



UNC  
SCHOOL OF LAW

NORTH CAROLINA  
BANKING INSTITUTE

---

Volume 18 | Issue 1

Article 3

---

2013

# Keynote Address: The Continuing Problem of Too Big to Fail

Simon Johnson

Follow this and additional works at: <http://scholarship.law.unc.edu/ncbi>



Part of the [Banking and Finance Law Commons](#)

---

## Recommended Citation

Simon Johnson, *Keynote Address: The Continuing Problem of Too Big to Fail*, 18 N.C. BANKING INST. 1 (2013).

Available at: <http://scholarship.law.unc.edu/ncbi/vol18/iss1/3>

This Comments is brought to you for free and open access by Carolina Law Scholarship Repository. It has been accepted for inclusion in North Carolina Banking Institute by an authorized administrator of Carolina Law Scholarship Repository. For more information, please contact [law\\_repository@unc.edu](mailto:law_repository@unc.edu).

## KEYNOTE ADDRESS: THE CONTINUING PROBLEM OF “TOO BIG TO FAIL”

BY SIMON JOHNSON\*

*Simon Johnson discusses the shortcomings of the Federal Reserve System's policy leading up to the 2007-2008 financial crisis, particularly regarding big banks. He addresses the repercussions of regarding big banks as “too big to fail” and “too big to jail.” Johnson analyzes the arguments supporting limited regulation of big banks, including (1) whether there are economies of scale and scope justifying the size of megabanks and (2) the role that subsidies play in banks' assumption of risk. Johnson argues that the Federal Reserve System must engage in the debate regarding the financial regulation of big banks in order to prevent future financial crises.*

In November 2002 Ben Bernanke, who was then a Governor of the Federal Reserve System, not yet the Chairman, spoke at a conference at the University of Chicago that commemorated the ninetieth birthday of Milton Friedman. Mr. Bernanke said, “I would like to say to Milton and Anna: Regarding the Great Depression. You're right, we did it. We're very sorry. But thanks to you, we won't do it again.”<sup>1</sup> So that was an apology, an official apology, from the Federal Reserve about seventy years after some huge policy mistakes, misunderstandings, and misapprehension about what the U.S. economy and the world economy had become.

The question I put before you for consideration now and today and tomorrow is: how long will it be until the Federal Reserve apologizes for its more recent policies? How much will that do for us? Can we push perhaps, not for an earlier apology—I think that given the way politics and regulation work an apology is unlikely, but can we push for a meaningful shift in Federal Reserve policy? I think that is the issue of

---

\* Simon Johnson is the Ronald A. Kurtz Professor of Entrepreneurship, Massachusetts Institute of Technology, Sloan School of Management.

1. Ben S. Bernanke, Governor, Bd. of Governors of the Fed. Reserve Sys., Remarks at the Conference to Honor Milton Friedman at the University of Chicago (Nov. 8, 2002), available at <http://www.federalreserve.gov/BOARDDOCS/SPEECHES/2002/20021108/>.

the moment and of the year—the policy of the Federal Reserve towards financial regulation.

Now, in case you think I'm being unfair in singling out the Federal Reserve, let me just make a couple of supportive points. First, this is the centennial of the Federal Reserve.<sup>2</sup> The Federal Reserve has presided over three major economic disasters since it was created. Its responsibility in the Great Depression of the 1930s is not controversial – this point is agreed to by Ben Bernanke.<sup>3</sup> The 1970s is not my topic today, but the failure of monetary policy in the United States was profound and fortunately Paul Volcker brought us back from the brink.<sup>4</sup> And regulatory policy failed a third time, dramatically in the run-up to 2007-2008, and it fails us today.

Let me focus on the run-up to 2007-2008 crisis.

What was the Federal Reserve responsible for in the early to mid-2000s? Consumer protection is one area. The Federal Reserve's performance was a complete disaster. I also do not think anyone would say they did well in that dimension of their financial stability work. And part of the result is the absence of full employment—not now, not for the last five years, and not anytime soon. How about price stability? That is a fascinating question, and the jury is still out on that one. It is not clear to me that they came at all close to hitting their objectives on any of these targets.

What is the outcome of the Dodd-Frank financial reform process?<sup>5</sup> Of course some of those pieces are still coming into place, but what can we see quite clearly from that legislation and from its implementation? Has the power and the authority of the Federal Reserve in the light of its disastrous record increased or decreased?

