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Working Paper Series on the Value of Large Banks

Working Paper No. 1: Identifying the Right Question

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I. Introduction

Notwithstanding ongoing implementation of recent financial regulatory reforms, some policymakers are once again questioning whether large banks play an essential role in the U.S. financial system or whether they exist primarily because of competitive distortions resulting from government policies. The Clearing House Association L.L.C. ("The Clearing House") continues to support implementation of Dodd-Frank Act provisions designed to enhance the safety and soundness of banks and to reduce systemic risk in the U.S. financial system.[1] We understand the importance of maintaining a healthy and diversified banking sector: large banks are essential service providers in the U.S. economy, supplying a unique array of products and services to retail consumers, small and medium sized businesses, multinational corporations, and other financial institutions.

The recent financial crisis highlighted a number of short-comings in the regulation and supervision of the financial system, and the last several years have witnessed an historic series of robust new financial regulatory reforms. The Clearing House has supported these reforms, including higher capital requirements focusing on better quality equity cushions, new liquidity and leverage ratios, and recovery and resolution planning.[2] These reforms are essential to ensuring the stability of the financial system, and The Clearing House is actively engaged in furthering the implementation of these measures.

In light of these substantial and ongoing changes to the regulation and supervision of large banks, many regulators and policymakers have cautioned against the introduction of new legislation until current reform efforts have been given the chance to run their course.[3] Banks are building robust capital bases, holding ample amounts of low risk and highly liquid assets, avoiding certain high risk activities, and operating under far greater regulation and enhanced supervision than ever before. Further, the markets are now adjusting to the new reality of a safer and sounder banking system and the new risk to banks' creditors resulting from the resolution regime being implemented by the Federal Reserve and FDIC.[4] With the banking sector becoming safer and sounder with the implementation of each genuine reform, the U.S. economy is growing again. Despite the passage and ongoing implementation of these reforms, some policymakers have continued to question the economic and societal value of large banks, and have called into question whether U.S. policy should directly or indirectly restrict the size of banks.

A. THE TBTF POLICY DEBATE

The central inquiry that has animated the recent discussion of the appropriate size of banks is whether U.S. government policy effectively "subsidizes" large banks through explicit or implicit forms of government support. Critics of large banks contend that explicit or implicit government policies confer on large banks an unfair competitive advantage relative to smaller institutions or an unfair economic advantage more generally.[5] Rejecting

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1 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 over 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 – through regulatory comment letters, amicus briefs, and white papers – the interests of its owner banks on a variety of important banking issues. Its affiliate, 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 clearinghouse, funds transfer and check-image payments made in the U.S. *See* The Clearing House: About Us, *available at* http://www.theclearinghouse.org/index.html?p=070877.

2 *See generally The Clearing House Association Advocacy: Regulatory.* http://www.theclearinghouse.org/index.html?p=070947.

3 *See* Troy A. Paredes, *Caution Needed as New Regulatory Regime Takes Shape*, The Harvard Law School Forum on Corporate Governance and Financial Regulation (Aug. 7, 2012 at 9:10am), http://blogs.law.harvard.edu/corpgov/2012/08/07/caution-needed-as-new-regulatory-regime-takes-shape/; *See also* Roberta Romano, *Regulating in the Dark* (Mar. 30, 2012), Yale Law & Economics Research Paper No. 442, *available at* http://ssrn.com/abstract=1974148.

4 *See* Zeke Faux, *Bank Outlook to Stable by Moody's 5 Years After Cut* (2013) *available at* http://www.bloomberg.com/news/2013-05-28/u-s-banking-system-upgraded-to-stable-by-moody-s-as-risks-fall.html.

5 *See, e.g.,* Anat R. Admati et al., *Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Expensive* (Rock Center for Corporate Governance at Stanford University Working Paper No. 86, 2011), at 22, *available at* https://gsbapps.stanford.edu/researchpapers/library/RP2065R1&86.pdf (finding that larger banks are able to borrow more cheaply since implicit or explicit government guarantees result in lower default risk premiums in their interest rates); *Correcting 'Dodd-Frank' to Actually End 'Too-Big-to-Fail'*, Hearing before H. Comm. on Fin. Serv. (statement of Richard W. Fisher, President and CEO of the Fed. Res. Bank of Dallas) (Jun. 26, 2013) (perceived tax-payer support allows megabanks to raise capital more cheaply), *available at* http://financialservices.house.gov/uploadedfiles/hhrg-113-ba00-wstate-rfisher-20130626.pdf; Andrew G. Haldane, Exec. Dir., Fin. Stability, Bank of England, Speech at the Institute of Economic Affairs, The 2012 Beesley Lectures, *On Being the Right Size*, at 7-8 (Oct. 25, 2012), *available at* http://www.bis.org/review/r121030d.pdf (estimating that the implicit subsidy garnered from their status as Too Big To Fail for the 29 global institutions identified as "systemically important" is roughly $300 billion per year); Simon Johnson, *Big Banks Have a Big Problem*, N.Y. Times (Mar. 14, 2013, 5:00am), http://economix.blogs.nytimes.com/2013/03/14/big-banks-have-a-big-problem (stating that big banks have a funding advantage); Peter Wallison & Cornelius Hurley, *Too Big to Fail Has Become a Permanent Bailout Program*, (Aug. 14, 2012), http://www.forbes.com/sites/realspin/2012/08/14/too-big-to-fail-has-become-a-permanent-bailout-program/ (arguing that large firms, through their designation as systemically important, are on the receiving end of a blatant taxpayer subsidy).

