

**Nothing but the Facts: “Lessons from the Crisis: Ending Too Big to Fail”**

This Nothing but the Facts statement by the Committee on Capital Markets Regulation<sup>1</sup> is in response a request for public comment by Neel Kashkari, President of the Federal Reserve Bank of Minneapolis. In his recent speech, “Lessons From the Crisis: Ending Too Big to Fail,”<sup>2</sup> President Kashkari contends that the largest U.S. banks are “too big to fail” and that their size poses a significant, ongoing risk to the U.S. economy.<sup>3</sup> President Kashkari then commits to deliver a plan to the public by the end of 2016 for a transformational restructuring of our financial system in order to end “too big to fail”.<sup>4</sup> In this statement, we identify six relevant facts that should be considered in evaluating whether a transformational restructuring of our financial system predicated on the existence of large banks is appropriate. While a constructive debate can revolve around the relative significance of these facts, we do not engage in that debate herein.

**(1) There has not been a comprehensive analysis of the effects of post-2008 reforms.**

Despite the extensive post-2008 financial reforms, there has been no analysis of the effects of these reforms to support the claim that transformational reforms are necessary. For example, the amount of capital held by the largest banks has more than doubled since the financial crisis and stress tests have ensured that even under the most adverse economic scenarios the capital levels of the largest banks would be higher than the levels of capital at the height of the financial crisis.<sup>5</sup> The liquidity position of the largest banks has also nearly tripled since the crisis.<sup>6</sup> According to Federal Reserve Chair Janet Yellen, large banks have also simplified their structures since the financial crisis, reducing the number of legal entities by 20 percent, thus easing the ability to wind them down in case of failure.<sup>7</sup>

**(2) Financial instability and asset price bubbles in the United States predate the advent of large banks.**

History indicates that financial instability and asset price bubbles in the United States predate the advent of large banks. In fact, scholars have noted that the United States’ fragmented system of *small* banks was a constant source of instability in the nineteenth and early twentieth

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<sup>1</sup> Professor Benjamin M. Friedman does not want to be associated with this statement.

<sup>2</sup> Neel Kashkari, Federal Reserve Bank of Minneapolis President, Speech at Brookings Institution (Feb. 16, 2016), [hereinafter Kashkari 2/16/16 Remarks] available at [https://minneapolisfed.org/~media/files/news\\_events/pres/kashkari-ending-tbtf-02-16-2016.pdf](https://minneapolisfed.org/~media/files/news_events/pres/kashkari-ending-tbtf-02-16-2016.pdf).

<sup>3</sup> Kashkari 2/16/16 Remarks at 2. President Kashkari notes that in his speech he uses “banks” to refer to “banks, bank holding companies and other nonbank financial institutions.” Kashkari 2/16/16 Remarks at 2 n.2.

<sup>4</sup> Kashkari 2/16/16 Remarks at 7.

<sup>5</sup> Randall D. Guynn, *Resiliency and Resolvability of U.S. G-SIBs: What Remains To Be Done?*, Practicing Law Institute, 3 (Dec. 16, 2015), available at [http://www.davispolk.com/sites/default/files/2015\\_12\\_16\\_PLI\\_Banking\\_Law\\_Institute\\_2015\\_presentation.pdf](http://www.davispolk.com/sites/default/files/2015_12_16_PLI_Banking_Law_Institute_2015_presentation.pdf).

<sup>6</sup> *Id.* at 4.

<sup>7</sup> *Monetary Policy and the Economy: Hearing Before the Committee on Banking, Housing, and Urban Affairs, United States Senate*, 114th Cong. (2015) (statement of Janet Yellen, Chair, Federal Reserve), available at <http://www.c-span.org/video/?327079-1/janet-yellen-testimony-us-monetary-policy-economy>.