The Federal Reserve has absolutely become more powerful. Yes, there are some other players in the mix around financial regulation. There is now a Financial Stability Oversight Council chaired by the

---

2. The Federal Reserve Act of 1913 created the Federal Reserve System on December 23, 1913. For more information regarding the centennial of the Federal Reserve System, see *Planning for the Centennial*, BD. OF GOVERNORS OF THE FED. RESERVE SYS. (Aug. 2, 2013), <http://www.federalreserve.gov/aboutthefed/centennial/about.htm>.

3. Bernanke, *supra* note 1.

4. Paul Volcker was Chairman of the Federal Reserve under Presidents Jimmy Carter and Ronald Reagan, from 1979 to 1987.

5. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of the U.S. Code).

Secretary of the Treasury,<sup>6</sup> but the Federal Reserve is the custodian of the thinking, of the beliefs, and of the ideology that governs how the financial system is treated.

In my book with James Kwak, *13 Bankers*, we provide a lot of nuanced history.<sup>7</sup> There are many footnotes. All this context and texture is important, but I think at the end of the day you have to blame someone. We blame Alan Greenspan.<sup>8</sup>

Alan Greenspan's thinking is at the heart of what went wrong. The idea that you can do nothing at all about asset bubbles, let them run their course, and clean up afterwards; this was Greenspan's idea.<sup>9</sup> Doing nothing about asset bubbles is a completely mistaken, dangerous belief.<sup>10</sup> It has been exploded. You do not hear it in the speeches of Federal Reserve officials today, and you will not hear it again for a very long time and for good reason. That was Greenspan's ideology.<sup>11</sup>

What is the problem now? What is the issue? Where do we need leadership from the Federal Reserve? I think it is very simple and very straightforward. It is the problem of the banks—the financial institutions—that are collectively referred to as “too big to fail.”

I wrote in a column recently that these banks were “too big to jail.”<sup>12</sup> My editor said, “Are you sure you meant jail, I thought it was fail?” I replied that it is all of the above.

There is a PBS documentary, *The Untouchables*, which reviewed why criminal and civil cases have not been brought against executives of the financial institutions that were at the heart of the disaster and at the heart of the many inappropriate things that happened subsequently, including the way foreclosures were handled.<sup>13</sup> Lanny Breuer, who headed the Criminal Division at the Department of Justice and

---

6. Dodd-Frank Act, 12 U.S.C. § 5321 (2012).

7. SIMON JOHNSON & JAMES KWAK, *13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN* (2011).

8. *Id.* at 207 (noting that Greenspan “believed that government regulation was rendered largely unnecessary by the free market”).

9. *Id.* at 147 (this policy was “true to the conclusion of Greenspan’s 1996 ‘irrational exuberance’ speech”).

10. See GEORGE COOPER, *THE ORIGIN OF FINANCIAL CRISES: CENTRAL BANKS, CREDIT BUBBLES AND THE EFFICIENT MARKET FALLACY* (2008).

11. Johnson & Kwak, *supra* note 7, at 147.

12. Simon Johnson, *Too Big to Jail*, PROJECT SYNDICATE (Feb. 22, 2012), <http://www.project-syndicate.org/commentary/too-big-to-jail>.

13. *The Untouchables* (PBS Frontline television broadcast Jan. 22, 2013), available at <http://www.pbs.org/wgbh/pages/frontline/untouchables/>.

whose resignation was announced after this interview,<sup>14</sup> said on camera that he and his colleagues did not bring criminal cases against very large financial institutions—there’s an interesting question whether this also extends to executives who run those institutions—because it would jeopardize financial stability.<sup>15</sup> He also said that he consults with experts on whether financial instability would be induced by bringing criminal charges.<sup>16</sup>

That raises a very interesting constitutional, regulatory question. Who are the experts with whom the DOJ consults? Is there a list? What are the criteria? Is this something that is applied uniformly across all potential cases, or perhaps something that is more improvised according to the circumstances? On these questions I am paraphrasing an articulate and pointed letter sent by Senator Sherrod Brown and Senator Grassley to the DOJ.<sup>17</sup> Mr. Breuer has asserted that certain financial institutions, because of their economic and financial role, are immune from a particular form of prosecution – despite the fact that such prosecutions are a very important disincentive pushing against corporate misbehavior.<sup>18</sup> If there are no criminal penalties, you can only face civil penalties. Civil penalties, in this context, are generally trivial. It is a small amount of shareholder cash that the executives are asked to hand over.

So the problem is “too big to jail,” but the essence of this issue is that certain financial institutions have a scale, a scope, a function, and a role that is regarded as so important that they cannot be allowed to fail. They cannot be allowed to go through bankruptcy in the way other American corporations go through it.

