

## Panel 4

# "Too big to fail" or "Too big to be rescued"

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*Moderator:*

John Bowler, Director, Country Risk Service, The Economist Intelligence Unit, London

*Speakers:*

Prof. William K. Black, white-collar criminologist and former senior financial regulator, Associate Professor of Economics and Law, University of Missouri, Kansas City

Jean de Demandolx Dedons, Member of the Collège de l'AMF, President, J. de Demandolx Associés and J. de Demandolx Gestion S.A., Paris

Prof. emeritus Hans Geiger, University of Zurich

Gildas Hita de Nercy, Head of Research, Exane Derivatives, Geneva

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"I think the idea of banks being 'too big to fail' and 'too big to be rescued' is central because of the scale of the financial crisis we have been through", said the moderator John Bowler as an introduction to this panel. There is a moral hazard in the sense that banks now have an explicit guarantee from governments and tax payers because of their potential impact on the economy, and this guarantee is going to encourage reckless behavior of these institutions and the expansion of bank balance sheets.

On the too big to fail issue, noted the moderator, one of the direct consequences of this crisis is that the banking sector has actually become more concentrated, and that large banks have become even larger, have built great power and pose an even greater risk to the system at large. On the too big to be rescued case, John Bowler pointed at the sheer scale of some financial institutions. The Royal Bank of Scotland, which was more or less fully nationalised by the UK government to bail it out, has a balance sheet that is bigger than UK's GDP. The same problem was seen in Ireland, where the country's sovereign credit rating is coming under pressure because the government has assumed the liabilities of the financial sector.

So regulatory changes are in order, said the moderator. Banks will likely have to hold more capital and more liquidity, and we will likely see some kind of restrictions on pay and bonuses to curb the risk of traders taking too much risk on behalf of their institution for their own benefit. Some regulation might be more controversial, as we might see some legislation on the size of banks, and some people are arguing for something similar to the Glass-Steagal Act introduced after the Great Depression, which actually split banks into safe utility-like deposit banks and divorce them from the more risky investment banking activities, which have been a much bigger contributor to the current crisis.

Professor William Black addressed specifically the "too big to fail" issue, calling the giant

financial banks "SDIs", for "Systemically Dangerous Institutions". The definition of these institutions, he said, is that if a single one of them goes down, there is a serious danger of global crisis resulting. "I think it is plain insane to allow them to continue to exist", he said, "unless you believe in perfect governance and regulation, and no regulator does". His proposal: simply end the systemically dangerous institutions. "Stop their growth immediately; require their shrinkage, by using intensive regulation until they have gotten down to the point where they can't cause a systemic crisis; go back to honest accounting rules and loss recognition; hold control fraud officers and CEOs accountable". This, argued the panelist, would not come at any loss of efficiency as there are not economies of scale in running a large systemically dangerous institution. Smaller banks would actually be more efficient.

Control fraud epidemics played a major role in this crisis, said the speaker, and while any size lender could use fraud, the SDIs are unique in five respects: 1. One failure leads to a global crisis. 2. They create regulatory "black holes". 3. They cannot be regulated successfully. 4. They create "downstream" fraud epidemic. 5. They aid and encourage other major and elite frauds. On the ability of SDIs to create regulatory black holes, the panelist said that these institutions had a very large political influence and exert dominant power in legislation in their favor. "The best return on asset in the US is always a political contribution", he said. Empirically, SDIs oppose regulation. Commenting on the fact that SDIs are too big to regulate, William Black said that there was no success stories ever in regulating systemically dangerous institutions. SDIs are even too big to manage, as AIG's CEO admitted in a statement cited by the speaker. All the global regulators combined would be outnumbered by any SDI, further argued the panelist. "The art form here is to chose your regulator and make sure they will fail, and create a self-fulfilling prophecy of failure", he said. Resident examiner end up "marrying the natives", so they are essentially useless. As Lehman Brothers went down, the FED testified that the world was on the verge of a complete collapse, yet they sent only 2 people, said William Black.

About echo epidemic, the key issue, said the speaker, is the existence of CDOs. "Without CDOs, the crisis on non-prime lending would have been a 300 billion dollar crisis. You need the CDOs to turn it into a 3.5 trillion dollar crisis". So-called "liar loans", on which CDOs were overwhelmingly backed no later than 2005, really earned their reputation, advocated the panelist. Citing MARI, the anti-fraud specialty entity of the mortgage bankers association – an industry panel – wrote in a report that when the stated incomes were compared to the actual incomes gathered from the Internal Revenue Service, the US fiscal entity, 90% of the stated income amounts were exaggerated by 5% or more, with almost 60% exaggerated by more than 50%. With such a fraud incidence of 90%, there has been only 36 criminal referrals by the investment banks that handled these loans. Which hints at a large-scale problem of adverse selection and serious doubts about the work of the rating agencies, which provided triple As to the liar loans backed CDOs.

