American Bankers Association

THE FINANCIAL SERVICES ROUNDTABLE

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FINANCIAL INDUSTRY ADDRESSES ALLEGED LARGE BANK SUBSIDY

WASHINGTON, D.C. – Today, the Financial Services Forum, the Financial Services Roundtable, The Clearing House, Securities Industry and Financial Markets Association, and the American Bankers Association, released the following policy brief in response to questionable assertions of a "taxpayer subsidy" to large banks. The following points should be kept in mind:

- The recent estimation that large banking companies enjoy a subsidy worth $83 billion is based on a flawed methodology, and on the extrapolation of stale and unreliable financial market data collected before passage of the Dodd-Frank Act.

- An IMF analysis completed in 2010 – before passage of Dodd-Frank – estimated the cost of funding advantage enjoyed by large banking companies to be only "about 20 basis points on average."

- Several more recent studies indicate that, since the passage of Dodd-Frank, any cost of funding advantage has been dramatically reduced or even eliminated. In fact, two recent studies conclude that markets are now imposing a cost of funding *premium* on large banks of up to 35 basis points.

Full Brief:

During his semi-annual Humphrey-Hawkins testimony before the Senate Banking Committee on February 26th, Federal Reserve Chairman Ben Bernanke was asked by Senator Elizabeth Warren (D-MA) about a February 20th editorial that alleges that large banking companies are the beneficiaries of a "taxpayer subsidy" worth $83 billion. Citing a working paper[1] by IMF staff that estimates that large banks enjoy an 80 basis point cost of funding advantage, the editorial attributes this advantage to the expectation on the part of investors that large banks are protected from failure.

Chairman Bernanke responded to Senator Warren: "Well, that's one study, Senator. You don't know whether that's an accurate number."

Chairman Bernanke's skepticism regarding the editorial's headline number is well-founded. First, the number is based on an extrapolation of an estimate based on borrowing costs from 2007 through 2009 – prior to the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which directly addresses the underlying issue of too-big-to-fail (TBTF).[2] In addition, the paper is based solely on estimated data provided by a single rating agency.

Given these analytic shortcomings, it is not surprising that the title page of the paper bears a boxed disclaimer stating in bold font: "This working paper should not be reported as representing the views of the IMF."

In stark contrast, another analysis written by IMF staff in response to a request by the G-20 heads of state in preparation for their June 2010 meeting – and bearing no disclaimer – estimated the cost of funding advantage of large banking companies to be "about 20 basis points on average."[3] But even this analysis did not account for the impact of Dodd-Frank, which was signed into law a month later on July 21, 2010.

More recent analyses of the funding costs of large banking companies – analyses based on market data after Dodd-Frank – show that any funding advantage is fading, or has reversed to become a penalty:

- A recent study of yield spreads on subordinated notes and debentures issued by the 19 largest banking companies before and after Dodd-Frank shows that the funding

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[1] "Quantifying Structural Subsidy Values for Systemically Important Financial institutions," Kenichi Ueda and Beatrice Weder di Mauro, IMF Working Paper, May 2012.

[2] See "Why Should Taxpayers Give Big Banks A Subsidy of $83 Billion Per Year, Or Any Other Made-Up Number For That Matter?" Matt Levine, Dealbreaker, February 21, 2013. Also see "No, 'Too Big to Fail' Is Not Worth $83 Trillion," Dylan Mathews, *The Washington Post*, February 27, 2013.

[3] "A Fair and Substantial Contribution by the Financial Sector: Final Report for the G-20," Staff of the IMF, June 2010, p. 56.

advantage enjoyed by large banking companies has been reduced by 76 percent since the passage of Dodd-Frank.[4]

- A similar analysis of yield spreads on senior bonds issued by the 19 largest banking companies before and after Dodd-Frank shows that any funding advantage has been completely eliminated. In fact, the data show that, following Dodd-Frank, the market has imposed a 25 to 36 basis point cost of funding *premium* on the senior bonds of large banks.[5]

- Just last week, Standard & Poor's issued a briefing that concludes that investors are now imposing a funding premium of 35 basis points on large banking companies.[6]

The change in market expectations is well-founded because Dodd-Frank addresses the issue of TBTF in several important ways that are material to the assertion that large banks enjoy a subsidy.

First, Title I of the Act establishes a special regime of "enhanced prudential supervision" for large institutions to minimize the occurrence of instability and failure. Aspects of safety and soundness for which the Title mandates "more stringent" standards for large banking companies include capital, leverage, and liquidity, as well as limits on asset concentrations and single counterparty exposures. Title I also requires large institutions to produce so-called "living wills," which serve as a detailed blueprint for their liquidation in the event of failure. In addition, Title I repeals the Federal Reserve's authority to provide extraordinary assistance to any single institution.

Importantly, Title II of the Act creates the legal authority and procedural framework for the orderly liquidation of large banking companies in the event of their failure. In other words, Dodd-Frank explicitly contemplates the failure of large institutions and establishes a procedural framework to govern their failure in a manner intended to protect financial stability and the broader economy. Title II also explicitly prohibits taxpayer losses stemming from the liquidation of a banking company of any size. These provisions address what had previously been perceived by the markets as the inability of a large institution to fail without severely damaging the broader economy.

Banking regulators have expressed confidence in the enhanced prudential supervision and orderly liquidation provisions of Dodd-Frank. For example, in a speech on May 10, 2012, FDIC Chairman Martin Gruenberg stated:

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[4] "Has Market Discipline on Banks Improved After the Dodd-Frank Act?" Bhanu Balasubramnian, University of Akron, and Ken B. Cyree, University of Mississippi School of Business Administration, June 8, 2012.