the view that recent reforms have effectively mitigated the so-called "too-big-to-fail" ("TBTF") dilemma, these critics suggest that a competitive advantage stems from a lingering market perception that large banks are likely to be "bailed out" by the U.S. government should they become insolvent, despite the express statutory prohibition on government bail-outs introduced by the Dodd-Frank Act.[6] Consequently, they posit that creditors provide these TBTF institutions with funding at interest rates lower than the rates these institutions would be required to pay in the absence of such government policies.

Other critics assert that large banks benefit disproportionately from federal deposit insurance and liquidity programs, or from the various types of extraordinary support provided by the U.S. government in response to the historic challenge facing the economy in 2008-2009.[7] Here again, large banks are alleged to reap an unfair cost-of-funding benefit due to a market perception that these large banks will be the favored recipients of government bailout funds should a future crisis emerge. Additionally, some maintain that this purported reduction in the cost of funding of large banks only incentivizes these banks to grow bigger than they would be in the absence of perceived government support. And the bigger they grow—the critics argue—the more unfair advantages large banks enjoy.

Arguments along these lines have been invoked in support of aggressive proposals to "break up" large banks on account of their size, either directly or through indirect measures. Recent proposals have ranged from placing absolute size limits on banks to imposing weighty and discriminatory regulatory "taxes" to force large banks to shrink.[8] Though many of these proposals have been proffered in the guise of prudential regulatory policy, each has as its objective a particular industrial policy: to restructure the banking industry not on the basis of identified systemic risks arising from size, complexity, or interconnectedness, rather on perceptions of the broader economy's need for banks of a certain size or for banks to conduct certain activities.

Other researchers have provided significant evidence to suggest that large U.S. banks do not receive an unfair cost of funding advantage, particularly so in the wake of Dodd-Frank and Basel reforms. They note that debt and credit-default swap (CDS) pricing shows substantial spreads to Treasury and agency debt, and substantial variation among firms—all consistent with the theory that creditors believe they are at risk of loss in a large bank failure. While ratings agencies assign to large banks both a standalone rating and a rating based on governmental support, evidence shows that large bank CDS actually trade at or near the standalone rating.[9]

Although while much of the recent debate has focused on the purported policy "problem" of large banks, much less attention has been paid to the essential and special role that large banks play in providing unique support and services on which our economy, businesses, and consumers depend. Upon closer examination, it becomes clear that large banks have not been the problem, but rather are the solution to the considerable challenge of meeting the evolving needs of a dynamic global economy and diversified commercial and consumer markets. Large banks provide an array of products and services—such as payments, clearing and settlement, cash management, trade finance, and investment banking—that smaller institutions do not. Historically, these institutions also have developed and spread innovations throughout the industry. Retail customers, in particular, have benefited from the convenience and cost reductions brought by ATM machines and networks, telephone and Internet banking, and debit cards, all of which have been made possible by large banks. The required economies of scale and scope make it difficult, if not impossible, for small banks to develop and offer many of these services independently.[10]

The increased focus on systemic risk, however, has prompted empirical research and a renewed debate on the role, activities, and function of large banks. Just as important, proposals to reduce the size of large banks—and the alleged TBTF problem they are intended

6 *See* 12 U.S.C. § 343 (prohibiting the Federal Reserve from using its authority under Section 13(3) of the Federal Reserve Act to assist a "single, specific company" in avoiding insolvency proceedings); 12 U.S.C. §§ 5384, 5386, and 5394 (imposing all financial institution losses under Title II of the Dodd-Frank Act on shareholders and creditors and flatly prohibiting taxpayer payments for such losses).

7 *See generally Too Big Has Failed: Learning from Midwest Banks and Credit Unions*, Hearing before H. Subcomm. On Oversight and Investigations (Aug. 23, 2010) (statement of Thomas M. Hoenig, President, Fed. Res. Bank of Kansas City), *available at* http://financialservices.house.gov/media/file/hearings/111/hoenig8.23.10.pdf.