William Black blames much of the lack of appropriate response on the anti-regulation spirit prevailing in US policy making in recent decades. "Alan Greenspan, former FED chairman, and Harvey Pitt, former chairman of the SEC, are classical example. They learned their economics from people like Easterbrook and Fischel, the dominant players in the US loan economics and corporate law. Fischel once said that 'a rule against fraud is not an essential or an important ingredient of

securities market', as he thought that securities market automatically exclude fraud". Yet in the words of economist Gregory Mankiew, who was chairman of President Bush's Council of Economic Advisors, "it would be irrational for operators in the savings and loan not to loot". This, said Mr Black, is what was taught in our business schools, which became "fraud factories". No wonder regulation failed, he added. The people in government hated regulation, and did everything to gut it and make it ineffective. "Mission accomplished", summed up the panelist.

The next speaker, Jean de Demandolx Dedons, offered some historical perspective on the changes that occurred in the financial world since he started as a banker in the US in the 1960s. "Banking was a dull business at the time. To be a banker at the time, like my father and my grand father, was to be strict. There was the Glass-Steagal Act, which said what we could do and not do. Ethics was important. You were basically on the client's side". The regulator was also quite strong, and there were very strict accounting rules, with no off-balance sheet items. Then in the 80s trading and the "Golden Boys mentality" took over banking, initiating a major change in the way business was done. With the rotation of people in banking, if you made a bad loan it was the successor who would have to deal with it, so people weren't held responsible anymore. "Behaviors really changed, said Mr de Demandolx Dedons. But what did the regulators do? I think they have been totally incompetent in the US, in France or the UK. They didn't realize what was happening in the banking and trading business. They thought they had to do with gentlemen, and didn't realize the world had change and banks were not anymore on the client side, and that instead of bankers they were dealing with salespeople.". When he was a banker at Chase Manhattan Bank, his division was called "Trust and investment". Trust was the key word. Now it is called "Equity sales and derivatives division". "Instead of being on the client's side, you are now a producer of financial products, and that is a major change. Instead of having gentlemen in banking, you now only have greed. We have a major problem with ethics. And regulation has not kept up with this evolution".

Professor Hans Geiger started his address with a simple question: why are banks regulated? The standard answer of economists is because of the risk of market failure. Yet, the speaker argued, in the banking sector the opposite has occurred, and regulation has increased the risk of market failure, especially for very large banks. "The real issue is wrong regulation", Professor Geiger said. As for the "too big to fail" issue, he said the size of banks isn't the real problem. "In the US, the six largest banks combined had total assets of about 25% of GDP before the crisis and it increased to 60% of GDP after the crisis. Well if this is a problem for the US, it looks like a solution for Switzerland. Before the crisis, one Swiss bank, UBS, had a balance sheet of 500% of Swiss GDP. Today, UBS and Credit Suisse combined still have assets worth about 500% of Swiss GDP". Where are the real problems he asked? There are six, the first three being "leverage, leverage and leverage", he said, especially for large banks. The second major problem is implicit and explicit state guarantee for banks. And the third is loose monetary policy.

On the issue of leverage or large banks, the panelist blamed this high level of leverage on bad regulation championed by banks, in particular the Basel II rules, and maybe even more the Basel III regulations which are just evolving. The starting point, he argued, was the 1996 implementation of the market risk amendment to Basel I. At that time the big banks insisted that they were smarter than the

regulators and supervisors, that they had better methods, and that their methods didn't agree with a supervisory idea anyway. And in a rather ununderstandable way the supervisors tended to agree. So two things were introduced: one was a menu approach so the banks could select which rule they would like to follow. And the other was that the banks were allowed to use their own internal risk models. "I have never seen any area where the participants, especially the big and dangerous ones, have the right to determine their own rules", said Professor Geiger. As a result, when UBS went down, it had an equity ratio of merely 1.6% – so that for every 100 Swiss franc lent or invested, UBS invested only 1.60 franc of their own capital, and the remaining 98.4% was foreign money. "Now if that is not overleveraged...", said the panelist. When the banking law was introduced in Switzerland in 1934, the gearing was 10% equity and 90% debt – so nearly 10 times more. "So the real issue is leverage and absolutely flawed regulation of leverage", said Professor Geiger.