At the present time there is a lot of pushback trying to defend

---

14. Sarah Childress, *Report: DOJ Criminal Chief Lanny Breuer Stepping Down*, PBS FRONTLINE, Jan. 23, 2013, <http://www.pbs.org/wgbh/pages/frontline/business-economy-financial-crisis/untouchables/report-doj-criminal-chief-lanny-breuer-stepping-down/>.

15. *The Untouchables*, *supra* note 13.

16. *Id.* (“But in any given case, I think I and prosecutors around the country, being responsible, should speak to regulators, should speak to experts, because if I bring a case against institution A, and as a result of bringing that case, there’s some huge economic effect—if it creates a ripple effect so that suddenly, counterparties and other financial institutions or other companies that had nothing to do with this are affected badly—it’s a factor we need to know and understand”).

17. Press Release, U.S. Sens. Sherrod Brown & Chuck Grassley, Sens. Brown, Grassley Press Justice Department on “Too Big to Jail” (Jan. 29, 2013), *available at* <http://www.brown.senate.gov/newsroom/press/release/sens-brown-grassley-press-justice-department-on-too-big-to-jail>.

18. *The Untouchables*, *supra* note 13.

the big banks. James Kwak wrote a post on our blog, *Baseline Scenario*, saying that he was surprised that the idea of breaking up the big banks—making them smaller, for example by subjecting them to a hard size cap—keeps being discussed.<sup>19</sup> This idea came into play briefly in 2010 and was taken up by Senator Sherrod Brown and Senator Ted Kaufman. They proposed an amendment to what became the Dodd-Frank financial reform legislation.<sup>20</sup> This amendment was defeated on the floor of the Senate, 61-33.<sup>21</sup> That seemed like it was the end, but this issue keeps coming back. I think this issue remains current is the continued use of power by and for this sector.

If you want a vivid example that spans all of this, think about LIBOR. Neil Barofsky wrote a piece in the *Financial Times* explaining the links between the LIBOR scandal and what he calls the “Geithner doctrine.”<sup>22</sup> The Geithner doctrine is the application of the idea that since some institutions are “too big to fail” they must get all the support we can provide.<sup>23</sup> It feeds directly into this “too big to jail” doctrine that was articulated on tape in an extraordinary moment by Lanny Breuer.<sup>24</sup>

The banks are naturally pushing back. Robert Rubin—former Secretary of the Treasury, the former head of Citigroup, a longtime supporter of President Obama before he became president, and the founder of a project at Brookings called the Hamilton Project—appeared on CNBC on February 7, 2013, arguing: the big banks are not a problem, don’t worry about them, and don’t try to break them up because that will just make things worse.<sup>25</sup> There is a firm in Washington called

19. James Kwak, *If the Fed Knows Banks Are Too Big, Why Doesn't It Make Them Smaller?*, THE BASELINE SCENARIO BLOG (May 14, 2013), <http://baselinescenario.com/2013/05/14/if-the-fed-knows-banks-are-too-big-why-doesnt-it-make-them-smaller/>.

20. Brown-Kaufman Amendment, S. Amdt. No. 3733, 111th Cong. (2nd Sess. 2010), available at [http://www.senate.gov/legislative/LIS/roll\\_call\\_lists/roll\\_call\\_vote\\_cfm.cfm?congress=111&session=2&vote=00136](http://www.senate.gov/legislative/LIS/roll_call_lists/roll_call_vote_cfm.cfm?congress=111&session=2&vote=00136) (showing the results of the roll call vote). )

21. *Id.*

22. Neil Barofsky, Comment, *The Geithner Doctrine Lives on in the Libor Scandal*, FIN. TIMES (USA EDITION 1), Feb. 8, 2013, at 7.

23. *Id.* (According to Barofsky, “The ‘Geithner doctrine’ made the preservation of the largest banks, no matter the consequences, a top priority of the US government.” Barofsky cites blogger Yves Smith as the creator of the phrase “Geithner doctrine.”)

24. *The Untouchables*, *supra* note 13.

25. *Robert Rubin on ‘Too Big to Fail’ Risk* (CNBC Squawk Box television broadcast Feb. 7, 2013), available at <http://video.cnb.com/gallery/?video=3000146493>.

