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Unbundling 'Too Big to Fail'

Why Big Is Bad and What to Do About It

By Ganesh Sitaraman

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Center for American Progress



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Introduction and summary

Since the 2008 financial crisis, the problem of financial institutions being “too big to fail,” or TBTF, has been front and center in the public debate over the reform and regulation of the financial industry. Commentators across the political spectrum decried bailouts of the biggest Wall Street financial institutions, arguing that bailouts would establish too big to fail as public policy. When it was time for reform, legislators tried to address this problem, and even incorporated into the full title of the Dodd-Frank Act that one of the bill’s purposes was “to end ‘too big to fail.’”¹

Yet more than five years after the financial crash, the biggest banks are 37 percent larger than they were before,² and the debate over what to do about the size of financial institutions continues. Policy proposals range from improving resolution mechanisms, to more stringent prudential standards such as leverage limits, to charging fees to eliminate the implicit government subsidy the biggest banks receive, to capping the size of the banks, to instituting a new Glass-Steagall Act. Each approach is hotly contested, with commentators frequently arguing that the proposed solution will not actually fix the problem of financial institutions that are too big to fail.³

The problem at the heart of the debate over too big to fail is that the popular moniker has come to mean more than the concern that big firms get a government bailout in the event of failure. It captures a variety of concerns with the financial industry: economic, competitive, systemic, firm level, political, legal, and regulatory. This report identifies the full range of reasons reformers might be worried about TBTF. It then describes the various policy options that are most frequently discussed with regard to reforming TBTF, and it connects the specific reforms to the concerns they address.

To make progress, reformers and critics alike need to engage in a more precise debate. Critics too often dismiss reforms without fully addressing the concerns reformers seek to address, and when outlining proposals, reformers could be clearer about the problems they seek to solve. Ultimately, people will disagree about what aspects of TBTF are most concerning to them. But the first step toward a more meaningful debate over reform requires greater clarity about the particular concern—or concerns—with big financial institutions and the specific solutions that address those concerns.

Unbundling too big to fail

The underlying concerns with big financial institutions can be grouped into five categories: systemic risk, bailout, competition, firm-level concerns, and political control. Each incorporates multiple related worries about the pernicious effects of the size of financial institutions.

Systemic-risk concerns

While there are a variety of definitions of systemic risk, the basic concept is simple: systemic risk exists when the failure of a single institution would have significant effects beyond the firm, to the financial system or the economy as a whole.⁴ These ripple effects are seen as so troubling that action must be taken to prevent them, whether that means bailouts after firm failure or some form of regulation before failure.

Size-based systemic risk

The concern about size-based systemic risk—the most natural reading of too big to fail in the systemic-risk context—is that the failure of a gigantic financial institution will have immense effects on the financial system or the economy as a whole, simply because the firm is extremely large. Size in this context is obviously a proxy for importance, albeit an imperfect one.⁵ Large institutions might be able to fail without harmful systemwide effects. Likewise, smaller institutions that are central to the functioning of the system might fail with disastrous consequences. But objections on these grounds are largely a debater's point. The argument is that size is a reasonable and relatively workable proxy for importance.

Interconnectedness-based systemic risk

Many argue that TBTF should instead be called “too interconnected to fail,” a description that identifies a different kind of systemic risk.⁶ The worry here is that an institution has too many links to other institutions in the economy, such that its failure would have negative effects throughout each of these firms and thus to the system as a whole. This form of risk is often called “contagion,” as the “disease” in one institution will spread to others with which it interacts.⁷ For example, if firm A is engaged in risky behavior and fails, it may not be able to fulfill its contracts with firms B and C, each of which then fail, affecting firms D and E, with whom they work, and so on. This cascade effect ripples through the economy.

Of course, interconnectedness is not limited to financial institutions. The bailout of General Motors, or GM, in 2008 and 2009 was in part justified by links between GM and its parts manufacturers, distributors, and others in the automotive industry.⁸ Similarly, imagine the systemic effects of a hypothetical Wal-Mart failure: The firm’s connections throughout the consumer-goods industry would have significant effects on major consumer-product companies.

System effects and systemic risk

A variety of systemic-risk issues also arise when multiple actors operate within a single system whether or not they are interconnected. Three main concerns arise. The first is informational.⁹ If firm A fails, people may scrutinize firm A’s risky practices, only to realize that firm B has been engaged in the same practices. If people believe those risky practices led to failure in firm A, they may no longer want to work with firm B because it engages in the same risky practices. The second concern is often called “common shock,” defined as a situation in which a single external event affects multiple firms at once, leading to the failure of the institutions simultaneously.¹⁰ The third concern is the conventional notion of a panic—that the failure of a TBTF firm will lead to widespread public panic that undermines multiple firms, regardless of the soundness of those other firms.¹¹

One phenomenon that might undergird each of these systemic risks is the “too-many-to-fail” concern, or so-called herd mentality within the industry.¹² Economists have shown that when there are isolated bank failures, regulators will allow other institutions to acquire the failing banks, but when there are many simultaneous

bank failures, regulators find it optimal to bail out some or all of the failing banks. As a result, smaller banks “herd” toward the policies of large banks to benefit from the bailout policy in the event of failure. This alignment means that multiple bank failures—and, as a result, bailouts—are more likely to occur at once.

