer "by ending bailouts." In light of the disastrous events of 2008, in which Americans saw their government rescue first Bear Stearns, then AIG, Citigroup, and Bank of America — among others — and when the only regret voiced by those who orchestrated the bailouts was that they couldn't bail out Lehman Brothers because it, too, was "too big to fail," the promises to end "too big to fail" and "end bailouts" are at the heart of the Dodd-Frank Act. The Dodd-Frank Act can be judged to succeed or fail on whether it makes good on these two claims.

Democrats' False Claims On Dodd-Frank Ending Bailouts:

"This legislation makes common-sense reforms that end the era of taxpayer bailouts and 'too-big-to-fail' financial firms."

- Rep. Nancy Pelosi
floor remarks, 6/30/10

"Because Of This Reform, The American People Will Never Again Be Asked To Foot The Bill For Wall Street's Mistakes. There Will Be No More Taxpayer-Funded Bailouts - Period."

- President Obama
remarks on passage of regulatory reform, 7/15/10

"Let Me Say That Again Because It Is One Of The Most Important Parts Of This Bill: No More Bailouts Because No Bank Is Too Big To Fail."

- Senator Harry Reid

But if we judge the Dodd-Frank Act on whether it "ends too big to fail" and whether it "ends bailouts," we have no choice but to conclude that the Dodd-Frank Act is a failure. The largest financial institutions in America remain "too big to fail"; in fact, they are even bigger now than they were at the height of the crisis. And the Dodd-Frank Act most certainly did not end bailouts; instead, it institutionalized them and made them permanent in the form of the "Orderly Liquidation Authority" set forth in Title II of the Act. American taxpayers are no better protected against bailouts than they were in 2008: if anything, they are even more exposed to the danger that government bureaucrats will pick their pockets to bail out the creditors of the next "too big to fail" institution that finds itself on the brink of failure.

The Persistence of Too Big to Fail

Anyone who looks at the rationale offered for the bailouts of 2008 — that certain financial institutions were "too big to fail" and therefore had to be rescued at taxpayer expense, no matter how incompetently run they were or how big the risks they took—has to be puzzled at the structure of the financial services industry in 2011. Surely, if the problem was that these institutions were "too big to fail," the solution cannot be to make these institutions . . . even bigger. Yet that is exactly what has resulted from the bailouts, the misguided policies adopted by panicked regulators, and the implicit subsidies that the Dodd-Frank Act offers to behemoth financial institutions to stay as large as they possibly can.

When the financial crisis struck the nation in 2008, officials pumped hundreds of billions of dollars into the country's biggest financial institutions because these officials feared that their failure would crash the entire financial system. But in 2011, the country's financial system is far more concentrated and less competitive than it has ever been. The five largest financial institutions control more than half of the industry's assets, which is equal to almost 60 percent of GDP. The largest 20 institutions control 80 percent of the industry's assets, which amounts to about 86 percent of GDP. Common sense says that "if they are too big to fail, make them smaller." No one can say with a straight face "if they are too big to fail, make them even bigger." Yet that is exactly what has resulted from misguided government policies and the Dodd-Frank Act.

The proponents of the Dodd-Frank Act will tell you that the Act bans bailouts. That government will never again come to the rescue of a large financial firm that finds itself in trouble. That taxpayers will never again be on the hook for paying off the creditors of an AIG or a Bear Stearns. There's just one small problem with that assertion: no one believes it. Not the creditors of these giant firms: they continue to lend to the too-big-to-fail firms—and they continue to lend more cheaply to these giant firms than they do smaller, less risky banks—because they continue to believe that when push comes to shove, government officials will intervene, no matter how much they say they hate bailouts and want to protect the taxpayer.

Not even the Secretary of the Treasury, Timothy Geithner, believes that the Dodd-Frank Act ended "too big to fail." When asked about the multiple rescues of Citigroup and whether the Dodd-Frank Act ended "too big to fail" by the Special Inspector General for the Troubled Asset Relief Program, the Secretary Geithner said out loud what everyone already knows to be the truth: "In the future we may have to do exceptional things again if we face a shock that large." But the Dodd-Frank Act was supposed to save government officials from doing "exceptional things"; that is the reason for its existence. If the Dodd-Frank Act means that "in the future we may have to do exceptional things," then the Dodd-Frank Act cannot credibly be said to have ended "too big to fail."

Treasury Secretary, Timothy Geithner acknowledges Dodd-Frank does not end bailouts.

Proponents of Dodd-Frank say it ends taxpayer-funded bailouts, but facts are stubborn things.

American taxpayers are still very much at risk for potential future Wall Street bailouts.

You Say You Want a Resolution?

But the proponents of the Dodd-Frank Act point to Title II of the Act — the "resolution authority" that gives the Federal Deposit Insurance Corporation the ability and the wherewithal to wind down in an orderly way a "too big to fail" firm. The reasoning that the supporters of the Dodd-Frank Act offer us is this: the FDIC can wind down a small bank with no problem at all; therefore, the FDIC can wind down a behemoth, multinational, complex financial institution, no problem at all. It doesn't matter how big, how complex, how international the firm is: the FDIC can "resolve" it. And this "resolution" can be done without costing the taxpayers a single dime. After all — the Dodd-Frank Act banned bailouts.

