

Ending Too-Big-To-Fail

On behalf of the 7,000 community banks represented by the Independent Community Bankers of America, thank you for convening today's hearing titled: "Examining How the Dodd-Frank Act Could Result in More Taxpayer-Funded Bailouts." Addressing the threat posed to taxpayers, our financial system, and the economy by a small number of too-big-to-fail firms is a top priority for community banks. The U.S. will not have a robust and truly competitive market for financial services until the too-big-to-fail problem is definitively resolved. We are pleased to present the community bank perspective on this critical issue in the following statement for the record.

Government-Subsidized Industry Concentration Continues Unabated

Four years after the crisis, the assets controlled by the megabanks have grown by more than \$1 trillion.¹ Today, the ten largest hold 77 percent of all U.S. bank assets compared with 55 percent of total assets in 2002, according to a study by Bloomberg Government.² The four largest banking companies alone control more than 40 percent of the nation's deposits and more than 50 percent of the assets held by U.S. banks. The greatest threat to the safety and soundness of our financial system today is the ongoing and increasing dominance of these megabanks.

A more diverse financial system would reduce risk and promote competition, innovation and the availability of credit to consumers of various means and businesses of all sizes. Most critically, the largest firms are too-big-to-fail. They are so interconnected with other firms that the failure of any one or a cluster of these firms would ripple through the financial system, abruptly shut off the flow of credit to businesses and consumers, and push the economy into another severe recession or worse. For this reason, we believe that the government would, in the event of a crisis, once again prop up a failing large financial firm with taxpayer dollars rather than risk the consequences. Any assurances the government might provide today about their refusal to engage in future bailouts will become empty promises. This implicit government backstop flouts the free market.

How do we account for accelerating industry concentration? The exponential growth of these large firms is a result of government support and its distortionary impact on competition. Too-big-to-fail is explicitly recognized by the bond rating firms who give the largest, most interconnected firms a ratings lift based on their implied U.S. support.³ Bond buyers accept lower returns from megabanks because they assume the government will support them if they falter. The value of this too-big-to-fail subsidy has been estimated at \$83 billion a year in a study by two IMF economists and a Bloomberg View.⁴ Various cost-of-funds studies estimate the megabank subsidy as being anywhere from 20 basis points to 80 basis points. ICBA has

¹ ICBA analysis of FDIC data.

² "Too Big To Fail?" Bloomberg Government. March 18, 2011.

³ "No Lehman Moment as Biggest Banks Deemed Too-Big-To-Fail." Bob Ivry. Bloomberg Markets Magazine. May 10, 2013.

⁴ "Why Should Taxpayers Give Big Banks \$83 Billion a Year?" Bloomberg View Editorial. May 20, 2013.

reviewed 15 studies that examine the question of whether a significant too-big-to-fail subsidy exists. All but one – which was conducted by a megabank – confirmed that a significant subsidy does exist.

Lower borrowing costs give the too-big-to-fail firms a clear competitive advantage, fueling yet more industry concentration, increasing systemic risk, and further entrenching the policy of too-big-too-fail. This trend can only be broken by a decisive change in policy. Tinkering with existing rules will not suffice.

Too-Big-To-Fail and Community Banks

Community banks are particularly vulnerable to the risk of too-big-to-fail. Over 400 community banks failed in the wake of the financial crisis fueled by the reckless behavior of mega financial firms. They were too small to save! And while these community banks were not deemed systemically important, at least on a national level, their failures continue to have a painful and lingering effect on the communities they serve as well as a lasting impact on the competitive landscape.

A less noted legacy of the financial crisis is the onslaught of new regulations enacted in response to the irresponsible actions of the too-big-to-fail banks. Community banks are low-risk, community-based institutions that did not cause the crisis and pose no threat to consumers or the financial system. While the new regulations are aimed at large banks, they often sweep in banks of all sizes, creating a crushing new burden for community banks, layered on top of an already significant regulatory burden. Large banks may not welcome new regulation, but, with their sizable legal and compliance departments, they have ample resources to cope with them. For community banks, on the other hand, with their relatively small asset bases and compliance staffs, regulation is a disproportionate burden and poses a threat to their very existence. While we welcome efforts to recognize the distinct business model of community banks by tiering regulation, this tiering provides only partial relief. Costly new regulation inhibits new bank charters, prompts the sale of community banks and leads to more consolidation, which exacerbates the threat of too-big-to-fail. This is why ICBA has renewed its emphasis on eradicating too-big-to-fail. The problem is the most significant threat to the future of a free-market, competitive banking system.

The Dodd-Frank Act

The Dodd-Frank Act – the primary legislative response to the financial crisis and taxpayer bailouts – provides a set of tools that are intended to allow for the resolution of a failing firm as an alternative to a taxpayer-funded bailout. While having a resolution authority mechanism is in our view an improvement over the chaos and lack of tools available during the financial meltdown, we have no doubt that the mechanism could be enhanced. For example, serious questions remain about the workability and coordination of resolution across international borders. ICBA is open to considering discrete reforms to resolution authority.

A more fundamental concern is that even a reformed and enhanced resolution authority would

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remain untested and uncertain. Policymakers need to take additional measures to reduce systemic risk before troubles arise so we are not faced with an agonizing choice, under threat of financial cataclysm, between the use of untested resolution authority or a bailout that will immediately calm the markets, though at the cost of strengthened moral hazard and significant expense to the taxpayer.

We believe that the policy emphasis should be put on ensuring that systemically important firms do not get into trouble in the first place. While both “front end” and “back end” solutions should be deployed, primacy should be given to the front end. Dodd-Frank does contain front end solutions, but they have not prevented the growth in industry concentration or dwindling equity capital ratios among the largest firms. The financial system is still far too risky.

Potential Solutions

ICBA is open to considering any constructive proposal to address the too-big-to-fail problem. ICBA has already supported several proposals, including the plan put forth by Federal Reserve Bank of Dallas President and CEO Richard Fisher and the industry restructuring proposed by FDIC Vice Chairman Thomas Hoenig which would separate the core banking activities of deposit taking and lending, which are covered by deposit insurance, from dealing and market making, brokerage and proprietary trading, which would be pushed out. Richmond Federal Reserve President Jeffrey Lacker has recently noted that resolution planning (“living wills”) has the potential to provide regulators a tool to impose higher capital or liquidity requirements on a risky firm or even order changes to its structure so that it can be more easily resolved in bankruptcy. Former FDIC Chair Sheila Bair has been prescient in recognizing the hazard posed by too-big-to-fail firms long before the crisis. Each of today’s witnesses have made important contributions to identifying the problem of too-big-to-fail and formulating thoughtful and constructive solutions.