Bailout concerns

Another common area of concern is taxpayer bailouts of failing firms. The worry is that the government will bail out firms that are seen as TBTF instead of letting them fail as the principle of creative destruction requires. Whether explicit or implicit, a policy of bailouts skews incentives for firms and harms taxpayers and markets as a result. Bailout recipients can differ—management, shareholders, or creditors—but regardless, bailout concerns focus on two specific issues: moral hazard and cost.

Moral hazard

First is the idea that bailouts lead to a moral hazard.¹³ TBTF firms know that they can benefit from government bailouts in the event of staggering losses. As a result, it is rational for them to take on riskier behavior because they will be able to capture the profits while socializing the losses among taxpayers. The result is a system that fosters more and more risky behavior because the government’s bailout policy has undermined the disciplining effects of the downside risks that accompany market participation, such as losses, failure, or acquisition.

Bailout costs

Bailouts also mean that taxpayers are on the hook for losses from the risky bets of private actors. If bailouts become a recurring practice, it is not obvious that this will result in financial returns for the U.S. Treasury. But even if the costs of bailouts are paid back to the Treasury over time, the practice is troubling for both moral and practical reasons. Morally, taxpayers should not have to rescue those financial institutions taking on risky activities that have questionable social value—including giving bonuses or golden parachutes to top executives whose actions caused their institution’s failure. Practically, in a world of constrained resources, there might be opportunity costs to spending money on bailouts for the largest financial

institutions during a financial crisis, rather than on economic stimulus policies or pro-growth policies such as investment in infrastructure or research and development. If Congress feels budgetary constraints, then prioritizing bailouts might mean that other important spending gets short shrift.

Competition concerns

TBTF also includes a variety of concerns about competition within the financial industry in which the biggest firms gain undue advantage over smaller firms. Large firms get an implicit subsidy because the market recognizes their TBTF status, and big firms are also better able to bear regulatory burdens.

Implicit subsidies

Just as TBTF firms know they can benefit from bailouts, other market actors can also identify which firms are likely to be bailed out, and they will therefore treat those firms as effectively having government insurance.¹⁴ The result is a skewing of the market: TBTF firms have a competitive advantage over other firms because they have a no-cost government insurance policy guaranteeing against losses, particularly for the risky activities that might get a high return.

The consequence is that market discipline will not be as effective against the TBTF firms.¹⁵ The value of this implicit insurance policy can be calculated by looking at the borrowing rates of different firms, though estimates of the size of the implicit subsidy vary widely.¹⁶ Some have even suggested that the largest Wall Street banks would not be profitable without the subsidy.¹⁷

Distribution of regulatory burdens

TBTF firms also benefit from the government's regulatory response to their size. Regulatory burdens are more difficult for small financial institutions such as community banks and credit unions to bear than for the largest firms because small firms do not have the same level of financial and personnel resources to devote to regulatory compliance. The Independent Community Bankers of America in particular has argued that regulations designed for the largest banks have affected their members adversely.¹⁸ This design of responsive regulation makes the playing field in the financial industry uneven and biased toward larger institutions.

Firm-level concerns

Many who are concerned about TBTF are worried about the effects that large size has within firms, particularly with respect to internal discipline on firm behavior. In other words, TBTF firms might turn out to be “too big to manage.”¹⁹ Specifically, the concern is that in large firms with multiple divisions and complex structures and practices, management will have a harder time controlling and overseeing the firm’s operations. Commentators have suggested this phenomenon might have been at work in a variety of recent scandals: JPMorgan’s London Whale case, HSBC and Standard Chartered’s extensive money laundering and sanctions violations, fraudulent mortgage practices, and LIBOR manipulation.²⁰

While the failure of internal controls might be a function of sheer size and complexity, it might also be a function of the TBTF implicit guarantee.²¹ On this theory, TBTF firms deliberately engage less stringent internal controls because they know they have an implicit government guarantee in the event that risky activities go awry.

Political-control concerns

In addition to market discipline and internal controls, firms are subject to external control via government regulation. However, the growth of financial institutions might weaken the effectiveness of political controls on firms and skew the ability of government to respond to economic crises.

Regulatory concerns

As a matter of regular oversight, TBTF firms might be “too big to regulate” because their sheer size and complexity makes it difficult for government regulators to do their jobs.²² This is problematic both for the public and for firms. Internally, supervisors who cannot understand or monitor firm activities through normal supervisory practices will be unable to prevent poor behavior before something bad actually happens.²³ At the same time, regulators designing the rules and guidance for these complex and dynamic activities will have trouble drawing up regulations that align with practices on the ground. The result might be that regulations themselves become extremely complicated and convoluted, requiring firms to go to great lengths in their compliance efforts.²⁴ In other words, TBTF might make supervision harder, lead to a disconnect between regulation and reality, and increase regulatory complexity.