Hamilton Place Strategies.<sup>26</sup> It is mostly, but not entirely, run by senior Republican communications professionals. They issued a report in February 2013 saying the same things as Mr. Rubin.<sup>27</sup> So, Mr. Rubin, a Democrat with the Hamilton Project is aligned closely with the Hamilton Place Strategies coming from the Republican side. I have read Alexander Hamilton closely and I've studied his work. I do not think he was on board with the idea of crony capitalism. Perhaps we should say we are looking for a Jeffersonian moment or a James Madison moment—a pushback against what are claimed to be the Hamilton ideals.

People who are aiming to protect the big banks make it sound very complicated. They have a lot of a lot of things you should consider. But I don't think it's actually that complicated.

Are there economies of scale and scope in banking that justify the current size of these banks? You often hear Jamie Dimon, the head of JP Morgan Chase, say that JP Morgan must be at its current size—slightly over 2 trillion dollars total balance sheet—otherwise very bad things would happen to the world economy.<sup>28</sup>

Dennis Kelleher from Better Markets points out that if it's the case that JP Morgan Chase must really at this scale that, then they must have been in big trouble in early 2008 before they acquired Bear Stearns—because they were only about a \$1.4 trillion bank at that point.

More broadly, where are the big gains in efficiency from a social point of view from this increase in banking scale that we have seen in the United States over the past twenty years? The six largest banks in the United States today have a combined balance sheet of over sixty percent of GDP. Those same banks back in the mid-1990s were around fifteen percent of GDP. Goldman Sachs was one of the best regarded investments banks in the world in 1998. It had a balance sheet of about \$250 billion, or about \$280-290 billion in today's money. When it came

---

26. HAMILTON PLACE STRATEGIES, <http://www.hamiltonplacestrategies.com/news> (last visited July 18, 2013).

27. PATRICK SIMS, HAMILTON PLACE STRATEGIES, *BANKING ON OUR FUTURE: THE VALUE OF BIG BANKS IN A GLOBAL ECONOMY* (Feb. 2013), available at [www.hamiltonplacestrategies.com/news/big-bank-debate-continues](http://www.hamiltonplacestrategies.com/news/big-bank-debate-continues).

28. See Steve Schaefer, *JP Morgan's Jamie Dimon: Here's Why Banks Should Be So Big*, FORBES MARKETS, Aug. 13, 2012, available at <http://www.forbes.com/sites/steveschaefer/2012/08/13/jpmorgans-jamie-dimon-heres-why-banks-should-be-so-big/>; see also Stephen Gandel, *Jamie Dimon: JPMorgan Is Still Too Small*, CNN MONEY, Feb. 28, 2012, available at <http://finance.fortune.cnn.com/2012/02/28/dimon-jpmorgan-bigger/>.

very close to failing—it was rescued by being allowed to become a bank holding company—in September 2008, it was a \$1.1 trillion bank.<sup>29</sup>

Show me the economies of scale or scope, the social benefit from those increases that we have seen over the past twenty years. I'm not suggesting we all go back to community banking—and that is not what Sherrod Brown's Safe Banking Act proposes.<sup>30</sup> This legislation suggests we put in a cap that would affect primarily those six largest institutions and roll back their size to where they were roughly speaking in the mid-1990s.<sup>31</sup>

The Bank of England view is that when you measure it properly and take out and adjust for the subsidies that the megabanks receive, there are no economies of scale and scope.<sup>32</sup> Now, up to \$100 billion total assets, perhaps there are some economies of scale, but not above that level. And none of the proposals on the table would push the banks back down to that level. They would substantially reduce bank size and the risk that any one institution can pose to the system. But they would not take them back down to \$100 billion.

The key point in what I just said is the subsidies. What are the subsidies in banking? For a long time I have been banging the table with a book by Anat Admati and Martin Hellwig, *The Bankers' New Clothes: What's Wrong with Banking and What to Do About It*.<sup>33</sup> I first started to pound the table with Anat's blog post.<sup>34</sup> That did not make a

29. Simon Johnson, *Goldman Sachs Concedes Existence of Too Big to Fail*, HUFFPOST BUSINESS "THE BLOG" (June 17, 2013, 10:47 AM), [http://www.huffingtonpost.com/simon-johnson/goldman-sachs-concedes-ex\\_b\\_3453972.html](http://www.huffingtonpost.com/simon-johnson/goldman-sachs-concedes-ex_b_3453972.html).

30. Brown-Kaufman Amendment, S.Amdt. 3733, 111th Cong. (2nd Sess. 2010).

31. Press Release, Sen. Sherrod Brown, Brown Introduces Bill to End "Too Big to Fail" Policies, Prevent Mega-Banks from Putting our Economy at Risk (May 9, 2012), available at <http://www.brown.senate.gov/newsroom/press/release/brown-introduces-bill-to-end-too-big-to-fail-policies-prevent-mega-banks-from-putting-our-economy-at-risk>.