In addition, ICBA has endorsed the Terminating Bailouts for Taxpayer Fairness (TBTF) Act (S. 798), introduced by Sens. Sherrod Brown (D-OH) and David Vitter (R-LA). S. 798 takes a clean approach to the problem—requiring the largest, riskiest banks to hold more leverage equity capital will allow them to operate more safely, absorb more losses and avoid a government or taxpayer bailout. S. 798 can be implemented without complex new rules. Banks over \$500 billion would be required to have a minimum of 15 percent leverage equity capital to reflect their scale and associated systemic risk. Banks between \$50 billion and \$500 billion would be required to have a minimum of 8 percent leverage equity capital. Banks under \$50 billion will be subject to capital rules comparable to the risk-based and leverage ratios that apply today. S. 798 recognizes that community banks and larger banks with less than \$50 billion in assets were not the problem. Importantly, there will be no complex risk weighting of the assets used to calculate the equity capital ratio. Risk weighting has been too easily gamed by the megabanks. In addition, off-balance-sheet exposures that sharply increase the risk level of megabanks would be included in total assets, as would certain derivatives exposures.

Attached to this statement is an ICBA white paper that elaborates on the problem of too-big-to-fail, reviews proposed solutions, including S. 798, and addresses and rebuts objections raised to

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higher capital requirements for large banks. We also provide a link to a short video that documents the growing recognition of the too-big-to-fail problem among financial policy makers, economists, and major industry figures from across the spectrum.

The Plan for Prosperity

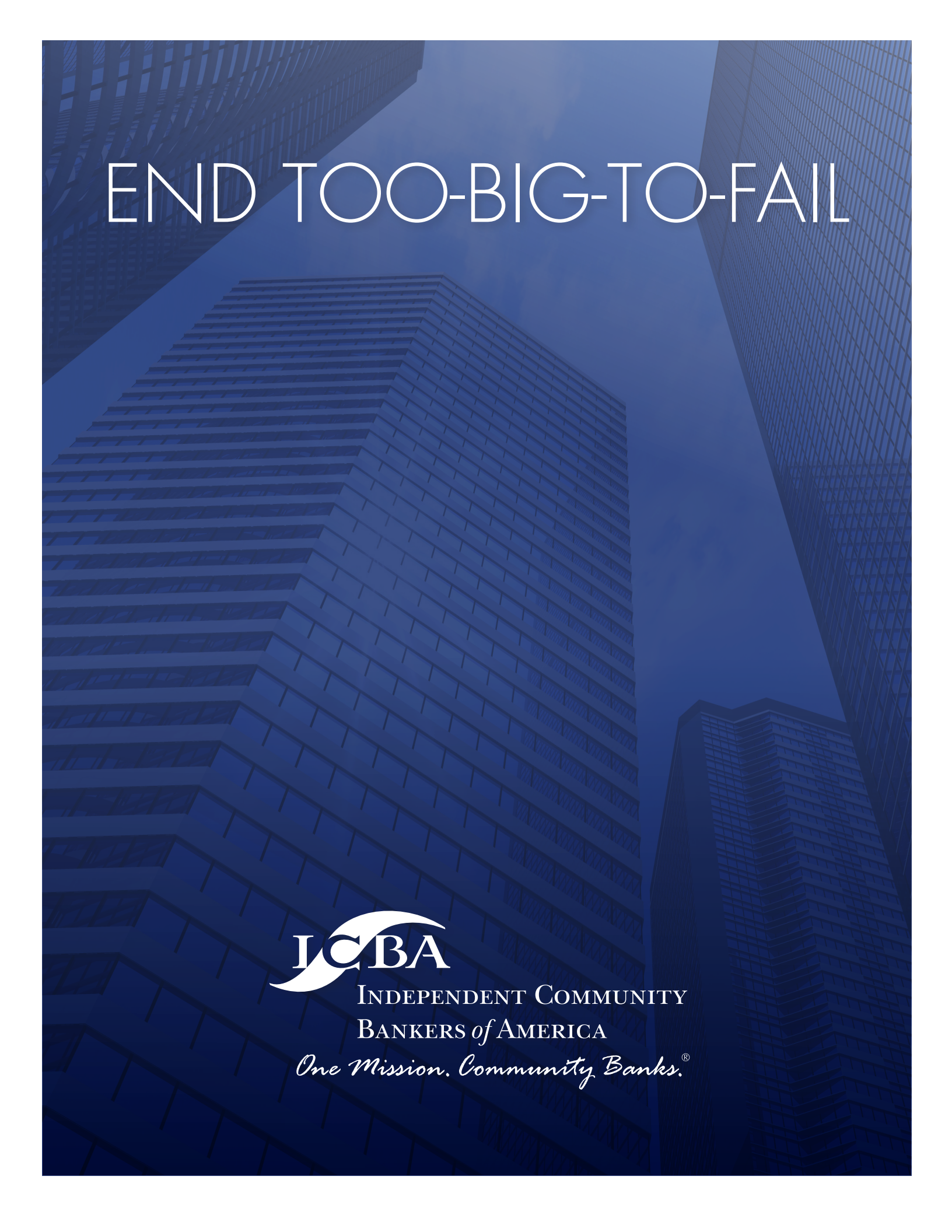
In closing we note that ICBA's Plan for Prosperity (PFP) would help offset the growing regulatory burden of too-big-to-fail on community banks and their customers. While too-big-to-fail is the ultimate source of the problem, and we urge this committee to pursue vigorous and practical solutions to too-big-to-fail, the regulatory relief provided by the PFP will help community banks promote entrepreneurship, economic growth, and job creation. Each of the dozen provisions of the PFP has come before this committee in prior congresses and is therefore positioned for immediate action. ICBA thanks this committee for passing the following PFP bills: H.R. 749, introduced by Rep. Blaine Luetkemeyer (R-MO), would eliminate the annual privacy notice requirement when a bank has not changed its privacy policies. H.R. 1062, introduced by Rep. Scott Garrett (R-NJ), would apply a cost-benefit test to new SEC rules. H.R. 801, the Holding Company Registration Threshold Equalization Act (H.R. 801), sponsored by Reps. Jim Himes (D-CT) and Steve Womack (R-AR), would allow thrift holding companies to take advantage of the new SEC deregistration threshold of 1200 shareholders. We encourage you to take up additional legislation that embodies PFP provisions. In particular, the CLEAR Relief Act (H.R. 1750), introduced by Rep. Luetkemeyer, contains eight PFP provisions, including mortgage reform, an increase in the SOX 404(b) exemption, and other provisions.

Thank you again for the opportunity to submit this statement for the record. ICBA is committed to working with this committee to end the problem of too-big-to fail and to advance the provisions of the PFP.

Attachments

- **“Ending Too-Big-To-Fail.” ICBA White Paper. May 2013.**
- **End Too-Big-To-Fail Video. <http://www.icba.org/TBTF/videos.cfm>**

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A low-angle, upward-looking perspective of several tall skyscrapers with glass facades, creating a sense of height and scale. The sky is a clear, pale blue.

END TOO-BIG-TO-FAIL



INDEPENDENT COMMUNITY
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Overview: Why Too-Big-To-Fail is a Problem

As a result of the megabank-induced financial crisis of 2008, our nation—and millions of hardworking Americans—experienced the most painful economic debacle since the Great Depression. When all was said and done, American taxpayers and citizens were left holding the tab. According to the Government Accountability Office, homeowners lost more than \$9 trillion in equity, and lost U.S. economic output associated with the 2007-2009 financial crisis could range from several trillion dollars to over \$10 trillion.¹ That's nearly \$20 trillion in ultimate potential damage inflicted on Americans.