8 *See, e.g.*, Simon Johnson, *Break Up the Banks*, The Baseline Scenario (Apr. 20, 2010), http://baselinescenario.com/2010/04/20/break-up-the-banks/ (arguing that there are no social benefits to having banks with over $100 billion in total assets); Simon Johnson, *The SAFE Banking ACT: Break Them Up*, The Baseline Scenario (Apr. 22, 2010), http://baselinescenario.com/2010/04/22/the-safe-banking-act-break-them-up/ (discussing the SAFE Banking Act); Lev Ratnovski, *Competition Policy for Modern Banks*, International Monetary Fund Working Paper 13/126, 2013, at 12, available at http://www.imf.org/external/pubs/ft/wp/2013/wp13126.pdf (suggesting that imposing taxes or fines on large banks will correct the unfair competitive advantage that they enjoy).

9 *See* Randy Kroszner, *A Review of Bank Funding Cost Differentials,* at 14 (Oct. 2013), *available at* http://faculty.chicagobooth.edu/randall.kroszner/research/pdf/Kroszner%20Bank%20Funding%20Cost%20Difs%20Oct%202013.pdf; Michal Araten et al., *Credit Ratings as Indicators of Implicit Government Support for Systemically Important Banks* (May 2013).

10 *See* The Clearing House, *Understanding the Economics of Large Banks* (Nov. 7, 2011), *available at* http://www.theclearinghouse.org/index.html?f=073048.

to address—are being debated at a time when U.S. and foreign regulators are determining what actions to take in a number of critical areas of prudential regulation. Contemplated reforms include establishing new minimum levels of capital and additional loss-absorbency (*e.g.*, long-term debt) for large banks, the methodologies for measuring exposures and calibrating such capital standards, and the appropriate structure and activities of banks and holding companies. Because issues of TBTF and large banks' purported unfair advantage are being raised when key regulatory policy decisions are pending, it is crucial that they are appropriately formulated and thoroughly addressed.

Among the most prominent of these research efforts is the study to be conducted by the Government Accountability Office (GAO) to measure "the economic benefits that [large banks] receive as a result of actual or perceived government support."[11] In requesting this study, Senators Sherrod Brown (D-OH) and David Vitter (R-LA) expressed concern that an "implicit—and in some cases explicit—taxpayer-funded safety net provides subsidies to these large institutions" and that the recent financial reforms "may not be sufficient to eliminate government support for the largest bank holding companies."[12] As explained below, The Clearing House will address these and other concerns in a series of papers.

In addition to issuing a full report, which is expected in Spring 2014, the GAO is expected to release an interim report regarding access to lender of last resort liquidity, deposit insurance, and emergency facilities established during the crisis. As we describe further below, The Clearing House will address these specific issues in a forthcoming working paper outlining how the federal deposit insurance and discount window lending programs are designed to protect our financial system from destabilizing runs and financial panics and not to provide special benefits to individual banks of any size, large or small.

B. THE CLEARING HOUSE'S WORKING PAPER SERIES ON THE VALUE OF LARGE BANKS

There is simply too much at stake for the U.S. economy to demand anything less than an objective, rigorous, and data-driven analysis of the issues to be addressed in the GAO report and in related studies. To inform the broader policy debate and to ensure the discussion is appropriately framed and evaluated, The Clearing House has established a *Working Paper Series on the Value of Large Banks*, the purpose of which is to evaluate and address each key issue that must be considered in assessing whether large banks truly enjoy some TBTF advantage. As this *Working Paper Series* will make clear, large banks play a unique and vital role in the U.S. economy—a role that is in no way dependent upon any government guarantee beyond the traditional forms of support offered to banks of all sizes. While a number of studies purport to demonstrate that large banks enjoy a significant and unfair funding advantage, taken as a whole the existing literature on banks' funding costs suggests that the net effect of government policy on large banks is at best ambiguous. At the same time, a more comprehensive body of evidence demonstrates that large banks are disadvantaged by various government-imposed costs that offset cost advantages legitimately achieved through economies of scope and scale. This *Working Paper Series* will examine all of the key issues and empirical evidence related to the material benefits enjoyed—and costs borne—by large banks.

In this first working paper of our series, *Working Paper No. 1: Identifying the Right Question*, we begin by appropriately framing the central inquiry of the policy debate. A narrow focus on government-conferred "subsidies" to large banks misses the point for several reasons. First, the term "subsidy" confuses the real question, which is whether large banks enjoy an unfair competitive advantage derived from express, implied, or perceived government support. Next, any analysis of government-conferred benefits on large banks requires a meaningful understanding of what large banks do and their unique and critical role in the financial system. We then explain that government-conferred benefits must be distinguished from advantages that arise from appropriate factors, such as economies of scope and scale, and that any analysis of purported benefits to large banks must be considered together with the disadvantages large banks experience as a result of additional financial regulation. Ultimately, a proposal to "break up" large banks due solely to their size is neither macro-prudential nor micro-prudential regulation, but a crude and value-destroying form of industrial policy.