32. Andrew G. Haldane, Exec. Dir., Fin. Stability & Member of the Fin. Pol'y Comm., On Being the Right Size, Speech at the Institute of Economic Affairs' 22nd Annual Series, The 2012 Beesley Lectures at the Institute of Directors, Pall Mall 12-13 (Oct. 25, 2012), available at <http://bankofengland.co.uk/publications/documents/speeches/2012/speech615.pdf>.

33. ANAT ADMATI & MARTIN HELLWIG, *THE BANKERS' NEW CLOTHES: WHAT'S WRONG WITH BANKING AND WHAT TO DO ABOUT IT* (2013).

34. Anat Admati, *What Jamie Dimon Won't Tell You: His Big Bank Would Be Dangerously Leveraged*, THE BASELINE SCENARIO BLOG (Dec. 4, 2010), <http://baselinescenario.com/2010/12/04/what-jamie-dimon-won%E2%80%99t-tell-you-his-big-bank-would-be-dangerously-leveraged/>.

lot of noise. Then she came out with a ninety-page paper.<sup>35</sup> Now, I can bang the table with this book launched in February 2013 at the Peterson Institute for International Economics.<sup>36</sup>

The endorsements on this book are amazing and impressive. The one that strikes me every time I look at it is from Mervin King, Governor of the Bank of England. The Bank of England, by the way, is not generally known as a hotbed of radical, leftwing thought. “At last,” Mervin King says, “[t]wo eminent economists explain in plain English what is wrong with banks and what needs to be done to make them safer.”<sup>37</sup> There is also a great quote from Frank Partnoy, another conference participant.<sup>38</sup>

The subsidy is easy to think about. The subsidy, by the way, is denied completely by the bankers. That is why you have to buy and read the book. The Federal Reserve is supposed to have the smartest, deepest-thinking people, economists, and lawyers. They are supposed to be the experts on this. They have not even engaged, to my knowledge, with Anat Admati. I am shocked by the lack of willingness of the Federal Reserve System to engage with the ideas.

The ideas are simple. If you are too big to fail, meaning that if you get into trouble there will be some protection provided—perhaps by the Treasury, perhaps by the Federal Reserve, perhaps by some other officials to be named later. Remember the creativity of the government in its various forms in the fall of 2008 when they were convinced that the failure of Goldman Sachs or Citigroup would cause massive destruction around the world? Do not deceive yourselves, the fact that Dodd-Frank places constraints on the ability of the Fed, the fact that it modifies the emergency powers, the fact that it changes other parts of the legal powers and authorities around the financial system does not mean that there cannot be and will not be another bailout.<sup>39</sup>

---

35. Anat R. Admati et al., *Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity Is Not Expensive* (Rock Ctr. for Corp. Governance at Stanford Univ., Working Paper No. 86, Stanford Grad. Sch. of Bus. Research Paper No. 2065, 2013).

36. Book Release Meeting for *The Bankers' New Clothes: What's Wrong with Banking and What to Do About It*, THE PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS (Feb. 11, 2013), [http://www.iie.com/events/event\\_detail.cfm?EventID=262](http://www.iie.com/events/event_detail.cfm?EventID=262).

37. THE BANKERS' NEW CLOTHES, WHAT'S WRONG WITH BANKING AND WHAT TO DO ABOUT IT, <http://bankersnewclothes.com/> (last visited July 18, 2013).

38. *Id.*

Now if Art Wilmarth offers you the ability to go to Las Vegas and gamble where Art will cover your losses, but you get to keep the upside, how much risk are you going to take on that trip to Las Vegas? Well, you can take Frank Partnoy with you; he's a world expert on risk and the history of risk and he can advise you. But I think the advice would be, "take as much risk as you can."

In the context of capital, which is the correct focus of Anat and Martin's book, how much capital do you want to have if you're a big bank with a "too big to fail" guarantee? You want to have as little as possible. Bankers will always be paid on return on equity, which is not properly adjusted for risk and risk taking. So you want to take a lot of risk. You hope that you get lucky a couple of years in a row. You can get a large amount of compensation out of that.

Caps on compensation in the financial sector, I'm afraid, will not prove effective. You get massive upside benefits and you have downside protection when it goes bad. When it goes wrong, that's someone else's problem. That is the essence of the incentive problem around banking. This problem is manifested to a greater degree when the banks are bigger, when the individual banks or a small group of banks have more political power, it is even worse.