Four years after the crisis, the assets controlled by the megabanks have grown by more than \$1 trillion.² The growth of these institutions is the gravest threat to the safety and soundness of our financial system today. This tremendous concentration of banking assets into so few institutions distorts the markets and contravenes the public interest. These firms are “too big to fail”—so big and interconnected that the government would not allow them to fail because it would cause too much damage to our financial system and push our economy into a severe recession or worse. A more diverse financial system would reduce risk and promote competition, innovation and the availability of credit to consumers of various means and businesses of all sizes.

Adding insult to injury, U.S. Attorney General Eric Holder recently stated that federal law enforcement has been inhibited from prosecuting large, interconnected institutions due to the “negative impact on the national economy.” Large or interconnected institutions are too big to prosecute, and their executives are too big to jail. The very firms that have inflicted the most abuse on consumers and the most damage to our financial system and economy are effectively immune from prosecution. As if we did not have incentive enough already to end the dominance of too-big-to-fail institutions, the attorney general's statement reveals a new, appalling aspect of the problem—that some individuals may be above the law.

Too-big-to-fail distorts free markets, incentivizes risky behavior, leaves taxpayers on the hook for bailouts, and creates unfair competitive advantages for the largest banks. But there is perhaps no greater reminder of the too-big-to-fail impact than the constant, oppressive regulatory burdens that community banks face on a daily basis.

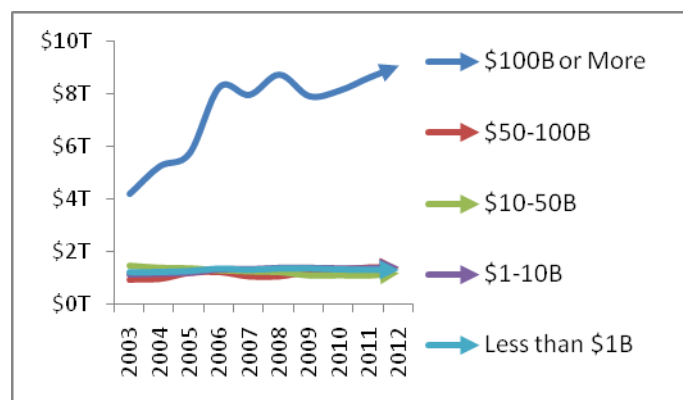
It's up to Congress, regulators and the American people to take a united stance against the problem of too-big-to-fail. Doing so is the only way to ensure that history doesn't repeat itself and that future generations can rely on a healthy, robust and diverse American economy.

¹ U.S. Government Accountability Office. Financial Crisis Losses and Potential Impact of the Dodd-Frank Act (January 2013).

² ICBA analysis of FDIC data.

Background: Too-Big-To-Fail and Community Banks

- The community banking industry is facing a number of challenges today—a sluggish recovery with weak loan demand from the business and housing sectors, artificially low interest rates that are compressing community bank margins, restrictions on interchange and other fee income, and a crushing regulatory burden.
- ICBA is working constantly to alleviate regulatory burden. We have strong prospects of achieving meaningful regulatory relief this Congress.
- The core problem—the problem that is causing all of the other problems—is the persistence and growth of firms that are too big to fail. These firms are so big and interconnected that the government would not allow them to fail because it would cause too much damage to our financial system and push our economy into a severe recession or worse. Taxpayers and community banks are held hostage to the whims of too-big-to-fail firms.
- While the Dodd-Frank Act created resolution authority as an alternative to bailouts, that authority remains untested and uncertain. The persistence of lower funding costs for the megabanks despite their riskier activities indicates that markets are disregarding resolution authority and continue to price in a government backstop. We need to take additional measures to reduce systemic risk in the first place so we are not faced with an agonizing choice, under threat of financial cataclysm, between the use of untested resolution authority or a bailout that will immediately calm the markets, though at the cost of strengthened moral hazard. Dodd-Frank took significant steps in the right direction but did not eradicate too-big-to-fail.
- Community banks are living with the wreckage of the megabanks. Their actions caused the recent recession and the artificially low interest rate environment the Fed has created to try to boost the economy. Their abusive practices have resulted in crushing new consumer and capital regulations that the megabanks take in stride but are nearly unworkable for community banks. Regulatory burden exacerbates consolidation and thereby compounds the problem of too-big-to-fail.
- The 12 largest U.S. banks, or 0.2 percent of all U.S. banks, hold nearly 70 percent of industry assets, dwarfing the rest of the banking system.³ JPMorgan alone holds \$2.4 trillion in assets.



Source: ICBA Analysis of FDIC data as of 12/31/2012

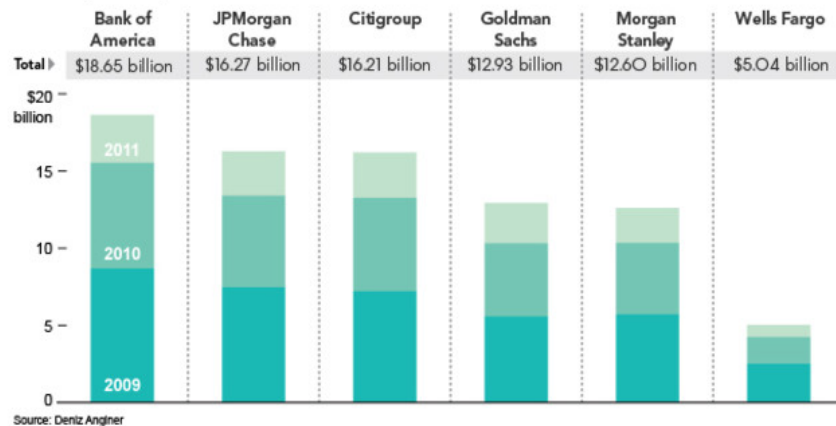
³ “Ending ‘Too Big to Fail’: A Proposal for Reform Before It’s Too Late.” Richard W. Fisher. Remarks before the Committee for the Republic. January 16, 2013.

- Because these firms are too big to fail, they court risks that no smaller firm would tolerate and act with impunity. The markets offer them credit at rates that do not reflect their true risk—rates that are subsidized by an implicit taxpayer guarantee. This too-big-to-fail subsidy, valued at \$83 billion annually by two economists with the International Monetary Fund (IMF) and

Discount Winners

Bond buyers accept lower returns from big banks because they believe the U.S. government would rescue them should they falter, according to a study by economist Deniz Anginer and others. Anginer calculated the borrowing advantage for the six biggest banks from 2009 through 2011 at \$81.70 billion.