Taking Switzerland as a model for the "too big to fail" issue, which is particularly problematic in a country where a single bank had assets worth 500% the Swiss GDP, the speaker described the way UBS's failure was dealt with. The government, the National Bank and the regulator immediately implemented a rescue package in October 2008. They doubled the leverage ratio requirements of Basel II for the two large banks, up to 4%. They implemented new rules on bonuses and incentives, and increased the amount of the deposit insurance scheme per client, from 30 000 to 100 000 Swiss francs. Since then, a governmental commission recently made recommendations for the future regulation in Switzerland to tackle the "too big to fail issue". Professor Geiger first talked about what this commission did not recommend. It does not favor absolute limit on the size of banks or their balance sheets, measures deemed as not helpful. The commission recommended not to introduce a special tax on big banks, as it would prompt them to ask for special guarantees. Further, there is no idea of a special fund to rescue big banks – an idea raised by the banks who "love to be rescued", said Mr Geiger. As for what the commission recommended: first, it said Switzerland needed a special regulatory regime for systematically important banks. This regime is indeed implemented, but it is not yet in the law, as it has to pass through Parliament before being enacted. Next, a new instrument should be introduced to convert debt into capital. This new financial instrument, dubbed COCO, is a conditional mandatory convertible bond that would be converted from debt into capital of a bank before bankruptcy starts, so in an early case when a trigger point is reached. Then the commission suggested some structural requirements that could facilitate the separation of systematically important banks into different units. It says much more capital is needed for these banks – real capital, not pseudo capital – and much more liquidity. The need was also called on more restrictive rules on risk concentration. Eventually, all these recommendations have to come in a new banking law in Switzerland.

For Gildas Hita de Nercy, in order to deal with the "too big to fail" issue, we first have to be able to identify these dangerous institutions before they go bankrupt. But this is not as easy a task as in the industrial sector, said the panelist. "You can easily spot a very large industrial corporation, as size is directly linked with market share and number of employees, and we have know for a long time to deal with monopolies". In finance, however, these identifying criteria – market share and payroll – do not apply. The risk of a financial institution is not strictly reflected in its balance sheet, nor in its number of employees. A risk analysis is therefore needed, which is totally

different. What are the risks of a financial institution, asked the speaker? A difference must be made between two types of financial activities: the traditional lending business, where the risk can be identified from the balance sheet, and is driven by the lending policy. Yet the securitization of risk has in part changed this activity. Instead of bearing the risk, the bank gets rid of it by selling it as a product on the securities market. "When you do this, you change job", said Mr de Nercy. "From being a banker responsible for its risks, you become a risk broker, which is fundamentally different. The question is not anymore the quality of your risk, but the quality of your margin, since you have sold your risk". So securitization, for all its positive aspects in allowing banks to manage their balance sheet in a more diversified way, is a real game-changer in the industry.

The second type of risk in finance, which has nothing to do with credit, is the investment risk. Here you don't have to know the client you are lending to, you merely manage a portfolio. And the risk in the investment activity is directly linked to the issue of leverage. "What makes finance special, is that an operator can manage a portfolio of 1 million or 10 billions with the same infrastructure, said the speaker. There are no economies of scale in investment finance. And the size of your operation might not even show in your balance sheet. So leverage control isn't achieved through cost control – it has to be done through regulation". Risk in investment banking is translated in exposure, which is dealt with by models, both for valuation and for risk management. "Things are highly modelized, and far away from an accounting view, which makes them extremely opaque, both for the public and for regulators", said Mr de Nercy. So it is very difficult to try to regulate "too big to fail" institutions, both in judging the lending guidance of credit institution and in judging the risk of exposure of proprietary trading in the investment activity. Another issue, which evolved in the past decade and is at the crossroad of the credit and investment activities, is the notion of credit derivatives. These instruments allow to transfer and leverage credit risks. And here, models are totally ineffective. "I come from the field of physics, so I know what a model is. And I can tell you that credit risk modelization simply does not exist, it is an illusion", said the panelist. So as soon as try to develop risk models on CDOs and CDSs, you are taking systemic risks on events that you cannot hedge beforehand. Another issue raised by the panelist is the co-existence of credit distribution and credit trading activities within an institution. "It is obviously a nest for conflicts of interest, said Mr de Nercy. And these things are absolutely not regulated".