In the coming months, The Clearing House will release individual working papers to address other key issues as part of our *Working Paper Series*, including the following:

- *The role, activities, and funding models of large banks in the U.S. financial system*. We will examine the reasons why some banks have grown large and also consider the relevance of an institution's size to systemic risk. The structure of financial intermediation has changed dramatically, having moved away from intermediation by banks and toward bank-facilitated intermediation in capital markets. In light of these important changes, we will explain why the services provided by large banks are critical to economic growth. Furthermore, we will consider both how the particular roles, activities, and funding models of large banks shape the effect of government policy on these institutions and how these

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11 Letter from Sen. Sherrod Brown & Sen. David Vitter to Gene L. Dodaro, Comptroller General of the U.S., at 1 (Jan. 1, 2013), *available at* http://www.fsround.org/fsr/dodd_frank/pdfs/Vitter-Brown-GAO-Study-Request-on-Megabanks.pdf.

12 *Id.*

characteristics should inform any study of potential competitive advantages of large banks.

- *Differences in the funding costs of large and small banks*. We will analyze and compare the differences in funding costs between large and small banks. Specifically, we will consider the various reasons for such differences and whether any advantages enjoyed by large banks stem from market-based factors or from any implicit perception of future government intervention in the event of financial distress or failure. We will explain why, due to their greater reliance on government insured deposits, smaller institutions enjoy comparable aggregate funding costs. In addition, we will evaluate the effect of the so-called credit ratings "uplift" to large banks and examine the overall funding cost differential between large and small institutions on a more granular, liability-by-liability basis.

- *Access to lender-of-last-resort liquidity and deposit insurance*. In connection with the GAO's expected interim report on these topics, we will outline how the federal deposit insurance and discount window lending programs are designed to protect our financial system from destabilizing runs and financial panics and not to provide special benefits to individual banks of any size, large or small. These programs are equally accessible to banks of all sizes on exactly the same price and conditions—though larger banks are disproportionately taxed under the FDIC's deposit insurance assessment scheme. If anything, FDIC deposit insurance benefits the largest banks less, given that they are disproportionately funded through liabilities other than FDIC-insured deposits. We will also discuss why a historical analysis of actions during the recent crisis is of little relevance to pressing questions of financial regulatory policy, given the widespread legal, regulatory, and practical changes that have occurred post-crisis.

- *Competitive disadvantages and responsibilities undertaken by large banks.* The country's largest financial institutions uniquely incur substantial regulatory costs above and beyond those incurred by smaller banks. These costs include the cost of SIFI capital surcharges and of higher deposit insurance premiums. The same will be true for the long-term debt requirements associated with facilitating a resolution under Title II, which also will be limited to the very largest banks. These additional costs borne by large banks are significant and measurable. No thoughtful analysis of the impact of government policies on large institutions can focus on the perceived funding advantages that large banks might enjoy while ignoring the substantial additional costs and resulting disadvantages faced by these institutions. Simply put, one must consider the total net effect of governmental policy on large banks, and not selectively assess a single component in isolation.

- *The effect of the new resolution authority on market perceptions of TBTF.* We will examine the role of the FDIC's new resolution authority in mitigating any lingering market perceptions that large banks will not be resolved though insolvency procedures but will instead be bailed out by the government. This credible resolution regime is dispelling any misconceptions that the U.S. government would prevent the failure of large banks or would absorb any losses from such failures and that these institutions have or will enjoy disproportionate, government-conferred benefits. Specifically, we will discuss how the timely and effective implementation of a long-term debt requirement would ensure that any large bank will have sufficient loss absorbing capacity to facilitate a single-point-of-entry resolution.

In releasing these individual working papers, The Clearing House aims to provide an objective and empirically supported contribution to the ongoing discussion over the critical role that large banks play in the U.S. financial system. Each day, millions of households, businesses, and non-profit organizations depend on large banks, which provide many unique services that other financial institutions cannot. The *Working Paper Series on the Value of Large Banks* is intended to assist policymakers in evaluating the important issues arising from the TBTF policy debate and in making appropriate decisions about the regulation of large banks. ■

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Identifying the Right Question: Executive Summary

II. Identifying the Right Question: Executive Summary

- A focus on the size of banks fails to appropriately consider the broad range of issues that must inform the TBTF policy debate. A meaningful analysis must be thorough and must not be based on inappropriate assumptions or a misleadingly narrow view of large banks and their function in the overall economic system. Conclusions yielded from such an incomplete analysis will inevitably lead to flawed policy prescriptions that could significantly dampen economic growth. In this *Working Paper No. 1: Identifying the Right Question,* we focus not merely on size but on all relevant factors pertaining to systemic risk such as complexity, interconnectedness, leverage, and risk management, as well as the significant and ongoing role of large banks in the U.S. economy. An analysis of the impact of government policies on large banks must be founded on a meaningful understanding of what large banks do, why some banks are necessarily large, and how they are vital to the overall economic system.