Borrowing advantage



Source: Bloomberg

- Bloomberg View, creates a competitive imbalance. The megabanks use the subsidy to unfairly compete, profit, and grow even larger, exacerbating industry consolidation.
- The Justice Department knows they're too big to fail, as Attorney General Holder recently admitted before the Senate Judiciary Committee. Worries about destabilizing the megabanks mean they are effectively immune from prosecution. When the too-big-to-fail banks are above the law, they're too big to jail!
- They are also too big to manage—a problem vividly illustrated by the recent London Whale trading debacle that has cost JPMorgan over \$6 billion and counting. If the crack management team at JPMorgan, supposedly the most competently managed of the megabanks, can't effectively manage its trading operations, which include more than 5,183 non-bank affiliates in 72 countries, how can lesser management teams be expected to oversee their sprawling and impossibly complex banks?⁴ Taxpayers are at the mercy of their next misstep.
- The banking industry is becoming more concentrated, and the trend will only continue as long as too-big-to-fail exists. The bigger and more complex the megabanks become, the more damage their failure would cause and the more surely they will be bailed out and immune from prosecution. The bigger and more complex they get, the harder they are to manage and the more likely they are to stumble and need another bailout. It's a vicious circle.
- While ICBA will continue to fight the regulatory burden caused by too-big-to-fail, we must recognize that burden as the symptom of a larger, systemic disease. We won't truly stabilize the consolidation trend and put community banking on a more secure footing until we treat the disease directly.

⁴ Ibid.

- That's why ICBA is putting so much emphasis on too-big-to-fail. It's a steep hill to climb, and it won't make us popular in Washington. In the span of a few short weeks, multiple millions of dollars have been spent on lobbying in support of the status quo and to churn out spurious research and misleading arguments.
- We need the support of community bankers nationwide and the state trade groups. We can't win this fight without their strong support.

A Range of Solutions Have Been Proposed

- ICBA has endorsed the Terminating Bailouts for Taxpayer Fairness (TBTF) Act (S. 798), introduced by Sens. Sherrod Brown (D-Ohio) and David Vitter (R-La.). The bipartisan sponsorship of this bill will put the too-big-to-fail issue above party politics and typical ideological divisions. The Brown-Vitter bill has the virtue of being simple and easy to implement without complex new rules. It takes an entirely new direction away from complex rules and regulations.
- ICBA has also endorsed other proposed solutions to the too-big-to-fail problem, including the proposals of FDIC Vice Chairman Thomas Hoenig and Federal Reserve Bank of Dallas President and CEO Richard Fisher. We expect S. 798 will prompt the introduction of other bills and that S. 798 too will undergo new iterations as it moves through the legislative process.
- There are many ways to tackle the problem of too-big-to-fail. Some go much further than Brown-Vitter and directly cap the size of banks. Some would re-impose a modern version of the Glass-Steagall Act to separate core commercial banking activities from high-risk activities such as proprietary trading. Some are merely political markers that are not designed to get any traction. Within the range of possible solutions, Brown-Vitter is squarely in the middle. It's neither too tepid nor too radical. It also recognizes that community banks and larger banks with less than \$50 billion in assets were not the problem.
- While we're focused on Brown-Vitter right now, as the most viable bill introduced, we're open to other approaches. But at this point, Sens. Brown and Vitter deserve our strong support because they've made a serious effort to craft a viable bill.
- Ninety-nine senators recently voted to end taxpayer subsidies for the megabanks. Now is the time to follow through and endorse a real and specific solution to the problem. The Brown-Vitter TBTF Act offers senators that opportunity.

What's in the Brown-Vitter TBTF Act

Use Capital to Avoid Bailouts and Protect Taxpayers

- Brown-Vitter takes a clean approach to the problem—requiring the largest, riskiest banks to hold more leverage equity capital will allow them to operate more safely, absorb more losses and avoid a government or taxpayer bailout. S. 798 can be implemented without complex new rules.
- Banks over \$500 billion would be required to hold a minimum of 15 percent leverage equity capital to reflect their scale and associated systemic risk. Banks between \$50 billion and \$500 billion would

be required to hold a minimum of 8 percent leverage equity capital. Banks under \$50 billion would be subject to capital rules comparable to the risk-based and leverage ratios that apply today.

- The Brown-Vitter bill would not allow Basel III to take effect in the U.S. for any bank.
- Importantly, there will be no complex risk weighting of the assets used to calculate the equity capital ratio. Risk weighting has been too easily gamed by the megabanks. For example, Greek bonds had the same 20 percent risk rating as other AA- and AAA-rated securities held on community banks' balance sheets, playing no small part in the failure of Cyprus banks.
- In addition, off-balance-sheet exposures that sharply increase the risk level of megabanks would be included in total assets, as would certain derivatives exposures. When off-balance-sheet exposures are included in total assets (as they are under the International Financial Reporting Standards used by European banks), this change alone cuts the leverage ratio of the average megabank by nearly half—from 6.17 to 3.88.⁵ This illustrates how current capital standards fail to adequately measure risk in the megabanks. By contrast, the leverage ratio of the average non-megabank, be it a community bank or even a large regional, is virtually unchanged under IFRS. Community banks don't carry high off-balance-sheet or derivatives exposures.

Prohibit Non-Bank Affiliates from Accessing the Federal Safety Net

- While higher equity capital ratios for the megabanks is the central pillar of Brown-Vitter, there are other provisions that will protect taxpayers from future bailouts.
- Brown-Vitter will stop the abuse of Section 23A of the Federal Reserve Act that allowed non-bank affiliates of megabanks to transfer risky assets to the safety net of their commercial bank affiliates and provide access to the discount window during the crisis. These "shadow banking affiliates," as Richard Fisher calls them, have no business accessing the safety net. At last count, the five largest megabanks had 19,654 non-bank subsidiaries.⁶
- Brown-Vitter would prohibit non-depositories from accessing deposit insurance or the discount window. The megabank holding companies wouldn't be able to use insured deposits as a cheap source of funding for their high-risk activities. Deposit insurance was created to protect depositors, not to finance the trading activities of the "London Whale."

Provide Regulatory Relief That Allows Community Banks to Support Economic Growth

- In addition to bringing market discipline to the too-big-to-fail banks, the TBTF Act also offers much-needed regulatory relief to community banks that will allow them to serve consumers and small businesses in their areas.
- The legislation would expand the definition of "rural" for purposes of the ability-to-repay/qualified mortgage rule; eliminate the annual written privacy notice requirement when a financial institution has not changed its policies; offer relief from new small-business data-collection requirements;

⁵ "Basel III Capital: A Well-Intended Illusion." Table 1: Capitalization Ratios for Global Systemically Important Banks. Thomas M. Hoenig. Speech before the International Association of Deposit Insurers, Basel, Switzerland. April 9, 2013.

⁶ "Ending 'Too Big to Fail': A Proposal for Reform Before It's Too Late." Richard W. Fisher. Remarks before the Committee for the Republic. January 16, 2013.

strengthen accountability in bank exams through the creation of a new ombudsman; and allow thrift holding companies to use the new 1,200-shareholder SEC deregistration threshold.

- This common-sense relief will help community banks do what they do best—create jobs and serve our nation’s cities, towns and rural areas.

End Too-Big-To-Fail by Supporting the Brown-Vitter TBTF Act

- By supporting market forces and the foundation of our nation’s banking system—capital—the Brown-Vitter TBTF Act will help end the too-big-to-fail threat to our financial system.
- A too-big-to-fail free financial sector means a more free-market economy where all banks are allowed to succeed or fail based on their merits and not the government picking winners and losers.