JP Morgan Chase is the world's largest bank, but it is not the world's largest bank in the tables that you see presented by the banking industry because those numbers are wrong. Those numbers show them in the middle of the pack of the top ten and are based on comparing U.S. GAAP (for US banks) and IFRS (for most international banks). But these are two fundamentally different accounting standards.<sup>40</sup> I do not understand the point of comparing apples and oranges in that way. I don't know why leading news agencies continue to do that, except that they are told that's the way to compare it by the banking industry.

The right way to make the comparison, in my view, is to compare on the basis of IFRS which does not allow for the generous netting of derivatives that you have under U.S. GAAP. It is a better measure of systemic risk in my view and in the view of the IMF, people I have

---

40. GAAP stands for Generally Accepted Accounting Principles. IFRS stands for International Financial Reporting Standards. The American Institute of CPAs (AICPA) published a primer in 2011 regarding IFRS, which highlights differences between GAAP and IFRS. See AICPA, INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS): AN AICPA BACKGROUNDER 8 (2011), available at [http://www.ifrs.com/pdf/IFRSUpdate\\_V8.pdf](http://www.ifrs.com/pdf/IFRSUpdate_V8.pdf).

talked to at the FDIC, and other places. If you convert JP Morgan's accounts to that basis, it's not a \$2.1, \$2.2 trillion bank, it is a \$3.9 or \$4.0 trillion bank—by far, the world's largest bank.<sup>41</sup> Now, this is a \$16 trillion economy. Some people like to say the European banks are bigger relative to their economies than JP Morgan Chase is relative to our economy, but I would suggest that's a complete non sequitur. If the Europeans want to pursue some crazy, insane policies promoting “too big to fail” banks with massive, distorted incentives and blow themselves up, why would we ever want to follow anything like that? You should evaluate the risk of JP Morgan Chase on the basis of the American economy.

The Clearing House ran a simulation of a bank failure, resolution scenario—which I think is deeply flawed and I would caution you against putting too much faith in the results—but I understand one of the results they had was not fail to on a Tuesday, because it is too long from Tuesday to the weekend when the FDIC normally closes banks.

So imagine it is Thursday and JP Morgan Chase is failing. You are advising the Treasury, the White House, FDIC, take your pick. Congress and you are told that JP Morgan could fail causing massive disruption to all the derivative markets in which it is so very active. The interlinkages across economies are mind-boggling. One of the claims made by the friends of the big banks comes from the Financial Services Roundtable and other people. They like to say Dodd-Frank solved the problem of “too big to fail.” There is no need to have the GAO or anyone else investigate the “too big to fail” subsidy. This is very strange logic. They say Dodd-Frank solved the problem because there is a new resolution authority granted to the FDIC to deal with the failure of non-bank financial institutions and bank holding companies.<sup>42</sup>

This is a sensible authority. I support the granting of it. But JP Morgan Chase operates in a hundred or so countries, if it fails there is no cross-border resolution authority and there never will be one. And if there was one frankly, would the French, would you trust them? Will other governments tie their hands by agreeing ex ante on how assets and liabilities are going to be handled and who will bear the cost of the in-

---

41. James R. Barth & Apanard (Penny) Prabha, *Breaking (Banks) Up is Hard to Do: New Perspective on 'Too Big to Fail'* 8 MILKEN INSTITUTE (Feb. 2013), <http://www.milkeninstitute.org/pdf/BreakingBanks.pdf>

42. Dodd-Frank Act, 12 U.S.C. §§ 5381-94 (2012).

solvency? Of course not. Everyone wants to figure it out for themselves. If you were an official in Korea, and I've talked to the Korean officials about this, would you trust the U.S. Treasury, or the IMF, or the FDIC to handle the failure of say Citigroup across borders in a way that would be protective of Korean interests? Of course not. You'd be crazy to trust them. The Koreans will preserve their freedom of actions. So will everyone else. I say this with all due respect to Paul Tucker from the Bank of England, who has appeared in the United States quite a bit recently, talking about the need for and aspirations of cooperation between the Bank of England and the FDIC on this issue.<sup>43</sup> It is a great aspiration, but it is not going to happen. Resolution for cross-border, global, mega-banks is an illusion.

