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OPINION

Focusing on Bank Size, Missing the Real Problem

By Randal K. Quarles And Lawrence Goodman

The new president of the Minneapolis Federal Reserve Bank, Neel Kashkari, recently made a stir by announcing that even after Dodd-Frank and the other regulatory responses to the financial crisis of 2008, the largest banks are still "too big to fail." In his view, along with that of Bernie Sanders, Elizabeth Warren, Sherrod Brown and other true believers, breaking up these institutions or turning them into regulated utilities is the only way the country can be confident that the 2008 bailouts won't be repeated.

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

Mr. Kashkari is a serious policy maker, but these proposals are seriously misguided. Focusing on bank size is politically appealing but diverts attention from the major source of systemic risk in the financial sector: a shortage of stable deposits. Banks are but one part of an interconnected financial sector providing over $40 trillion of credit to the economy, but that credit is supported by only about $11 trillion of bank deposits.

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

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

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

When losses grow large enough in an environment of crowded trades—such as in housing in the last decade—large banks can fail, with devastating consequences. The failure of small institutions can lead to the same results. The collapse of smaller unit trusts in the 1929 market crash ultimately escalated to threaten the nation's largest financial institutions.

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

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

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

In the real world of capital markets, however, there are not enough natural investors in bank equity seeking utility-like returns. Institutions capitalized largely with debt would encounter similar constraints.

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

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

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