Wall Street’s Frantic Push Back

- If you’re not convinced that Brown-Vitter is a serious, politically viable effort, you only need to look at the vigorous and expensive campaign that Wall Street has launched against it. The American Bankers Association, The Clearing House, Goldman Sachs, Standard and Poor’s, the New York law firm of Davis and Polk, and just about every trade group representing Wall Street and the megabanks are producing hundreds of pages of analysis, charts, graphs and dire predictions of the demise of the U.S. and global banking systems.
- It’s hard to keep up with all of the arguments they’re putting forth, but here are some of the myths they are promoting, and the truth behind the myths:

Myth: Too-big-to-fail is no longer a problem.

- In fact, since the financial crisis, the financial system has become ever more concentrated, with the largest firms controlling significantly greater proportions of the nation’s economic resources. According to FDIC Vice Chairman Thomas M. Hoenig, “The 10 largest U.S. banking companies held assets the equivalent of 25 percent of GDP in 1997, 58 percent in 2006 and, since the crisis, it has increased to over 71 percent.”⁷ Or consider another measure of concentration: The 12 largest U.S. banks, or 0.2 percent of all U.S. banks, held 69 percent of industry assets.⁸
- Clearly, the problem of too-big-to-fail persists and is getting worse.

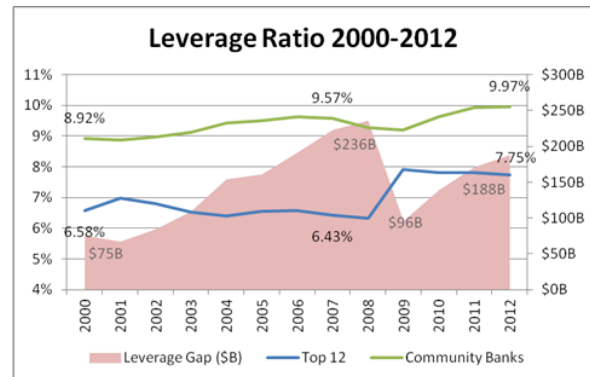
Myth: The megabanks have record capital levels.

- Those who make this claim are manipulating megabank capital ratios by using a risk-based ratio and neglecting to note the role of TARP taxpayer funds in boosting capital.
- Using meaningful measures, megabank capital ratios are declining.

⁷ “A Turning Point: Defining the Financial Structure.” Thomas M. Hoenig. Remarks before the 22nd Annual Hyman P. Minsky Conference at the Levy Economics Institute of Bard College, New York. April 17, 2013.

⁸ Fisher, IBID.

- The leverage ratio of the 12 largest banks, the most conservative (and useful) measure of bank capital, steadily declined during the 2000s, spiked up following the financial crisis as a result of TARP injections, and resumed its decline thereafter. (See graph)
- By contrast, community banks have the highest leverage ratios of the past decade. It would take \$188 billion for the nation's largest banks to achieve the same leverage ratio as the nation's community banks.



Source: ICBA Analysis of FDIC data as of 12/31/2012

Myth: Brown-Vitter will reduce lending by as much as \$2.8 trillion and slow economic growth.

- On the contrary, lending and economic growth would be more likely to increase overall.
- Brown-Vitter would result in the megabanks retaining more capital than they do today and re-configuring their executive compensation strategies to be based on true performance, but it will not result in fewer loans being made.
- There are significant other sources of credit, including community and regional banks. Community banks already finance more than 55 percent of small-business loans under \$1 million and have sufficient capacity to lend more if the megabanks shrink their lending.
- But even if the six largest banks split themselves into 20 banks, lending may well be redistributed among these new banks, but it will not be reduced in the aggregate. In fact, the increased competition and innovation would likely result in more lending, more jobs and greater economic growth.
- The breakup of AT&T resulted in an explosion of growth and innovation in the telecommunications business. The same result could be achieved by the break up, by incentive if not by mandate, of the financial oligopoly.
- Critics of Brown-Vitter are happy to play on a popular confusion between capital and reserves. Reserves are a percentage of deposits held in the form of vault cash or in deposits at a regional Federal Reserve bank. Capital, on the other hand, is not set aside and kept idle.

It could be both disruptive and costly, but *doing nothing* will be even costlier, as we saw during the financial crisis. Do we want to go through that again, this time with an even more concentrated and entrenched banking industry shielded by Dodd-Frank? *That* would be significantly more disruptive and prohibitively costly.

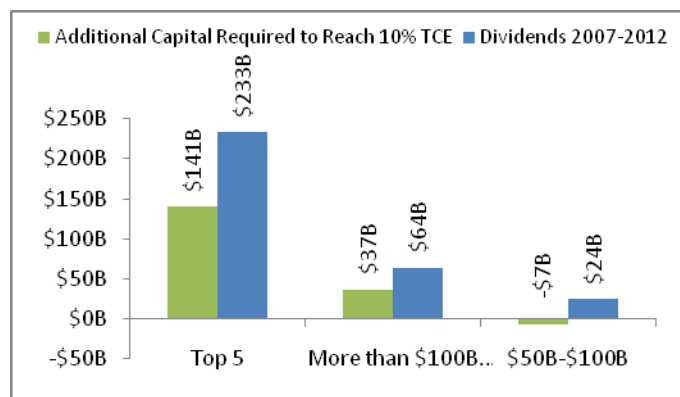
**Q&A with Richard Fisher
on TBTF, 2012 Dallas Fed
Annual Report**

Capital can be lent.

- While the megabanks are eager to estimate the economic cost of Brown-Vitter, however dubious their analysis, they never factor in their too-big-to-fail subsidy nor the staggering cost of periodic financial crises and recessions—unemployment, lost wages, depressed home values, shrunken retirement portfolios, and depressed interest rates. It's like griping about the cost of a fire department without considering the cost of not having one.

Myth: The megabanks will have to raise more equity to meet the 15 percent equity capital ratio.

- The impact of the new equity capital target on the megabanks is being dramatically overstated. First of all, they'll have five years from the date of any final regulations to meet the target equity capital ratio. They don't have to get to 15 percent overnight; they can start today.
- The megabanks could simply retain more earnings to meet most of the new target without selling new stock or shedding assets. Or they could use some combination of retained earnings and new stock. For example, over the past five years, during the worst financial crisis since the Great Depression, the five largest banks have paid out \$233 billion in dividends. If 60 percent of those dividends had been retained, these banks would have attained a leverage equity ratio of 10 percent. This does not even take into account the additional amount that was paid out of earnings in stock and cash bonuses. Earnings retention is the best way to grow capital.



Source: ICBA Analysis of FDIC data as of 12/31/2012

Objection: Brown-Vitter will reduce returns on equity for the megabanks.

- This is undoubtedly true and is the real reason the megabanks are pushing back so furiously. For decades their return on equity has been amplified by a degree of leverage that would not even be possible without an implicit government guarantee. A free market would never tolerate that much leverage without a government backstop.
- Megabank bonuses and stock incentive compensation are tied to return on equity (ROE). If megabankers can't use stratospheric leverage to boost ROE, they will have to make money the old-fashioned way—the way community bankers do—by earning it.