But the Dodd-Frank's "resolution authority" has a couple of problems that its supporters would rather you did not notice. The first is that it simply won't work for the largest, most complex financial institutions. Remember how the supporters of the "resolution authority" told you not to worry, because this was just like "resolving" a small bank? Let's take that claim seriously. This is how the FDIC resolves a "small bank," according to a 2009 article in the *Economist* magazine:

> If the FDIC agents had tear gas rather than briefcases, we'd understand them to be a SWAT team. Eighty of them flew into Clark County, checked into hotels under assumed names, gave false reasons for their visit, and around 6 P.M. on that Friday, walked in and assumed control of the bank. By all accounts—including those of the employees at the Bank of Clark County—the FDIC was almost startlingly competent, professional, and sophisticated. Even the workers who were seeing their labor dismantled and their jobs destroyed sound impressed by the cool efficiency of the Feds.

That sounds pretty good. In on Friday, out by Monday. There's just one small problem:

> The Bank of Clark County had 100 employees and assets of $440 million which, if you're not used to bank numbers, is a really small bank. But it took 80 FDIC agents, 50 bank employees, and 100 employees [from the neighboring bank that

> assumed control] working round-the-clock for three days to take it over and have it reopen for business.
>
> Most of the largest banks in trouble right now—Citibank, Bank of America—are about 6,000 times the size of Bank of Clark County, not to mention much, much more complicated.
>
> For those who don't have calculators handy 80 multiplied by 6,000 is 480,000. On the bright side, that's one hell of a stimulus opportunity.[1]

But let's leave aside, for the moment, the "you and whose army" problem that the "resolution authority" poses. Let's look at the "you and whose money" problem. That one is easy to answer: whose money? The American taxpayers', that's whose.

Those who believe in the "resolution authority" are fond of telling you that it won't cost you a dime: the Dodd-Frank Act bans bailouts, and it mandates that no taxpayer funds be used in resolving a financial institution. But remember Secretary Geithner and the "exceptional things" that "we" may have to do? That "we" means regulators and government officials (they decide) and you (more specifically, your dollars). Here is how it works.

FACT BOX: HOW DODD-FRANK CONTINUES AIG-STYLE BAILOUTS

- **Section 204** of the Dodd-Frank Act permits the FDIC to lend to a failing firm; purchase the assets of a failing firm; guarantee the obligations of a failing firm; take a security interest in the assets of a failing firm; and/or sell or transfer assets that the FDIC has acquired from the failing firm.
- **Section 210** authorizes the FDIC to borrow up to 10% of the book value of the failed firm's total consolidated assets in the 30 days immediately following its appointment as receiver. After those 30 days, the FDIC is authorized to borrow up to 90% of the fair value of the failed firm's total consolidated assets. For Bank of America, that's $2 trillion in bailout authority alone, to be paid for by the taxpayer.

[1] "Scenes from a nationalization," *The Economist*, April 8, 2009, at http://www.economist.com/blogs/freeexchange/2009/04/scenes_from_a_nationalisation .

Among other things, the "resolution authority" gives the FDIC the power to lend to a failing firm; purchase its assets; guarantee its obligations; and — most important — *pay off its creditors*. The "resolution authority" also gives the FDIC the authority to borrow money from the Treasury. Lots of it. How much? The FDIC can borrow up to 10% of the book value of the failed firm's total consolidated assets in the 30 days immediately following its appointment as receiver. After those 30 days, the FDIC can borrow up to 90% of the fair value of the failed firm's total consolidated assets.

Maybe if we look at the asset sizes of the too-big-to-fail firms, we can get a sense of just how much the FDIC can borrow:

Firms Protected by Democrat "Too Big to Fail" Bailouts

	Total Assets	Potential Bailout Liability
JPMorganChase	$2,265,792,000,000	$2,039,212,800,000
Bank of America	$2,136,577,907,000	$1,922,920,116,300
citi	$1,873,878,000,000	$1,686,490,200,000
WELLS FARGO	$1,313,867,000,000	$1,182,480,300,000
Goldman Sachs	$923,718,000,000	$831,346,200,000
Morgan Stanley	$749,898,000	$674,908,200
Total Potential Taxpayer Exposure for "TBTF" Institutions		$7,663,124,524,500

Source: Federal Financial Institutions Examination Council (as of December 31, 2011)

So for Bank of America, for example, if "we" had to do "an exceptional thing," it could cost us about $2 trillion. Same for JP Morgan Chase. And Citigroup. And make no mistake: that's *your* money. The FDIC can borrow it from the Treasury, and the Treasury is you. The proponents of the Dodd-Frank Act say that you will be paid back. Let's hope that you are. But the bottom line is that it is *your* money, and you bear the risk.

