Focusing on Bank Size, Missing the Real Problem

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The new president of the Minneapolis Federal Reserve Bank, Neel Kashkari, recently made a
rush to announce that even after
Dodd-Frank and the other regulatory
responses to the financial crisis of
2008, the largest banks are still “too
big to fail.” In his view, along with
that of Bernie Sanders, Elizabeth
Warren, Sherrod Brown and other
the true believers, breaking up these
institutions is the way the country
can be confident that the
2008 bailouts won’t be repeated.

Populist ‘too big to fail’
attacks don’t address
the real financial risk: not
enough stable deposits.

Mr. Kashkari is a serious policy
maker, but those proposals are seri-
ously misguided. Focusing on bank
size is politically appealing but
diverts attention from the major
source of systemic risk in the finan-
cial system: a shortage of stable
deposits. Banks are but one part of
an interconnected financial system
providing over $40 trillion of credit
to the economy, but that credit is
supported by only about $14 trillion
of bank deposits.

The gap must be closed largely
with professionally managed, ”wholesale”
funding, such as short-term
repurchase agreements. Wholesale
funders are quick to pull their sup-
port by not rolling over short-term
credit if they perceive those funds
are at risk. This leads to periodic
tanks on financial institutions and
the resulting demand for govern-
ment intervention to prevent the
failure of those institutions.

Substantial wholesale funding is
necessary to sustain the current
level of financial-sector credit that
supports the economy. And now this
traditional source of systemic risk
has been joined by a new one: the
Federal Reserve’s unconventional
monetary policy. Years of near-zero
interest rates have led to a rise in
specialized positions across a wide
crange of asset classes, as all finan-
cial institutions find themselves
under intense pressure to seek ade-
quate returns.

These institutions, small and
large, tend to make the same risky
bets, what the market calls
crowded trades.” For instance,
energy markets and investments
became an increasingly central and
centralized part of many financial
institutions’ portfolios, not just
those of the large banks. With the
swift decline in oil prices, they
have suffered losses.

When losses grow large enough in
an environment of crowded trades—
such as in housing in the last de-
cade—large banks can fail, with
damaging consequences. The fail-
ure of small institutions can lead to
the same results. The collapse of
smaller unit trusts in the 1980 mar-
ket crash ultimately escalated to
threaten the nation’s largest finan-
cial institutions.

Whether there are 10 big banks in
the country or 10,000 small ones,
there will still be insufficient stable
financing from deposits, and a
resulting reliance on wholesale
funds. And an artificially imposed
cap on the size of bank intermedi-
aries will do nothing to stop crowded
trades, at least as long as interest
rates are held artificially low.

If Mr. Kashkari wants to rid the
financial system of liquidity risk and
a taxpayer backup, he should be
clear about what it would require:
Reducing financial-sector assets to
them in line with available
deposits carries lower systemic
growth and incomes. And for these
measures to be effective, the entire
lending market would need to be
brought back inside the insured
banking system. Given how unpopu-
lar this would be, populists from
both sides of the political aisle pre-
fer to focus on intermediaries, with
ideas such as breaking up the banks.
This is treating the symptom rather
than the disease.

Mr. Kashkari’s alternative pro-
posal, promoted by academics in-
cluding most vocally Stanford eco-
nomist Anat Admati, is to ramp up
bank capital to such a degree that the
possibility of failure would be
remote to nonexistent. But the con-
sequence of a dramatic increase in
bank capital is an increase in the
cost of bank credit, meaning higher
interest rates across the board.
Those who favor much higher bank
capital argue this would not happen,
because investors would accept
lower returns if the banks put
their money in were safer.

In the real world of capital mar-
kets, however, there are not enough
natural investors in bank equity
seeking utility-like returns, institu-
tions capitalized largely with debt
would encounter similar con-
straints.

Given these structural facts, the
job of the regulatory system is
clear. First, facilitate the realoc-
ation of capital during the inevitable
periodic crises through orderly liq-
uidation of failing or failed banks.
Second, adopt a monetary policy
rule, such as the Taylor rule, that
would normalize interest rates and
reduce the incentive for big banks
and even smaller institutions to
take dangerous risks.

Lastly, fully measure and evaluate
the impact of Dodd-Frank on the
financial system before arbitrarily
taking an ax to big banks and irrepa-
riably damaging the economy.

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