What, then, should be done to address the "too big to fail" risk? First, a simple and evident thing to do, said Mr de Nercy, is to separate the activities where conflicts of interest are obvious: "People doing credit derivatives shouldn't be too close to people doing traditional banking and deciding over defaults. This is common sense". Second, leverage has to be regulated. "This is common sense as well, continued the panelist. Everybody's leverage is checked, since you know very well that leverage is the best way to go bankrupt. When you go to your banker, he checks your leverage. Corporate leverage is the first thing one looks at in a balance sheet. Yet the only people escaping scrutiny over their leverage are hedge funds, whose core activity is around leverage!" So checking and regulating leverage is central, as much for the security and stability of the financial system as for the stability of the macro-economy as a whole. "One of today's largest risk is that, with interest rates lower than 1%, leverage becomes even more attractive since it is nearly free! So

people will leverage even more, without being controlled". The third point of action should be in the area of derivatives, by making clear distinctions, said the speaker. "I think certain products ought to be outright forbidden. For me a CDO or a CDO square are much too complex and totally un-modelizable to be authorized. I hope that all exotic securitization products will be excluded from financial laws and regulations".

As for CDS, they need to be centralized, said Mr de Nercy, for reasons of compensation and security of the financial system. And they should actually become instruments of monetary policy. We have largely seen during the crisis that governments started issuing guarantees on deposits, on assets and liabilities, but without compensation. But in the market, issuing guarantees in the form of CDS gets paid for. So governments should use CDS as monetary instruments and get compensated for issuing credit guarantees. An example is the Greek crisis, where the ECB, the European Central Bank, could have issued CDS as guarantees against a Greek default at 300 bps. I would have reassured the markets and allow the ECB to earn money instead of being forced to spend funds to support Greece.

Concerning securitization products, Mr de Nercy that exotic ones shouldn't even be touched, and argued for a strengthening of the regulation on the way they are used, in order to avoid that toxic credits get easily passed on to the market. He further remarked that there are various kinds of derivative products that went through this crisis unarmed, such as exchange derivatives, stock derivatives, derivatives on indices or commodities. These are based on fundamental works by Nobel Prize winner economists and their edging models are thus very robust.

So the main message in dealing with "too big to fail", concluded the speaker, is separation. It was enforced during many decades after the Great Depression in the form of the Glass-Steagal act, and it proved to work very effectively.

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**QUESTIONS & ANSWERS**

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## Question

When the crisis of 1907 happened, the capital ratio of banks was about 50%. What gives you any confidence to believe that through working only with the capitalization ratios of banks you can prevent banking failures? Don't you also think there is some room for the argument of keeping the size of institutions down, so that when they fail the sweep of the disaster can somewhat be limited?

## Hans Geiger

One rule is certainly not enough, I completely agree with you. I said we should introduce a leverage ratio rule, but not risk weighted, because the risk weighting didn't weight the risk, it was completely odd. The risk weight of toxic assets was zero. So UBS for instance had 850 billion of so called trading assets on their balance sheet, that included the toxic triple A CDOs. And for this risk they didn't maintain any significant capital, maybe just a fraction of a percent. So my first point is: get away with that risk weighting, because there is no way a regulator can understand what the real risk is. And the bank will always play the game or regulatory arbitrage, that's their profession today, that's their understanding. They will use any measures. So I am looking for a robust measure and I say it's a leverage ratio of 5% or 10% of total assets. In reality, I do not really believe in that. I think there should be two or three limits. You don't need complicated rules, you need simple, robust rules; rules on which the banks cannot arbitrage. I suggest 5% of total assets, or 150% of the yearly gross income, whatever is larger. Because no banker wants to earn less just because it can reduce capital, but that's a very primitive, so a very good, solution.

## Question

But isn't there a point where you think that the size of banking institution should be limited, say relative to GNP, even if the assets are good. Because the central bank cannot take up these assets in case of a crisis if the banking institution is too large. In the US, where we have the greatest GNP in the world, we are still challenged to cover the kind of debts that banks would get into, even if they had good assets. Isn't there the argument for limiting the size?

## Hans Geiger

I think if you have credibly high requirements on equity capital, you naturally limit the size of the bank. Because if you have, let's say, a 10% leverage, most of the business they have done is not profitable for the shareholders anymore. So that is for me the most natural thing.

## Question

Richard Fischer, the President of the federal Reserve in Dallas, write in an article that the very large institutions pose high social costs that are much greater than any

benefits they may provide. And he is recommending that we need to find some international convention to limit their size. On the other side, Edward King, a finance professor at Boston College and an authority in financial institutions and regulators, says the regulators themselves are not very happy to get much more active, because they want to avoid being blamed for missteps in oversight, especially if these companies cannot be controlled as Mr. Black pointed in his speech.