But what is the money going to be used for? This is where it gets interesting. Remember how the proponents of the Dodd-Frank Act said that the Act ended bailouts? Well, they are about 7% right: the shareholders of the failed institution don't get a dime.[2] The management may well be fired. But the creditors of a highly-leveraged institution are going to get paid off. That's the point. That's how you make the resolution of a "too big to fail" institution "orderly." That's how you keep financial markets from panicking when a "too big to fail" institution . . . fails. You pay off everyone in sight.

> *"The [Dodd-Frank Act] claimed to end the era of "too-big-to-fail" institutions and sought to address the fundamental structural weaknesses and conflicts within the financial system. To falsely declare an end to Too Big to Fail without actually accomplishing that end is more damaging to the credibility of U.S. markets than a failure to act at all... In fact, Dodd-Frank reinforces the market perception that a small and elite group of large firms are different from the rest."*
>
> **- Josh Rosner,**
> Managing Director of Graham Fisher & Co

Lest you think this is an unfair characterization, consider the bailouts of Bear Stearns and of AIG. The Bear Stearns shareholders got very little — first $2 a share, and then $10, but dollars that came by way of the Federal Reserve did not end up in shareholder pockets. Instead, those dollars were used to guarantee toxic assets in order to entice someone else (in this case, JP Morgan Chase) to buy up Bear Stearns. Bear Stearns shareholders got little; JP Morgan Chase got both a bargain and even bigger; and you got all the risk. The AIG shareholders also got wiped out. But the AIG counterparties got paid off 100 cents on the dollar, and you got an interest in an off-balance sheet vehicle of the Federal Reserve Bank of New York. Pay close attention: these are how the non-bailout bailouts are going to work. You will front the dollars; you will take the risk. If it works out, you may not lose very much. But you aren't going to get any of the profit. That's going to go to others.

Maybe it is worth stepping back to figure out what is wrong with this picture. Republicans argued strongly for an enhanced bankruptcy regime that would force the creditors of large, complex financial institutions to bear the consequences if the firms to which they extended credit failed. That's what bankruptcy does: it spreads the losses among the shareholders of a firm and its creditors. The United States Treasury — and thus the taxpayer — is not involved.

---

[2] The new Basel Standards mandate a capital buffer of 7% for financial institutions, so that's why the supporters of the Dodd-Frank Act are 7% right and 93% wrong when they say that it ends bailouts. Shareholders — the 7% — may well get nothing; it's the other 93% — the institution's creditors — that are the problem.

But Rep. Frank objected to this, and tried to change the subject, asking on the House floor: "If Republicans are so in favor of bankruptcy, why don't they want it for banks?"

> *"What the orderly liquidation authority does allow [the government] to do . . . is bail out the counterparties to [a failed] financial institution, so not unlike the treatment that Goldman Sachs got with regard to AIG."*
>
> **- Stephen J. Lubben**
> Daniel J. Moore Professor of Law, Seton Hall University School of Law
> Hearing of the Subcommittee on Financial Institutions and Consumer Credit
> June 14, 2011

That's a good question. But a better question would have been this: "Why did Democrats want to extend deposit insurance to the creditors of 'too big to fail' institutions?" Banks — and their depositors — are protected by deposit insurance. Banks and their depositors pay for it, and it makes sense: we don't expect small, unsophisticated retail bank depositors to thoroughly scrutinize their bank's balance sheets and quiz the bank's employees about how the bank is using their deposits.

But for the creditors of "too big to fail" institutions (who are often themselves "too big to fail"), we do — and we should — expect more. We expect them to be careful about their decisions to lend millions and billions to large financial institutions. We want them to analyze the risks they are taking on, rather than expecting that the FDIC will step in to pay them off if things get bad enough. It is, after all, the analysis of risk (rather than relying on an implicit government guarantee or an FDIC-provided backstop) that is necessary to allocate capital efficiently in our economy. Without an efficient allocation of capital, our economy cannot grow. Instead, by subsidizing "too big to fail" institutions and insuring the creditors of these institutions against the consequences of their poor decisions, the Dodd-Frank Act all but ensures that capital will continue to be misallocated while our economy continues to founder.

> *"Instead of breaking up banks, Dodd-Frank separates banks with more than $50 billion in assets and certain other large financial institutions into a class of 'systemically important' entities — too big to fail by another name...Inevitably, 'systemically important' will come to mean 'protected by Uncle Sam.'"*
>
> - **Eric Schurenberg,**
> Fiscal Times

> *In the future we may have to do exceptional things again if we face a shock that large.*
>
> **– Obama Administration Treasury Secretary Timothy Geithner**
>
> December, 2010

> *"It was apparent to SIGTARP from the context of the interview, including the reference to doing something exceptional "again" in the face of a future financial crisis, that Secretary Geithner was referring to the possibility of future bailouts."*
>
> **- Office of the Special Inspector General of the Troubled Asset Relief Program**
>
> January 26, 2011