- The question policymakers should be asking is: *Do large banks today enjoy unfair economic benefits as a result of express, implied, or perceived government policies?* The term "subsidy" confuses the real question, which is one of unfair economic or competitive advantage.

- Finally, looking only at the perceived benefits enjoyed by large banks tells only part of the story. Any assessment of large banks' relative advantages must take into account the total net effect of government policies on large banks, including the important functions and responsibilities undertaken by large banks, as well as the additional regulatory and other costs directly arising from government policies. Upon closer examination, these costs effectively offset any benefits conferred on large banks as a result of government support. ■

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An Analysis of Whether Large Banks Enjoy an Unfair Advantage Must Be Framed Appropriately

- "Subsidy" is a misleading term and confuses the real issue.
- A policy to "break up" large banks based on their size disregards the fundamental aims of both micro-prudential regulation and macro-prudential policy.
- An analysis of the impact of government policies and potential unfair advantage must be founded upon a meaningful understanding of what large banks do, why some banks are necessarily large, and how they are vital to the overall financial system.
- Economic or competitive benefits attributable to implied government policies of support during an economic crisis must be distinguished from advantages arising from appropriate market factors.
- Any assessment of large banks' relative advantages must take into account the additional costs borne by large banks as a result of government policies.

III. An Analysis of Whether Large Banks Enjoy an Unfair Advantage Must Be Framed Appropriately

An inquiry into the advantages enjoyed by large banks that is framed too narrowly presents a clear and dangerous risk: wrongly-drawn conclusions that form the basis of equally flawed policy prescriptions that significantly dampen economic growth. The Brown-Vitter letter frames its analysis through a series of specific questions about the purported "subsidy" conferred on large banks. That term, however, is misleading and confuses the real issue. At issue is not whether government has somehow transferred wealth to large banks—which is clearly not the case—but instead a broader question of fundamental importance:

> *Do large banks today enjoy unfair economic benefits as a result of express, implied, or perceived government policies?*

As we describe in this *Working Paper No. 1*, when properly framed in this way, a meaningful analysis of this question can and should accomplish four central objectives. First, the debate must take into account the goals of both micro-prudential regulation and macro-prudential policy. Second, an analysis should identify and distinguish the particular roles, activities, and funding models of large banks with those of smaller banks and examine how these features uniquely influence the impact of government policy. Third, the analysis should differentiate between unfair advantages to large banks attributable to express, implied, or perceived government policy and those advantages attributable to appropriate market factors. Finally, the disadvantages associated with government policies affecting large banks must also be considered in order to provide a comprehensive analysis of the net effect of government policy on large banks.

The real question is whether large banks today enjoy a competitive advantage derived solely from express, implied, or perceived government support. That support arguably can take several forms, including deposit insurance and lender-of-last-resort liquidity programs of the kind that were employed during the global financial crisis. These and other purported forms of government support will be analyzed in greater detail in this *Working Paper Series.*

A. A POLICY TO "BREAK UP" LARGE BANKS BASED ON THEIR SIZE DISREGARDS THE FUNDAMENTAL AIMS OF BOTH MICRO-PRUDENTIAL REGULATION AND MACRO-PRUDENTIAL POLICY.

Several policy proposals are emerging that would directly or indirectly "break up" large banks based on their size. Such policies would represent an abrupt departure from the micro- and macro-prudential objectives that appropriately motivate the regulation of the complex and diverse U.S. financial system. These approaches can be made to work in tandem to stabilize individual financial institutions and the system at large. A policy measure with the central purpose of "breaking up" banks based on size—an arbitrary and misguided metric for singling out banks for increased oversight—disregards the fundamental aims of both micro-prudential regulation and macro-prudential policy.