There are the living wills required by Title I of Dodd-Frank.<sup>44</sup> In the living wills the banks have to explain how to handle them in a bankruptcy. Bill Dudley, who is a former Goldman Sachs executive and current President of the New York Fed, said in a speech in November 2012 that the living wills have not worked, that they have not revealed to the regulators and supervisors how to handle the failure of these banks in a way that would not be disruptive.<sup>45</sup> When the New York Fed tells you something that is critical of Wall Street, write it in your diary. It is not going to happen again anytime soon. So, the living wills are meaningless. They will never be effective. Resolution authority is not cross-border. JP Morgan is \$4 trillion dollar bank, what are you going to do?

Who would let JP Morgan Chase fail with losses to the creditors, unknown with regard to the geographic impact, all of your corporate contacts are screaming about the situation—and all of the people you know in and around finance are saying you must save JP Morgan Chase, what are you going to do? Who would let JP Morgan Chase fail or even attempt to go through this completely unknown, unproven black box of resolution? Who would let JP Morgan Chase fail? They are “too big to fail.” They do not have enough capital. They will never have

---

43. See Paul Tucker & Martin Gruenberg, *Global Banks Need Global Solutions When They Fail*, FIN. TIMES, Dec. 10, 2012, <http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech625.pdf>.

44. Dodd-Frank Act, 12 U.S.C. §§ 5381-94 (2012).

45. William C. Dudley, President, Fed. Reserve Bank of N.Y., Solving the Too Big to Fail Problem, Remarks at the Clearing House's Second Annual Business Meeting and Conference, New York City (Nov. 15, 2012), *available at* <http://www.newyorkfed.org/newsevents/speeches/2012/dud121115.html>.

enough capital if left to their own devices.<sup>46</sup>

The degree of confusion and disinformation around capital and equity in banking is extraordinary and that's why this book by Anat Admati and Martin Hellwig is the most important book of the year, the most important book we have had for many years.<sup>47</sup> I hope that all of you read it, and I hope all of you teach it. I hope all of you engage in it with your colleagues, and I hope that you push the bankers to engage with it, too. They must answer the critique of banking in this book and so must the Federal Reserve.

The last argument is: at the end of the day we will do the bailout and we'll save the day. Isn't this what you hear from Treasury and what Mr. Geithner said in his farewell speeches? The government didn't lose money on TARP he tells us.<sup>48</sup> Well, I think this is the most problematic and disingenuous belief of all, and one you hear not so much from the Federal Reserve. It is more a view that is associated with Mr. Geithner directly.

The cost of any financial crisis is not primarily in the emergency provision of capital liquidity by authorities that may or may not be paid back; the cost of financial crisis is the loss of jobs and the loss of growth. If we are talking about a housing crisis there are many other dimensions around the disruption of mortgages and the way that homeowners were treated. We just experienced the greatest financial crisis since the 1930s because incentives in the financial system encouraged people to take excessive risk, to have too little capital, too much leverage, and too much debt relative to thin cushions of equity.

If you don't believe me, read the work of Richard Fisher and Harvey Rosenblum of the Dallas Fed. Richard Fisher and Harvey Rosenblum, highly respected on the right of the political spectrum, argue that allowing the banks to have this distortion of incentives has completely messed up monetary policy and the ability of monetary policy to

---

46. Admati et al., *The Leverage Ratchet Effect* (Rock Ctr. for Corp. Governance at Stanford Univ., Working Paper No. 146, 2013), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2304969](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2304969).

47. ADMATI & HELLWIG, *supra* note 33.

Tim Massad, *The Response to the Financial Crisis – In Charts*, TREASURY NOTES BLOG (Apr. 13, 2012), <http://www.treasury.gov/connect/blog/Pages/financial-crisis-response-in-charts.aspx> (“In addition, the latest available estimates indicate that the financial stability programs are likely to result in an overall positive financial return for taxpayers in terms of direct fiscal cost.”)49. Richard W. Fisher & Harvey Rosenblum, *The Blob That Ate Monetary Policy*, WALL ST. J., Sept. 28, 2009, at A23.

be effective, at least when the economy slows down and when there are various forms of downside scenario around the financial system. One of their first pieces was an op-ed in the *Wall Street Journal* called *The Blob That Ate Monetary Policy* talking about the way in which the failure of those banks in 2007-2008 broke down the standard transmission mechanism for monetary policy, the way the Fed tries to stabilize the economy, and resulted in all kinds of additional damage—more jobs lost, and use of unconventional monetary policy, the consequences of which we don't fully appreciate.<sup>49</sup> No Federal Reserve officials are confronted by this disaster, the Fed's role in it, and the enormous consequences for macroeconomic stability and for monetary policy. The Fed explicitly denies they have that responsibility. They have made and backed away from their other responsibilities. Why doesn't the Fed take this on? Why don't we hear clear speeches from Ben Bernanke on this topic? Why won't top Fed officials meet with Anat Admati and discuss these ideas?

