A Note on Too Big to Fail Banks

Trustee Leadership Forum for Retirement Security

Overview:

Between 1990 and 2009 in the U. S., 37 banks consolidated into just 4 mega-banks, largely made possible by deregulation, including the repeal of the Glass-Steagall Act in 1999. Critics have argued that the size and complexity of these new mega-banks made it difficult to regulate their risky behavior, a circumstance that most certainly contributed to the financial crisis; a crisis which, in turn, dealt a debilitating blow to pension funds, their members and beneficiaries.

Today, the question remains, have financial reforms helped protect against the failure of these mega-banks, or Systemically Important Financial Institutions (SIFIs), as they are now called. Some analysts and academics, notably Simon Johnson, James Kwak, and Sheila Bair (among others), have warned that banks have grown even larger since the run-up to the crisis, and many have argued that their very size has created an implicit government guarantee – in effect a subsidy – because they are Too Big to Fail (TBTF). These government guarantees, critics argue, mean that executives at large banks are encouraged to continue their risky behavior and to operate with relatively small amounts of shareholder equity (capital).

How Might Pension Trustees Consider TBTF Banks?

Pension fund trustees face many challenging issues when it comes to investment decisions. First and foremost, they must fulfill their fiduciary duty by providing a secure retirement for current and future beneficiaries. In doing so, they are often faced with questions about how to sustainably ensure the long-term health of their funds, and questions as to what considerations are material to their decisions.

TBTF banks are a good example of a long-term issue of embedded risk that responsible investment is designed to integrate into decision-making. Funds may view TBTF banks as good investments as individual pieces of a portfolio. However, investors who view investment decisions through a systemic, long-term lens may also view these banks as creating risk and volatility for the market as a whole, and potentially posing a risk to the economy, their communities, and/or the participants of their funds.

What kind of risk might TBTF banks pose?

- Banks are operating with small amounts of shareholder equity (i.e., they have a lot of debt relative to that equity). For a small bank, overleveraging can mean failure. But a TBTF bank that over borrows can pull large parts of the economy over a cliff.

- Subsidizing TBTF banks may create outsized losses in the event of crisis or failure, as the banks are themselves so large.

- Implicit guarantees to bailout TBTF banks may create perverse incentives for banks to deal in opaque and complex products like derivatives and credit default swaps, which put more risk in the economy.

- The size and complexity of TBTF banks may make it more difficult for regulators to fully and consistently regulate, and therefore create undue weakness throughout the financial system.

- In consolidating, banks have taken on many different types of financial services beyond core-banking functions, creating conflicts of interest that can, for instance, impact the independence of analysts, and reduce competition in the market. These risks are enhanced by the increasing size of TBTF banks.

- TBTF banks may consolidate financial power in the hands of a few, which can lead to regulatory capture, aka regulators and politicians that go easy on powerful banks. Some regulators may move between working for government and banks, affecting their willingness to enforce regulations fully against former and/or future employers.

How might pension trustees consider these potential risks? Some questions:

- How will pension funds fare if a TBTF bank has to be bailed out? (Hint: Not well. Under the proposed FDIC/Federal Reserve approach to bank resolution, long-term investors that operate without leverage will face big losses if they are shareholders or even creditors.)

- Can considering market volatility caused by TBTF banks help better manage risk when making investment decisions?

- What investment policy options are there to decrease exposure to risks associated with TBTF banks?

- How can pension funds respond to TBTF risk as shareholders?

- What role can investors play in addressing the structural causes that have led to massive bank consolidation?

What Can Trustees Do?

If TBTF banks pose a systemic threat to the economy, pension fund trustees have good reason to call for incorporating these concerns into the investment decision making process through risk committees, engagement as shareholders, and larger efforts at systemic change.

TBTF and Investment Strategy

Risk Management:

- Scrutinize funds' holdings for risk associated with TBTF banks.
- Integrate TBTF bank risk into the fund's investment analyses.
- Consider using bank size as a sign of potential risk.

Governance

- Call for engaging mega-banks on their corporate governance.
- Insist on stronger independent boards of directors, including well-informed risk committees.
- Use shareholder activism to bring issues to the fore, including supporting shareholder resolutions calling on banks to develop a plan to spin off non-core banking activity and/or opposing joint chairman and CEO roles.

TBTF and Systemic Change

Collective calls or joint advocacy by trustees around mega-banks as an issue that may affect the long-term sustainability of their investments could be a way to address larger, structural issues which may be enriching in the short-term, but, in the long-term, may add to the volatility of the economy as a whole, and therefore pension funds. Two current pieces of legislation that address TBTF concerns are:

- 21st Century Glass-Steagall Act – would separate traditional banks from risky financial services
- Terminating Bailouts – would limit government safety nets to traditional banking, and put capital standards on banks based on their size and complexity

Conclusion

TBTF banks and the potential risk they pose is one of a number of system level concerns that pension fund trustees may grapple with today. The ideas of responsible investment can provide a framework and tools for examining these high-level, long-term questions about how larger risks to the economy may be considered as investors. As an alternative to investments in TBTF banks, investors may consider advocating for prudent investments in the real economy, while being skeptical of the promise of out-sized rewards.

Further Reading

13 Bankers: The Wall Street Takeover and the Next Financial Meltdown
Accessible history of bank consolidation, "the rise of concentrated financial power", the 2008 financial crisis, and concerns about the continued volatility caused by mega-banks.
13 Bankers: The Wall Street Takeover and the Next Financial Meltdown, by Simon Johnson and James Kwak, 2010

Exile on Wall Street: One Analyst's Fight to Save the Big Banks from Themselves
Personal story of a Wall Street analyst's experience blowing the whistle on risky behavior by big banks, earning him the title of one of the few who predicted the 2008 financial crisis.
Exile on Wall Street: One Analyst's Fight to Save the Big Banks from Themselves, by Mike Mayo, 2011

"Universal Investors and Socially Responsible Investors: A Tale of Emerging Affinities"
This paper posits three types of investors in today's financial markets: Universal Investors, Social Investors and Rational Investors. It argues that the Universal and Social Investor are theoretically inclined to seek returns that benefit society and the environment as a whole, while the tenets of modern portfolio theory lead the Rational Investor to seek returns based primarily on market price.
Universal Investors and Socially Responsible Investors: A Tale of Emerging Affinities, by Steven Lydenberg in Corporate Governance, May 2007

Recent Articles Suggested by Professor Simon Johnson

CLSA Analyst Mike Mayo: 8 Reasons You Should Sell Your Bank of America Stock The Motley Fool, April 29, 2015

Analyst: Bank of America Should Consider Splitting Up by Stephen Gandel in Fortune, March 26, 2015

JPMorgan Worth More In Pieces? Goldman Analysts Think Breakup Makes Sense by Steven Schaefer in Forbes, January 5, 2015

Opinion: Break up Citigroup — and Save the Financial System by Simon Johnson in Market Watch, December 30, 2014

Big Banks Still a Risk by Gretchen Morgenson in the New York Times, August 2, 2014

Debate: Should The U.S. Break Up Big Banks? Featuring Simon Johnson in a debate on NPR, October 23, 2013

Sheila Bair Takes on the Banks, Interview by Bill Moyers, March 22, 2013