Micro-prudential regulation is aimed at preventing the failure of individual financial institutions.[13] As scholars have explained, this type of regulation seeks to reduce the probability of bank failure by ensuring that banks maintain adequate capital and liquidity buffers.[14] Because all banks—large and small alike—have access to federal deposit insurance and the Federal Reserve's discount window, micro-prudential regulation prevents individual banks from incurring additional risk as a result and to ensure the safety-and-soundness of institutions. Size is largely irrelevant to micro-prudential regulation. Banks of any size can fail due to poor strategic or tactical decisions by management resulting in known or unknown risk concentrations, speculative activity, inadequate information systems, and poor internal controls and governance. If anything, the greater reliance by small banks on insured deposits as a funding source arguably makes them more reliant on deposit insurance (and less subject to market discipline) than large banks—a topic that will be addressed in more detail in a subsequent working paper.

By contrast, a macro-prudential approach seeks to stabilize the financial system by limiting the potential consequences of bank failures or market disruptions on the broader financial system and the economy.[15] Most regulators and scholars agree that size alone is not a

13 Samuel G. Hanson et al., *A Macroprudential Approach to Financial Regulation* (Nov. 12, 2010), Chicago Booth Research Paper No. 10-29, at 1, *available at* http://ssrn.com/abstract=1708173.

14 *Id*. at 2-3.

15 *Id*. at 3-4.

meaningful indicator of systemic risk.[16] Perhaps the most prominent example is the Basel Committee on Banking Supervision's assessment methodology for global systemically important banks ("GSIBs").[17] In taking the view that "global systemic importance should be measured in terms of the impact that a bank's failure can have on the global financial system and wider economy," the Basel Committee looks to size as only one of five equally weighted factors in considering whether to designate a particular institution as a GSIB.[18] Far more important to the GSIB assessment methodology than simply size is the aggregation of factors such as cross-jurisdictional activity, interconnectedness, substitutability/financial institution infrastructure, and complexity. Along with the robustness of a bank's risk management framework, these considerations are far more important to assessing the potential systemic risk of a financial institution than the size of its asset base.

Some scholars, such as Professor Hal S. Scott of Harvard University, have gone even further—suggesting that size has little to do with what he believes to be the most important source of systemic risk: the risk of contagion. In analyzing the distress of such nonbank financial institutions as Lehman Brothers and AIG during the financial crisis, Professor Scott explains that "even if banks were split up or limited in size, such a limitation on its own would not solve the problem of systemic risk posed by contagion."[19] What is more, Professor Scott suggests that the "economies of scale" and "diverse business lines" that are usually correlated with increases in bank size both "can mitigate risk and help [larger banks] to better withstand specific shocks."[20]

Any proposal to "break up" large banks—either directly or indirectly—therefore has no credible basis in micro-prudential regulation or macro-prudential policy, but is in reality a crude form of industrial policy. Traditionally, industrial policy has been defined as "an effort by a government to alter the sectoral structure of production toward sectors it believes offers greater prospects for accelerated growth."[21] In short, it is a policy of the government "picking winners." The converse is also true: industrial policy can take the form of the government forcing politically disfavored industries to, in effect, become "losers." In either case, government attempts to "right size" a given industry or sector—by artificially pumping it full of investment or by squeezing its potential for market-based growth—have generally been disfavored in the United States. Regardless of the intermittent popularity of the political rhetoric that underlies many plans aimed at breaking up large banks, such proposals should be considered for what they really are—crude attempts to subject the banking sector to an industrial policy of downsizing.

16 *See* Klaus Düllmann & Natalia Puzanova, *Systemic Risk Contributions: A Credit Portfolio Approach* (Aug. 2011), Deutsche Bundesbank Discussion Paper Series 2: Banking and Financial Studies, No. 08/2011, at 19-21, *available at* http://www.econstor.eu/bitstream/10419/45638/1/659509679.pdf.

17 *See* Basel Committee on Banking Supervision, *Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement – Rules Text* (Nov. 2011), *available at* http://www.bis.org/publ/bcbs207.pdf.

18 *Id.* ¶ 15; 19.

19 Hal S. Scott, Committee on Capital Markets Regulation, *Interconnectedness and Contagion*, at 106 (Nov. 20, 2012), *available at* http://www.capmktsreg.org/pdfs/2012.11.20_Interconnectedness_and_Contagion.pdf.

20 *Id.* at 105-06.

21 Marcus Noland & Howard Pack, *Industrial Policy in an Era of Globalization: Lessons from Asia*, at 10 (2003).

B. AN ANALYSIS OF THE IMPACT OF GOVERNMENT POLICIES AND POTENTIAL UNFAIR ADVANTAGE MUST BE FOUNDED UPON A MEANINGFUL UNDERSTANDING OF WHAT LARGE BANKS DO, WHY SOME BANKS ARE NECESSARILY LARGE, AND HOW THEY ARE VITAL TO THE OVERALL FINANCIAL SYSTEM.