centuries.<sup>8</sup> Perhaps the most obvious of these asset-price bubbles is the Great Depression, punctuated by the stock market crash of 1929. Depression-era banking in the United States did not feature prominent national banks; instead, when the crises began, over 8,000 commercial banks belonged to the Federal Reserve System, and nearly 16,000 did not.<sup>9</sup> Indeed, many scholars characterize the Great Depression as a series of regional banking panics rather than a “nationwide banking crisis.”<sup>10</sup> One article summarizes: “Banks in the United States (unlike banks in other countries) did not operate throughout the country. They were smaller, regionally isolated institutions. In the United States, therefore, large region-specific shocks might produce a sudden wave of bank failures in specific regions even though no evidence of a shock was visible in aggregate macroeconomic time series.”<sup>11</sup>

**(3) There is no evidence that eliminating large banks would eliminate the need for future government support of the U.S. financial system.**

We are aware of no evidence that the mere *existence* of large U.S. banks was a significant factor in the housing price bubble and collapse or that eliminating large U.S. banks would prevent future asset prices bubbles. History indicates that financial systems of all shapes and sizes have proven vulnerable to manias, panics, and crashes, as famously observed by Charles Kindleberger and now Robert Aliber.<sup>12</sup> President Kashkari suggests that the “job losses, home foreclosures, and lost savings” show that we must solve the too big to fail problem.<sup>13</sup> However, we note that these losses were more directly tied to the housing bubble and collapse than the need for government intervention to stabilize certain large financial institutions. In other words, the widespread and global mispricing of residential and commercial real estate that occurred and the excess credit issued on that inflated value was bound to face correction at some point, and “job losses, home foreclosures, and lost savings” were an inevitable consequence of that correction.

**(4) The size of losses in the S&L crisis were far smaller than the size of losses in the housing collapse.**

President Kashkari suggests that the financial crisis was more damaging than the S&L crisis, because big banks were threatened in the 2008 crisis whereas only small banks were threatened in the S&L crisis.<sup>14</sup> However, it is important to note that in the S&L crisis, the size of the losses from bad loans across the financial system were much smaller than the housing-related losses across the financial system in the 2008 crisis.

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<sup>8</sup> See, e.g., Michael D. Bordo et al., *Why Didn't Canada Have a Banking Crisis in 2008 (or in 1930, or 1907)* (Nat'l Bureau of Econ. Research, Working Paper No. 17312, 2011), <http://www.nber.org/papers/w17312>.

<sup>9</sup> Gary Richardson, *Banking Panics of 1930 and 1931*, FEDERAL RESERVE HISTORY (Nov. 22, 2013), <http://www.federalreservehistory.org/Events/DetailView/20>.

<sup>10</sup> See, e.g., Richard S. Grossman, *The Shoe That Didn't Drop: Explaining Banking Stability During the Great Depression*, 54 J. ECON. HIST. 654 (Sept. 1994).

<sup>11</sup> Charles W. Calomiris & Joseph R. Mason, *Fundamentals, Panics, and Bank Distress During the Depression*, 93 AMER. ECON. REV. 1615, 1617 (Dec. 2003) (internal citations omitted).

<sup>12</sup> See generally Charles P. Kindleberger & Robert Z. Aliber, *MANIAS, PANICS, AND CRASHES: A HISTORY OF FINANCIAL CRISES* (5th ed. 2005).

<sup>13</sup> Kashkari 2/16/16 Remarks at 2.

<sup>14</sup> *Id.* at 2-3.

Total direct costs attributable to the closing of insolvent thrift institutions over the 1986–1995 period (the S&L crisis) amounted to \$146 billion; over the same period, indirect costs due to the loss of Treasury revenue because of the tax benefits that accrued to acquirers of failed institutions amounted to \$6 billion.<sup>15</sup> Of these losses, the taxpayers absorbed approximately \$123 billion; the thrift industry itself bore approximately \$29 billion of losses.<sup>16</sup> The Congressional Budget Office (“CBO”) estimated that the total losses in productive capital resulting from the S&L crisis amounted to \$398 billion.<sup>17</sup> Combining the direct losses and indirect costs with the CBO estimate amounts to an aggregate loss of \$550 billion. No significant effect on the broader stock market occurred during this period.