Myth: Dodd-Frank solved the problem of too-big-to-fail. It should be implemented and given a chance to work before taking any additional steps.

- The megabanks and Wall Street fought tooth and nail against Dodd-Frank. Now, ironically, many are taking shelter behind it just as tough new too-big-to-fail legislation is advancing. They not only fought Dodd-Frank in Congress, they're still fighting it in the courts and the agencies.

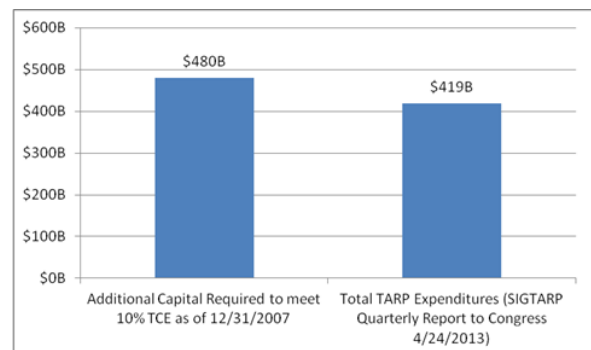
- Since the financial crisis, the megabanks have only gotten larger. Risk is more concentrated than ever in fewer banks. Dodd-Frank does not prevent further growth and concentration.
- While Dodd-Frank provided tools for resolving large bank failures, such as resolution authority to conduct orderly liquidation of a large firm, there still are no systems in place that deal with a global financial crisis. As Simon Johnson, MIT professor and former chief economist of the IMF, wrote:

The heart of the problem is cross-border resolution, ie. the ability of the FDIC to manage the government-supervised approach to handling the failure of a global megabank. The resolution authority in Title II of Dodd-Frank, which granted powers to the FDIC does not apply across borders – it needs to be supplemented by a network of agreements with other countries, which would agree in advance exactly how to handle various assets and liabilities. Citigroup, for example, does business in over 100 countries. So far the FDIC has an agreement with the Bank of England, but there is no agreement or even prospect for one with the eurozone or Asia or any other market where Citi (or our other largest five banks) have their global presence.⁹

- Dodd-Frank included enhanced regulatory supervision and oversight of mega-institutions, but more is needed to help reduce the risk these institutions pose and to reduce the impact their failure would have on the broader financial system and the economy. By reducing systemic risk at the outset, there is greater likelihood that the tools established in Dodd-Frank will work to avoid taxpayer bailouts and allow institutions to fail and be liquidated in an orderly manner. Brown-Vitter will help prevent crises that Dodd-Frank is designed to resolve.
- Almost three years after the passage of Dodd-Frank, the regulators still have been unable to reach timely agreements on the implementation of regulations. Meanwhile, the too-big-to-fail banks get even bigger. Brown-Vitter, by contrast, takes a simple approach and gives megabank lobbyists little opportunity to argue and stall the rulemaking.

Myth: By preventing the implementation of Basel III, Brown-Vitter would walk away from an international agreement and the United States would abandon its seat at the table of global banking reform. Systemic risk must be addressed on an international basis because large banks are multinational. Brown-Vitter would undermine that effort and make the U.S. banking industry less competitive in world financial markets.

- International cooperation is important. But if there's a better solution, we shouldn't neglect it for the sake of international cooperation. We have to recognize when international cooperation is leading us into costly and ineffective solutions. Basel III will result in greater complexity and will not be effective in resolving the problem of too-big-to fail.
- Brown-Vitter's simple solution of higher capital for the large banks and less complexity, if



Source: ICBA Analysis of FDIC data as of 12/31/2012, SIGTARP Quarterly Report to Congress 4/24/2013

⁹ Simon Johnson. "The Case for Megabanks Fails." New York Times (May 2, 2013).

successful, may be adopted by other countries and form the basis of a new international agreement.

- By taking these bold steps, the U.S. would be acting as a leader in global banking reform, and the increased safety and transparency of our banking system would make our banks *more* competitive globally, not less.

Myth: Brown-Vitter is based on the false premise that the large banks enjoy a funding advantage due to their perceived too-big-to-fail status. Recent studies have shown that there is no funding advantage.

- Both a study by two IMF economists and a Bloomberg View analysis estimated that the implicit megabank subsidy equals approximately \$83 billion a year. Various cost-of-funds studies estimate the megabank subsidy as being anywhere from 20 basis points to 80 basis points. Wall Street admits to a funding advantage.
- ICBA has reviewed 15 studies that examine the question of whether a significant TBTF subsidy exists. All but one confirmed that one does exist. The only exception was the study performed by JPMorgan Chase.
- Even Standard & Poor's rating agency in its report released in late April 2013—which the megabanks claim supports their case—cautioned that the Brown-Vitter bill could result in lower credit ratings for the megabanks despite requirements to hold higher capital ratios.

*It is tempting to assume that we would raise credit ratings because higher capital increases creditworthiness to bondholders. ...Under our methodology, we would potentially no longer factor in government support if we believed that once large banks are broken up, we would not classify these banks as having high systemic importance.*¹⁰

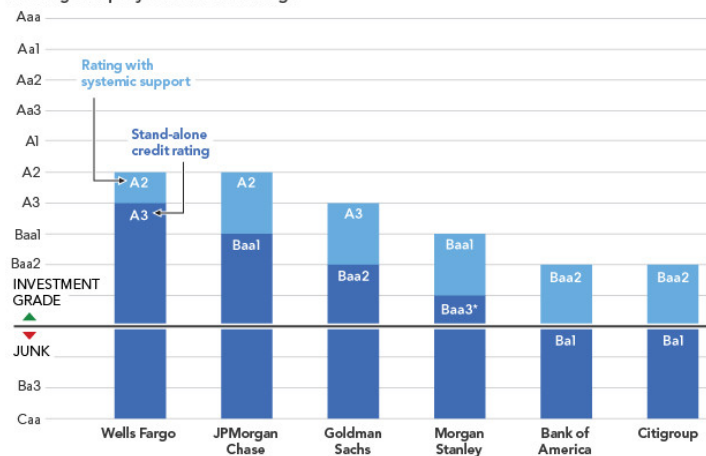
Translation: If this bill passes, these banks would no longer be backed by taxpayers as too big to fail and would lose their subsidy, so we would downgrade them.

- A borrower's debt rating has an indisputable impact on its cost of funding. Moody's Investor Services explicitly recognizes the impact of implied U.S. support of the megabanks on its debt ratings. Two of the megabanks would be rated below investment grade, and pay significantly higher funding costs, but for implied U.S. support.

Rescued From Junk

Moody's Investors Service would rate Bank of America and Citigroup holding company debt below investment grade without implied U.S. support, according to a March 27, 2013, report.