Well, I think you have to go back to the DNA of the Federal Reserve System. You have to talk to Peter Conti-Brown, who is at this conference, and you have to wind the clock back to 1907 when the U.S. did not have a central bank. You have to follow the debate from 1907 to 1913 when there were two conflicting views about creating a central bank.<sup>50</sup> On the one hand, there were the oligarchs who were associated with Nelson Aldrich, who was arguably the most powerful Senator of the time. His daughter married John D. Rockefeller's son. Imagine what that Facebook page would look like? They said we don't want a central bank because it will make the government too powerful. We want some support in crisis—that was the lesson from 1907—but we want that to be in private hands. On the other side there was Louis Brandeis, there was the Peugeot Committee in the House that said, wait a minute, this is bankers using other people's money. There has to be a public, government role.

What was created in 1913 was a hybrid—it was a mixture of public and private. This was not unprecedented. There have been other central banks in history that have had some of that commingling, but I

---

49. Richard W. Fisher & Harvey Rosenblum, *The Blob That Ate Monetary Policy*, WALL ST. J., Sept. 28, 2009, at A23.

50. ELMUS WICKER, THE GREAT DEBATE ON BANKING REFORM: NELSON ALDRICH AND THE ORIGINS OF THE FED ch. I (2005), available at <https://ohiostatepress.org/Books/Book%20PDFs/Wicker%20Great.pdf>.

would argue that the extent of the private sector sway—and particularly the Wall Street influence and the role of the New York Fed—this was something you have never seen anywhere else.

This system failed completely in the 1930s and it was replaced by something that adjusted the balance a little bit more towards the Board of Governors and a little bit more towards government authority, but still it preserved this very powerful voice of Wall Street. Perhaps you can argue in the immediate post-WWII period that the Fed had moral suasion over the private sector. There are some instances where Paul Volcker arguably asserted this moral suasion, for example when the Hunt brothers corner on the silver market failed and the Fed stepped in to prevent financial disruption.<sup>51</sup> There was a lot of moral suasion in that case. In the past twenty years it has turned around. It is all about capture. It is all about ideas. It is coming from Wall Street. The Wall Street influence in the New York Fed amounts to having excessive power within the Federal Reserve System.

Some of the smartest, best voices on what needs financial reform come from within the Fed: Richard Fisher, the Dallas Fed head, and Tom Hoenig who is now Vice Chairman at the FDIC. There are others: Gary Stern and Ron Feldman of the Minnesota Fed wrote a book called *Too Big To Fail* in the early 2000s that foreshadowed many of these same issues,<sup>52</sup> but the New York Fed won't go there. The New York Fed will not shift, will not engage, and will not have this conversation. The New York Fed will not come and debate these questions with you, me, Dennis Kelleher, or Anat Admati, or anyone.

The issue is financial regulation. There will not be legislation in this cycle, but there is a huge amount up for grabs in terms of implementation and in the belief system of officials. The thinking of many officials, including at the Federal Reserve in the run-up to 2007-2008, was as fundamentally flawed as their thinking was in the 1920s and early 1930s. The question is, do they recognize this? Will they make adjustments? Is this a moment of realignment in their thinking? There have been many such realignments in their thinking and there will be many more, I am sure.

---

52. GARY H. STERN & RON J. FELDMAN, *TOO BIG TO FAIL: THE HAZARDS OF BANK BAILOUTS* (2004).

In the coming seventy years eventually they are going to apologize for this. It is not going to do us a lot of good, but it might help our grandchildren, or it might not. Why won't they move? Because of the influence of Wall Street and the way that filters through their system and influences their thinking.

Can they be pushed? Absolutely. Senator Sherrod Brown won reelection against Wall Street money. Senator Elizabeth Warren won election against Wall Street money. Senator Brown works with republican Senator David Vitter and republican Senator Chuck Grassley on some of these issues. You can push your politicians, your social network, the people you know to reevaluate, to read this book, *The Banker's New Clothes*.<sup>53</sup> The Federal Reserve must come out and engage on the substance. If it continues to hide in its bunkers, if it continues to deny that there is a debate, it is failing us just as profoundly as the people who ran the Federal Reserve failed the American public in the early 1930s.

---

53. ADMATI & HELLWIG, *supra* note 33.