It is essential that the set of issues presented in the TBTF debate are framed and analyzed within the proper context. If the question of large bank advantage is framed without understanding the overall context in which large banks operate, policymakers are certain to fall short of the mark of improving the functioning of the U.S. financial system. In particular, policymakers must understand and acknowledge that large banks provide essential functions in the U.S. economy not provided by smaller institutions, that size—in the form of economies of scale and scope—is a critical factor in ensuring that large banks can efficiently provide those unique services, and that the funding models of large and small banks differ significantly. These contextual observations help to put any potential funding cost differentials between large and small banks in perspective. They also caution against assuming that large banks can be broken up without significant societal consequences.

Large banks are necessary in the modern bank ecosystem, providing particular and important financial services not provided by smaller banks. While banks of varying sizes are necessary and play different roles in the modern banking system, large banks uniquely provide three types of financial services that are critical to the U.S. economy:

- Payments and clearing services to move cash, settle financial transactions, and record and transfer ownership of securities.
- Commercial banking services for cash management, lending, and trade finance, particularly for middle-market and larger companies.

- Investment banking services for underwriting the debt and equity offerings of corporations and governments and providing liquidity to financial markets—both directly by acting as dealers in securities and indirectly by providing financing and other prime brokerage services to institutional investors.

In order to provide these services to customers in an efficient manner, banks have grown in size to achieve economies of scale and scope. Moreover, in addition to providing the critical financial infrastructure to serve the needs of the business community as well as to support the activities of community banks, large banks have better met the needs of retail and commercial customers as a direct result of their size and scope. This is especially true for large banks that compete with international institutions in the global marketplace. Large customers in the U.S. or any customer needing international services are particularly well-served by large banks, and U.S. institutions can and should be able to safely and soundly compete in these international markets in order to service these customers.

When analyzing any potential competitive impact between institutions, it is very important to account for the fact that small and large institutions generally compete in different market segments. And when they do compete in the same market segments, large and small institutions provide different products and services or target different customers within those segments. As a result, the effects of any competitive disparities between large and small institutions may be minimal.

Another key difference between large and small banks is their funding models. During the last two decades, the U.S. financial system has become less reliant on demand deposit funding and more reliant on other forms of shorter-term credit. Large institutions, in particular, use a higher proportion of non-deposit liabilities to fund their operations, including issuing debt and using securities as collateral for borrowing. This shift in funding has created opportunities (*e.g.,* commercial paper, money market funds, etc.) for investors to look for "safe" investments (*i.e.,* collateralized) with higher returns than uninsured deposits. Small institutions rely more on deposits—which can be cheaper than other types of liabilities—but do not meet the needs of many large businesses, pension funds, and other institutional investors.

Finally, although critics of large U.S. banks often criticize the U.S. banking system as too large and too concentrated, the facts reveal just the opposite—relatively speaking, the U.S. banking system is less concentrated than both its peer banking systems abroad and its peer industries domestically. Both the overall size of the U..S banking system and the aggregate size of America's largest banks are, as a proportion of the national economy, well below the average for G-7 countries.[22] Similarly, based on the based recent available census figures, the four largest American banks account for a substantially smaller share of total industry revenues than their counterparts in a number of other industries, including computers, auto manufacturing, wireless telecommunications, and pharmaceuticals.[23]

All of the above are important considerations, and any study that ignores them will produce unfounded conclusions that will fail to properly inform—and indeed may *misinform*—the broader policy debate. As we will examine in detail in a subsequent study in this *Working Paper Series*, large banks play a unique role in the U.S. financial system and engage in different activities than smaller U.S. institutions. An analysis of whether large banks enjoy any unfair competitive advantage must take into account these key considerations.

C. ECONOMIC OR COMPETITIVE BENEFITS ATTRIBUTABLE TO UNFAIR EXPRESS, IMPLIED, OR PERCEIVED GOVERNMENT POLICIES MUST BE DISTINGUISHED FROM ADVANTAGES ARISING FROM APPROPRIATE MARKET FACTORS.

Economic or competitive advantages can arise from a variety of sources. In order to assess the presence of any benefit, advantages attributable to unfair government policies must be distinguished from advantages enjoyed by large banks arising from market factors.

Specifically, any analysis that quantifies the cost differential between large and small banks must control for other advantages that are natural and appropriate. The most obvious natural advantages are economies of scale and scope. Economies of scale generally arise in businesses that serve many customers and that require expensive technology or infrastructure because spreading high fixed costs over many customers reduces unit costs. Historically large banks have been able to reduce their unit costs by spreading fixed costs—particularly for infrastructure and technology—over a large customer base. Economies of scale in large banks provide an estimated $25 billion to $45 billion of annual value, comparing actual costs to what costs would be in a system with no large banks.[24] While large banks enjoy substantial cost reductions, these lower costs permit banks to provide services to customers at lower prices and to make investments in technologies that benefit their customers, including smaller banks.