Jean de Demandolx Dedons

Let me make a comment. I think the nature of a bank, historically, is to go bankrupt. If you look at history, all the banks, the Lombard banks in Italy, the church banks, older banks, all of them one day all went bankrupt. Except they were bailed out by the governments. But in history, like all of us will die one day, the banks will also die with certainty. Why? Because if you do only lending, and you make a loan for 10 years, you make a net profit on this loan after all costs of 1%. If after four years the company you lent to goes under, you made only four dollars. It will take 25 years with another good credit to recuperate your loan. With a 10% debt to equity ratio, your net worth is wiped out with a bad loan.

William Black

Didn't de Gaulle say that the graveyards are full of indispensable men? So are they of indispensable banks...

John Bowler

William, you mentioned in your presentation that it was doubtful that once banks got beyond a certain size that there were any economies of scale. And that seems a reasonable argument to me. If we can't be absolutely certain that bigger banks pose a bigger risk, at least we should ask the question, what are the economies of scale? What is the social usefulness? If we can't find conclusive answers to that, then maybe we ought to go on the side of caution and limit the size of banks.

William Black

Actually to state it more strongly, large banks become less efficient. Not only are there no economies of scale, at those levels there are diseconomies of scale. The CEO's are fairly frank about it if you ever get them outside a public audience. On top of that, because of their political power, the banks manipulate and gut regulations to create these kinds of black holes. One of the things they seek is increased liquidity. Another is these guaranteed accounting profits. Liquidity wouldn't have done much if we didn't have losses in the system. The fact that we were creating over a trillion dollars in liar's loans is important to the story, because leverage can magnify those losses. Switzerland is interesting in that they are able to get some significant reforms that Hans Geiger went through. In the US, there is nothing comparable. We have gone the other direction. We have made our systemically dangerous institutions bigger. We have allowed them to hide their losses. That means their capital ratio, their leverage ratios, have expanded dramatically. Accounting is everything! You could have a higher capital requirement and you simply do what Iceland did. Do people understand that Iceland simply lent itself the capital? Bank A gave to bank B, which gave to bank C and gave to their insiders. Any amount of capital you want to create, banks can create. So leverage ratios are good, I am actually in favor of simplicity as well, but you can never rely on them, you always

have to know if the accounting is real, that it isn't self funded capital. And that requires vigorous examination because frankly, we already have convertible capital. It's called subordinated debt. And we have not a single successful case of subordinated debt anywhere in the world, in the history of the world, that I have ever been able to find.

Hans Geiger

But the difference is that subordinated capital only has to bear a loss in case of a bankruptcy. And this COCO in Switzerland, has an early mandatory intervention upon a certain trigger point. If for instance the leverage ratio decreased to a certain level, then debt will be converted into equity before bankruptcy.

William Black

But the problem is, precisely what you cite. You are citing the prompt corrective action law, and it is still in effect. You will note that Citibank has not been subject to prompt corrective actions..

Question

I want to ask a question about the derivatives market. In the derivatives markets, we are talking about moving the majority of the 700 trillion dollar market onto two or three centralized counterparties in terms of clearing. There is a school of thought which says that this system is potentially going to create of new single point of failure, because if one of these clearers starts to have a problem in the future, who is going to step in and resolve this problem linked to the 700 trillion dollar derivatives market? I would like to ask the panel if they have any comments on that particular school of thoughts.

William Black

You can look up if you wish my congressional testimony in front of the Senate on this. I testified that the weakness of the clearing house is in the massive overstatement of asset values. That clearing house would not have set aside remotely sufficient capital. And that they would have failed catastrophically, and a very conservative economist said in the panel, "yep, that's right". I almost fell off my chair, but occasionally I convince people!

Gildas Hita de Nercy

It is true that the market concentration generates systemic risk, because basically through the counterparty risk, when you are a big player, you are at the center of the market and so you become a systemic risk. So the only way to deal with that is to centralize again, and to put that under the guarantee of a government as every listed derivative markets. It is the only way to deal with that. And as a government if you start to guarantee a compensation of derivative markets, you would have to ask for very big collaterals, because your risk is basically to lose 100% of the nominal tomorrow. That means that these markets will become less and less retail markets, and more and more very highly professional markets exclusively used by banks just to diversify their risk. All other solutions will be bad solutions. The only way is to centralize, give the guarantee of the government, and back this guarantee with very high level of collateral, just to make sure, in the case of a big trouble in the market, that you will never have any bankruptcy of these new compensation authority.

Hans Geiger

I like the idea of a central counterparty. I think it would greatly reduce the opacity and the risk in the whole system. If you look at the last crisis, which sector of the financial market were not involved? These were the organized exchanges and the organized clearing settlement institutions. The transaction that went through that type of institution didn't suffer, and the whole rest is Over The Counter and direct interbank and bilateral transactions that were affected. So I think that should be one element of a new architecture.

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