[5] "The End of Too-Big-To-Fail? Evidence From Senior Bank Yield Spreads Around the Dodd-Frank Act," Bhanu Balasubramnian, University of Akron, and Ken B. Cyree, University of Mississippi School of Business Administration, June 23, 2012.

[6] "The Game Changer for Bank Funding Costs, Diane Vazza, Standard & Poor's, March 1, 2013. See http://ratings.standardandpoors.com/feeds/view?video=194049081

> Prior to the recent crisis…[t]here was no authority to place the holding company or affiliates of an insured institution or any other non-bank financial company into an FDIC receivership to avoid systemic consequences…This authority has now been provided to the FDIC under the Dodd-Frank Act.
>
> The new resolution authority does not provide insurance or credit protection for creditors and counterparties, and creditors will always be subject to potential losses. This is a central feature of the new resolution authority and is designed to ensure that there is market accountability…In all likelihood the firm's equity holders will be wiped out and their claims will likely have little or no value…the FDIC expects that it will have to look to subordinated debt or even senior unsecured debt claims as the immediate source of capital. These debt holders can thus expect that their claims will be written down…

Similarly, during his recent Humphrey-Hawkins testimony, Fed Chairman Bernanke stated:

> There's a three-part plan [to address TBTF] under Dodd-Frank. Part number one is to impose costs on large institutions that offset the benefits they get in the funding markets…Number two is the orderly liquidation authority, which we're working closely with the FDIC and with our foreign counterparts to figure out how we would take down a large institution without bringing down the system. And part three is a whole raft of measures to try to strengthen the overall financial system so it will be more credible that we can take down a large institution without bringing down the system.

Policymakers will no doubt continue to debate the efficacy of these approaches. But regardless of the perspective taken, it is important to acknowledge that there is substantial evidence that the market recognizes the impact Dodd-Frank has had on investor expectations. Given the sizeable costs associated with new regulations, together with the new orderly liquidation framework, any purported TBTF-related funding advantage has clearly been reduced or even eliminated. In fact, as mentioned above, recent research suggests that markets may even be imposing a funding penalty on large banking institutions.

As Chairman Bernanke observed during his recent testimony, the markets have begun to treat large U.S. banking companies differently:

> [I]t's working…even though U.S. banks are stronger financially than European banks, frequently U.S. banks have wider credit default swap spreads, indicating a higher probability of actual failure because of the differences between the U.S. and Europe in terms of perceived government support.

Indeed, Moody's cited the orderly liquidation provisions of Dodd-Frank as part of its September 21, 2011 announcement that it had downgraded the credit ratings of several large banking companies:

> Moody's decision to assign a negative rating outlook reflects the possibility it may further reduce its systemic support assumptions in the future as a consequence of the process set in motion by the enactment of the Dodd-Frank Act. Under the rules recently finalized by the FDIC, the orderly liquidation authority included in Dodd-Frank demonstrates a clear intent to impose losses on bondholders in the event that a systemically important bank such as BAC was nearing failure. If fully implemented, the provisions of Dodd-Frank

> could further lower systemic risk by reducing interconnectedness among large institutions and could further strengthen regulators' abilities to resolve such firms.[7]

Standard & Poor's downgraded a number of large banking companies on December 13, 2011, followed by Fitch on December 16th.

An economy of the size, complexity, and diversity of the U.S. economy needs financial institutions of all sizes, business models, and market strategies. Each charter, business model, and size of institution meets particular needs of particular customers and clients. The value provided by large diversified institutions is particularly important to large, globally active U.S. corporations, and to the further development of global markets for U.S. goods and services – both of which contribute directly and importantly to economic growth and job creation here at home. In the same way, regional and community banks provide essential support to a wide range of business, consumer, and municipal needs in their communities.

Flawed arguments regarding subsidies to large banking companies are at best out of date, and their use to call for draconian structural limits on the financial industry is out of step with the diverse financial needs of the 21st century U.S. economy.

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The Financial Services Forum

The Financial Services Forum is a non-partisan financial and economic policy organization comprising the CEOs of 19 of the largest and most diversified financial services institutions doing business in the United States. The purpose of the Forum is to pursue policies that encourage savings and investment, promote an open and competitive global marketplace, and ensure the opportunity of people everywhere to participate fully and productively in the 21st-century global economy. Follow the Forum on Twitter: @fsforum

American Bankers Association

The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's $14 trillion banking industry and its 2 million employees. Learn more at aba.com.

The Clearing House

Established in 1853, The Clearing House is the oldest banking association and payments company in the United States. It is owned by the world's largest commercial banks, which collectively employ more than two million people and hold more than half of all U.S. deposits. The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing –

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[7] See http://www.moodys.com/research/Moodys-downgrades-Bank-of-America-Corp-to-Baa1P-2-Bank--PR_226511#

through regulatory comment letters, amicus briefs, and white papers – the interests of its owner banks on a variety of systemically important banking issues. The Clearing House Payments Company L.L.C. provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer, and check-image payments made in the U.S. *Follow The Clearing House on Twitter @TCHtweets*

The Financial Services Roundtable

The Financial Services Roundtable represents 100 integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine, accounting directly for $98.4 trillion in managed assets, $1.1 trillion in revenue, and 2.4 million jobs.

Securities Industry and Financial Markets Association

The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.