Economies of scope also provide large banks with a market-based source of competitive advantage. The scope of large banks across multiple businesses, their geographic

22 *See* The Clearing House, *Scaled to Serve: The Role of Commercial Banks in the U.S. Economy*, at 6 (July 2012).

23 *Id*. at 7.

24 *See* The Clearing House, *Understanding the Economics of Large Banks*, at 8-15 (Nov. 7, 2011).

penetration and reach, and their balance-sheet size allow large banks to offer products and services that are critical to the financial system but that smaller institutions cannot provide. The unique ability to offer these services enables large banks to enjoy greater profits and lower overall costs, particularly with respect to those services that are less easily commoditized. Once again, large banks benefit but so do their customers. Large-bank offerings are particularly vital in helping companies and asset managers operate internationally as well as in helping companies finance their activities through the capital markets. The Clearing House estimates the scope of large banks' products and services provides $15 billion to $35 billion in direct value to customers annually. We further estimate that banks with assets over $500 billion are responsible for $10 billion to $20 billion of the total. These numbers do not include indirect benefits to the economy at large, which also may be significant.[25]

Thus, benefits enjoyed by large banks due to these natural market forces should not be confused with, but should be distinguished from, any advantages conferred by unfair government policies. That said, due to the multitude of factors that must be included in the analysis, quantifying any competitive advantage enjoyed by large banks derived from explicit or implicit government support will be difficult.

D. ANY ASSESSMENT OF LARGE BANKS' RELATIVE ADVANTAGES MUST TAKE INTO ACCOUNT THE ADDITIONAL COSTS BORNE BY LARGE BANKS AS A RESULT OF GOVERNMENT POLICIES.

For any study of funding costs to be meaningful, it must evaluate both the positive and negative effects experienced by large banks due to government regulation and other mandates. Large banks are increasingly subject to significantly higher regulatory costs. Policymakers, regulators, academics, and other observers universally recognize that forms of government regulation targeting large banks may effectively "offset" any potential unfair advantage attributed to government support.[26] After all, this logic is implicit (and sometimes explicit) in the arguments of those advocating for even more stringent regulation of the largest banks in the form of a "tax" that would negate the so-called government "subsidy" they claim large banks enjoy.[27]

Later in this *Working Paper Series*, we will itemize and detail some of the increased regulatory and other costs directly related to the functions and responsibilities undertaken by large banks. Some of the more burdensome additional costs include the following:

- The SIFI capital surcharge will result in significant additional costs for larger financial institutions.
- Changes in the assessment scheme for the nation's Deposit Insurance Fund will result in significant additional costs for larger financial institutions.
- Long-term debt requirements associated with facilitation resolution under Title II will result in significant additional costs for larger financial institutions.

Not evaluating such "offsets" when considering the question of unfair economic or competitive advantage would leave any such analysis materially incomplete and highly misleading. ■

25 *Id.* at 9.

26 We will further address the potential effects of offsetting regulations in a future working paper.

27 Jeremy Stein, *Regulating Large Financial Institutions* (Apr. 17, 2013)(speech at the "Rethinking Macro Policy II," a conference sponsored by the International Monetary Fund), *available at http://federalreserve.gov/newsevents/speech/stein20130417a.htm.*

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Conclusion

IV. Conclusion

The inquiry into large banks' purported economic advantage must be appropriately framed. The Clearing House proposes an analysis that is both comprehensive and thorough in order to yield conclusions that will productively inform the broader policy debate about large banks' role in the U.S. financial system. Falling short of that mark could result in policies that jeopardize the products and services large banks provide each day to the millions of American households and businesses. Accordingly, the question policymakers must ask is: *Do large banks today enjoy unfair economic benefits as a result of express, implied, or perceived government policies?*

Proposals that would directly or indirectly "break up" large banks based on their size fail to consider the crucial and complex role of large banks in supporting the economy and instead resemble "industrial policy" of the kind long rejected in our system. Instead, the analysis must be founded on a meaningful understanding of what large banks do, why they need to be large to do those things efficiently, and how these institutions are vital to the overall economic system. Any economic or competitive benefits enjoyed by large banks because of unfair government support must be distinguished from those advantages arising from other appropriate market factors. Moreover, the analysis must consider the extent to which large banks are distinctly disadvantaged by specific government policies that may offset any relative advantages they enjoy from unfair explicit or implicit forms of government support.

In forthcoming papers in our *Working Paper Series*, we will further explore the factors that must inform this important inquiry into the purported benefits conferred on our nation's largest financial institutions and dispel the misconceptions that undergird the dominant TBTF rhetoric. ■

ABOUT 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 over two million people and hold more than half of all U.S. deposits.

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