Holding Company Senior Debt Ratings



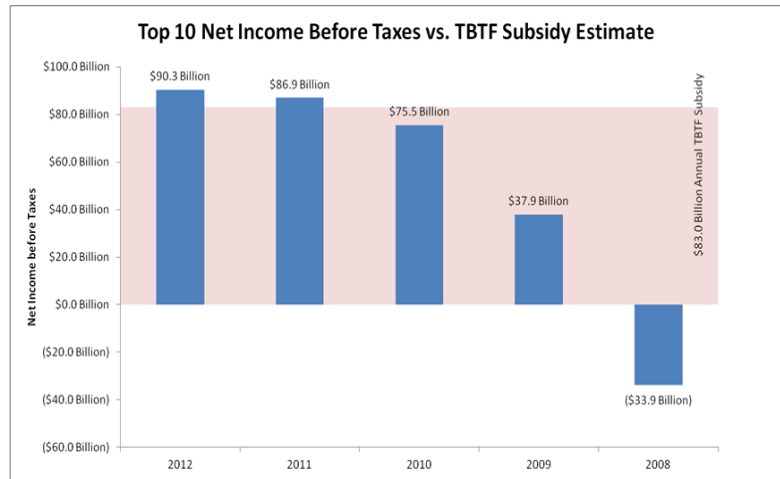
*Factored with Mitsubishi UFJ Financial Group shareholder support. Source: Moody's Investors Service

Source: Bloomberg

¹⁰ Standard and Poor's, "Brown-Vitter: Game-Changing Regulation for U.S. Banks" (April 25, 2013).

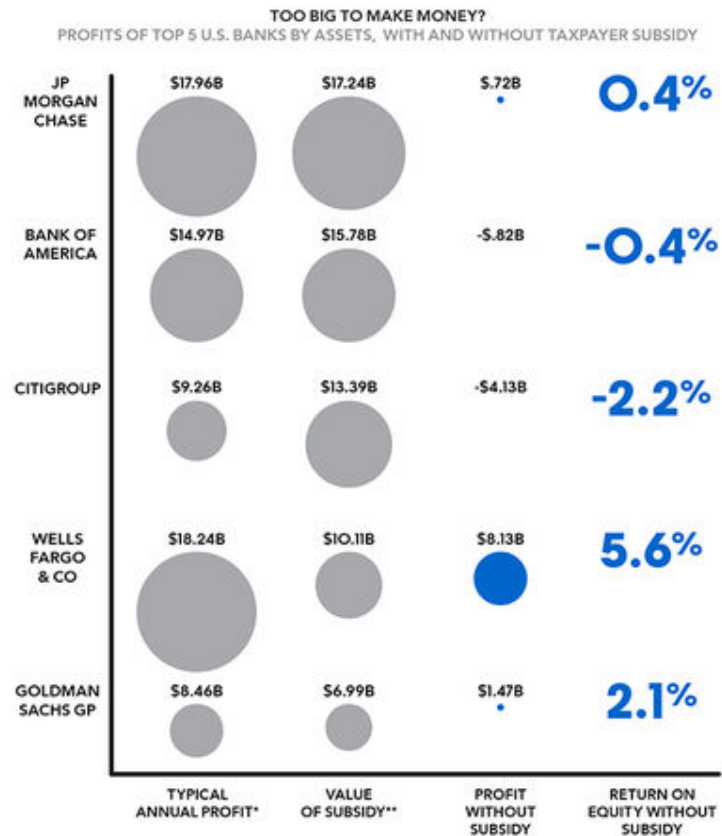
Ending Too-Big-To-Fail

- How important is the subsidy to the megabanks? As illustrated in this chart, the subsidy enjoyed by the 10 largest banks has more or less equaled or exceeded their net income in recent years.



Source: ICBA Analysis of FDIC data as of 12/31/2012, Bloomberg View, Ueda and Di Mauro

- The graph at right illustrates the value of the subsidy for the top five banks individually. Two of the five largest banks would incur a loss in a typical year, but for the value of the subsidy.



* Average return on assets for past 10 years, applied to current level of assets.
 ** Too-big-to-fail borrowing discount of 0.8 percentage point multiplied by bank's total liabilities.
 Sources: Bloomberg data, Bloomberg View analysis, Kenichi Ueda & Beatrice Weder di Mauro
 Chart: Bloomberg View

Source: Bloomberg View

Myth: By eliminating risk weights, Brown-Vitter will encourage more risky lending. A bank that has to have equity of 15 percent against a U.S. Treasury note or a high-yield junk bond will choose the junk bond to maximize its returns. Brown-Vitter will create more risk, not less.

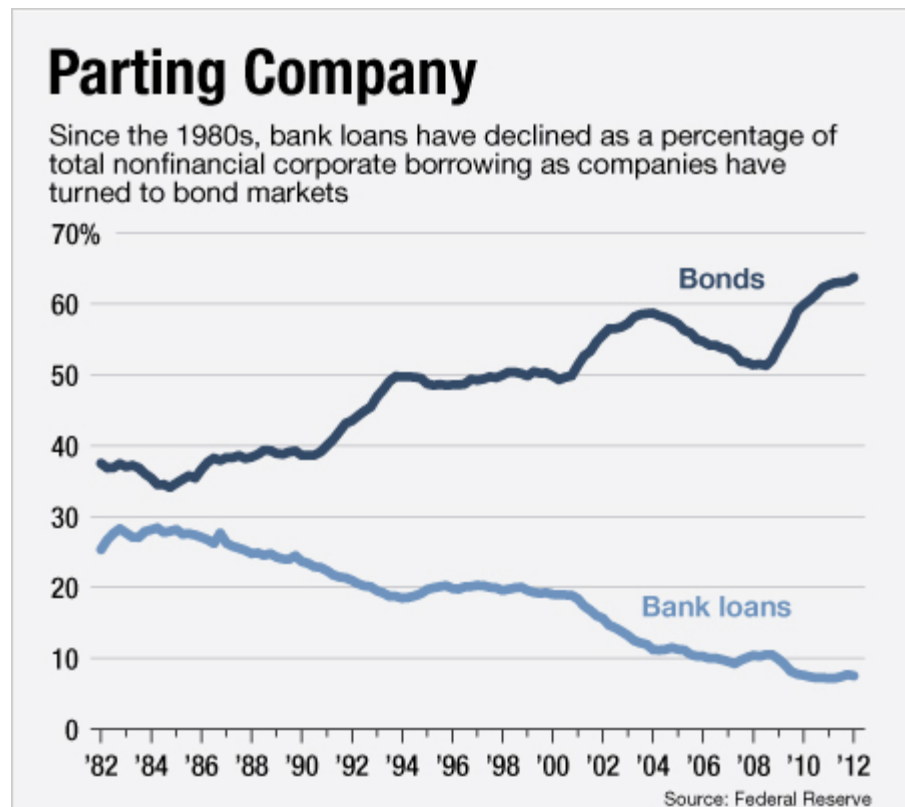
- Prior to the financial crisis, credit rating agencies assigned subprime mortgage collateralized debt obligations AAA ratings, putting them in a low risk-weight category. Yet the rate at which these CDOs defaulted belied their AAA ratings.
- Brown and Vitter have concluded that it's impossible to get the risk weights right. Trying to do so will only make them more complex and more vulnerable to being gamed.
- Brown-Vitter (S. 798) specifically provides that the regulators may establish supplemental risk-based capital requirements for any financial institutions with more than \$20 billion in assets to measure the relative risk in certain assets and to prevent investment in excessive amounts of riskier assets. No one is advocating doing away with risk-based capital standards. They can provide an important check on any equity capital ratio, particularly for the larger banks.
- The capital ratio measurements of the largest U.S. globally important banks point to the inherent problems with complete reliance upon risk-based capital ratios. For example, Morgan Stanley's recent risk-based Tier 1 capital ratio was 17.72 percent. However, its leverage equity capital ratio—without risk weights and using GAAP—is 5.79 percent, about two-thirds less. Even more alarming: When international accounting measurements (IFRS) are applied, which places more of Morgan Stanley's derivatives onto the balance sheet than does U.S. GAAP standards, the tangible leverage capital ratio is only 2.55 percent. Morgan Stanley is a stark illustration of the failure of risk weighting.