With regards to the housing bubble, the total loss from 2007 to the first quarter of 2009 reached \$17 trillion, dwarfing the \$550 billion lost in the S&L crisis. Of the approximately \$17 trillion lost, \$5.6 trillion was due to declining housing prices and much of the remainder was due to the declining value of financial assets.<sup>18</sup> Stock market losses during the housing bubble totaled \$8 trillion<sup>19</sup> with retirement fund assets losing approximately \$4 trillion in value.<sup>20</sup> It is further notable that even the collapse of the tech bubble in 2000 was significantly smaller than the collapse of the housing bubble. The amount of wealth lost in the collapse of the tech bubble was \$6.5 trillion.<sup>21</sup> An estimated \$5.0 trillion of that wealth has been attributed to stock market losses.<sup>22</sup>

**(5) Large banks played a stabilizing role in the financial crisis in acquiring several of the failed financial institutions.**

Many large financial institutions did in fact fail during the financial crisis. However, the impact of those failures on the broader economy was significantly mitigated by the ability of large banks to absorb the failed firms. For example, Bank of America acquired Countrywide Financial in July 2008 (\$172 billion in assets) and Merrill Lynch in September 2008 (\$668 billion in assets).<sup>23</sup> JPMorgan acquired Washington Mutual in September 2008 (\$307 billion in assets),<sup>24</sup> and Wells Fargo acquired Wachovia in October 2008 (\$707 billion in assets).<sup>25</sup>

<sup>15</sup> Timothy Curry & Lynn Shibut, *The Cost of the Savings and Loan Crisis: Truth and Consequences*, FDIC BANKING REVIEW 26, 32 (Dec. 2000).

<sup>16</sup> *Id.* at 32–33.

<sup>17</sup> CBO Study, *The Economic Effects of the Savings & Loan Crisis*, (Jan. 1992).

<sup>18</sup> FIN. CRISIS INQUIRY COMM’N, 112TH CONG., THE FIN. CRISIS INQUIRY REP., 391 (Comm’n Print 2011), available at <http://fcic.law.stanford.edu/report>.

<sup>19</sup> Markus K. Brunnermeier, *Deciphering the Liquidity and Credit Crunch 2007-2008*, *Journal of Economic Perspectives*, 23(1):77 (Winter 2009).

<sup>20</sup> U.S. Dept. of Treasury, *The Financial Crisis Response In Charts*, 5 (Apr. 2012).

<sup>21</sup> FCIC Report, *supra* note 17.

<sup>22</sup> Olivia Oran, *5 Dot-Com Busts: Where They Are Today*, *TheStreet.com*, (Mar. 9, 2011), <http://www.thestreet.com/story/11034141/1/5-dot-com-busts-where-they-are-today.html>.

<sup>23</sup> Martin Neil Baily et al., *The big four banks: The evolution of the financial sector, Part I*, *The Brookings Institution*, 8-10 (May 2015), available at <http://www.brookings.edu/~media/research/files/papers/2015/05/26-big-four-banks-asset-share/big-four-final.pdf>.

<sup>24</sup> Robin Sidel et al., *WaMu Is Seized, Sold Off to J.P. Morgan, In Largest Failure in U.S. Banking History*, *The Wall Street Journal*, (Sep. 26, 2008), <http://www.wsj.com/articles/SB122238415586576687>.

<sup>25</sup> *Id.*

**(6) The stability of the global financial system is of crucial importance to the U.S. financial system and economy.**

According to President Kashkari, “[i]f other countries want to take extreme risks with *their financial systems*, we can’t stop them.”<sup>26</sup> This statement is likely true but it must be recognized, nonetheless, that the U.S. is critically exposed to risks posed by foreign countries and their financial institutions. Thus, the U.S. should work with other global financial centers on any major efforts to reform the global financial system. If the breakup of large U.S. banks resulted in larger financial institutions elsewhere in the world, then their collapse, which is out of our control, would still impose major risk to the U.S. financial system and economy.

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Should you have any questions or concerns, please do not hesitate to contact the Committee’s Director, Prof. Hal S. Scott ([hscott@law.harvard.edu](mailto:hscott@law.harvard.edu)), or its Executive Director of Research, John Gulliver ([jgulliver@capmksreg.org](mailto:jgulliver@capmksreg.org)), at your convenience.

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<sup>26</sup> Kashkari 2/16/16 Remarks at 6.