Institution	Basel Tier 1 Risk-based Capital	Tangible Capital	
		GAAP	IFRS*
Average: All U.S. GSIBs	13.49	6.17	3.88
Bank of America	12.89	5.79	3.55
Bank of New York Mellon	15.02	4.02	3.77
Citigroup	14.06	5.61	3.57
Goldman Sachs	16.75	7.07	3.87
JPMorgan Chase	12.59	5.89	3.48
Morgan Stanley	17.72	5.79	2.55
State Street	19.13	5.78	5.64
Wells Fargo	11.75	8.13	7.78
Source: Thomas M. Hoenig. "Basel III Capital: A Well-Intended Illusion." Table 1: Capitalization Ratios for Global Systemically Important Banks.			

Myth: If the nation's largest banks are forced to shrink due to higher capital ratios, who will make the loans to big U.S. companies, such as Caterpillar, John Deere and Boeing?

- This objection is based on a misconception of what types of services banks provide to large, multi-national corporations. Banks help these corporations access the capital markets through debt and equity underwriting. Banks arrange and participate in loan syndicates that involve multiple creditors. Banks provide cash management services, trade finance, and foreign exchange. These services can be provided by banks with assets of less than \$500 billion.
- Nearly all of the short-term funding of large corporations is provided by money market funds. Long-term funding is principally provided by the bond markets as illustrated in the chart below. Direct bank loans to large companies are typically syndicated among multiple lenders.

- What large companies need is a strong and stable financial system that is not so top-heavy that the collapse of one institution results in a domino effect on the rest of the banking system. The financial crisis of 2008 resulted in a credit crisis of unprecedented proportions coupled with millions of lost jobs and employee layoffs.



Source: American Banker

Myth: Brown-Vitter would drive complex banking services to the underground shadow banking world.

- Brown-Vitter, which would apply new capital requirements only to financial institutions, would not ban complex financial activities. It would ensure that financial institutions include their exposures from derivatives and other complex financial activities in their total assets and subject to a capital charge. It would also ensure that the non-bank affiliates of a financial institution, in which complex financial services are often situated, do not have access to the federal safety net.

- Financial institutions may find that it makes sense to divest their non-bank affiliates, once their activities are no longer subsidized. But these newly independent firms, together with other financial firms that have never been affiliated with commercial banks, will be free to offer complex financial services subject to regulation by the SEC and Commodity Futures Trading Commission but without the Brown-Vitter capital requirements. Such services will not be “driven underground.”

- The five largest banks control 19,654 non-bank subsidiaries in more than 90 countries. These large banks are, in effect, part of the shadow banking industry today. The government currently makes no meaningful distinction

between a commercial bank and a shadow bank. This was confirmed by the bailouts of two shadow banks during the 2008 financial crisis that were supposedly outside the federal safety

	Total nondeposit liabilities (\$B)	Nondeposit liabilities as % of GDP	Total subsidiaries	
J.P. Morgan Chase	983	6.3%	5,183	72
Bank of America	890	5.7%	4,647	56
Goldman Sachs	817	5.2%	3,550	53
Citigroup	816	5.2%	3,556	93
Morgan Stanley	609	3.9%	2,718	64
Total	4,115	26.3%	19,654	338

Source: "Which Banks Could Face Cap on Size?" by Victoria McGrane, *Wall Street Journal*, Oct. 11, 2012; Financial Stability Oversight Council.

net—American International Group (AIG) and Bear Sterns. Another shadow bank, Lehman Brothers, was allowed to fail, but its failure triggered bailouts of a cluster of commercial banks as well as money market funds that were connected with it. The solution is better defined limits on the federal safety net and better regulation of the shadow banking industry.

Myth: By forcing megabanks to downsize, Brown-Vitter will prevent U.S. banks from being globally competitive.

- Brown-Vitter does not force banks to downsize. It simply requires megabanks to hold additional capital to compensate for the increased systemic risk they present to the financial system due to their sheer size, complexity and interconnectedness.
- If the U.S. wants a global competitive advantage, it should pursue policies that result in smaller institutions that need less intrusive oversight, which would allow them to capitalize on technological change and outmaneuver giant rivals in other countries. U.S. banks don't have to be the biggest, but they should be the strongest.

Myth: The megabanks have repaid their TARP funds with interest. The bailouts were a success, and any remaining concerns are misplaced.

- While the megabanks have repaid funds acquired through the Capital Purchase Program (which was part of TARP), this does not represent the full range of subsidies provided by the government.

- The six largest banks have received \$102 billion from the federal government since the end of 2008 in the form of tax breaks, Federal Reserve purchases of mortgage-backed securities, and interest paid on reserves held at the Federal Reserve.¹¹
- The government and the taxpayer bailed out the megabanks during an emergency. A dollar of bank capital during a financial crisis when the bank has nowhere else to turn is worth infinitely more than a dollar after the crisis has passed and the recipient bank has stabilized. In other words, repayment of funds borrowed on an emergency basis, though expected and welcome, shouldn't deter us from administering strong medicine to deter future bailouts.

New myths and other objections to Brown-Vitter will no doubt emerge as the bill and other solutions to too-big-to-fail gain momentum, but it is clear that Wall Street has already put its best arguments on the table, and none of them withstand scrutiny.

Closing

Banks should exist to serve the economy, to provide the credit and other financial services that help launch and expand businesses and create new jobs. A robust market for financial services helps consumers obtain home mortgages and other loans at competitive rates and on customized terms. When banks compete freely, consumers have access to a range of solutions for savings and investment.

But today's market for financial services is not free. A small number of banks, under the implicit protection of the government, have grown so exponentially large that they pose a critical threat to the economy and the taxpayer, thwart the free market and stifle competition. There is growing recognition of the problem of too-big-to-fail by economists, central bankers, consumers and political leaders across the political spectrum. On March 22, 2013, the U.S. Senate voted 99-0 to end government subsidies for too-big-to-fail firms. A public survey conducted in March 2013 found that half of all U.S. adults favor breaking up the largest banks, and only 23 percent opposed breaking them up.

We urge you to join ICBA in pushing for vigorous but practical solutions that will restore a free and safe market for financial services and tap the true potential of the American economy.

¹¹ Bob Ivry, "No Lehman Moments as Biggest Banks Deemed Too-Big-To Fail." Bloomberg Markets Magazine (May 10, 2013).