Legal accountability

After a crash or after an illegal action, TBTF might also undermine the ability of the U.S. Department of Justice to punish bad actors and firms. This phenomenon is known as “too big to prosecute,” “too big for trial,” or “too big to jail,” and has been condemned across the political spectrum.²⁵

When asked about the fact that neither HSBC nor any of its employees were prosecuted for years of sanctions violations and money laundering,²⁶ Attorney General Eric Holder noted that “the size of some of these institutions becomes so large that it does become difficult for us to prosecute them when we are hit with indications that if we do prosecute—if we do bring a criminal charge—it will have a negative impact on the national economy, perhaps even the world economy.”²⁷

In other words, after-the-fact legal controls and ramifications on bad behavior might be ineffective against TBTF firms because the U.S. Department of Justice is worried about the effects on the economy of enforcing the law.

Political influence and capture

The size of financial institutions might also give them outsized influence over the political and regulatory process more broadly—commonly called political, regulatory, or cognitive capture. Under political capture, firms have outsized influence over congressional activity by virtue of being able to contribute to legislators’ campaigns and spend greater resources on lobbying.²⁸ Wall Street, for example, spent more than \$1 million a day on lobbying during the lead up to the Dodd-Frank Act.²⁹

Regulatory capture is similar, but operates via the firms influencing regulators, either through the revolving door between regulators and firms or through lobbying efforts at the agency level. Cognitive, or epistemic, capture is more subtle: TBTF firms can shape the views of individuals within the political and regulatory process by shared educational and cultural experiences in which regulators themselves come to believe that the TBTF firms’ perspective on an issue is optimal even though an unbiased assessment would come to a different conclusion.³⁰ Even academics and intellectuals can be captured cognitively—

and indeed, they are sometimes targets for capture. Size, when coupled with complexity, increases capture concerns. In a fragmented financial industry, firms within different segments of the industry may have different policy preferences, enabling regulators to divide the industry and evade capture.³¹ When the industry is not fragmented because TBTF firms dominate in multiple segments, regulators have a harder time playing firms against each other, and capture becomes more likely.

Reforming too big to fail

Commentators have suggested a wide range of options to address TBTF and the problem of big financial institutions. Reformers debate bankruptcy and resolution mechanisms, size caps, a new Glass-Steagall Act, the Volcker Rule, internal controls, and prudential regulations, among other options. Studies have been written on all of these reforms, with commentators debating each in extreme detail.

Despite the high-quality debate at the technical level, the political and policy debate often suffers from commentators not connecting the problem to be solved with the solutions that might actually address the problem. For example, commentators often claim that a new Glass-Steagall Act would not put an end to big institutions and the original act's repeal in 1999 was in fact not the cause of the financial crash in 2008.³² Whatever the merits of those assertions, supporters of a new Glass-Steagall Act do not solely, or even mostly, rely on those arguments. They instead argue that the principle behind the law was separating financial functions to limit the interconnectedness of financial practices and potential conflicts of interest.³³

To make progress in the debate over reform, we need to understand the main categories of solutions and then connect those solutions to the concerns they address.

Approaches to reform

Some of the biggest differences in policy reforms are on the fundamental approach to reform: Should it be ex ante or ex post? Should it be structural or technocratic? Each of these is explored in detail below.

Ex ante versus ex post³⁴

Ex-ante reforms are policies that are activated before an undesirable event takes place. They are preventive in nature, hoping to stop bad conduct or the subsequent effects before they happen. Ex-post reforms are policies that are activated only after an undesirable event occurs. Their purpose can be to punish bad actors, to mitigate ill effects, or to create incentives that will deter bad or risky conduct—in fact, in this latter sense, ex-post actions can have ex-ante effects. For example, bank supervision over money laundering is an ex-ante policy, while prosecution for money launderers is an ex-post policy. Similarly, the theory behind capital requirements is that they are an ex-ante way to prevent bank failures because funding a proportion of a certain asset by equity instead of debt should make losses less problematic. But the theory behind resolution is that banks still might fail, and there must be a process in place for addressing such failures.

The great benefit of ex-ante reforms is that they directly attempt to prevent the ill effects of TBTF in the first place. This is particularly important because in some areas, ex-ante reforms might be the only way to address the underlying concerns. For example, there is a strong argument that the bailout, moral hazard, and implicit subsidy concerns with TBTF are primarily sociological and psychological, not legal or regulatory. That is, they are based on people's belief that big firms will be bailed out if they fail.³⁵ If that is true, then removing the government's legal authority to bail out big banks or instituting bankruptcy proceedings might be helpful. But even if that were to happen, people might still believe that in a serious crisis, regardless of the existing laws, Congress or the executive branch would authorize a bailout. An implicit bailout policy would therefore still exist. The central drawback of ex-ante reform is that it might not solve the problem. Even with prophylactic rules, illegal activity or risky activity might still take place. Firms might still fail. In that case, ex-post rules will be necessary.

Structural versus technocratic reforms

Structural reforms seek to make fundamental changes to the structure of the financial industry. For example, proposals to cap the size of financial institutions and Glass-Steagall-style separation of functions are structural reforms. Technocratic reforms keep the basic structure of the financial system intact but seek to mitigate harmful effects by changing rules or policies in incremental or moderate ways. They also assume that expert regulators and bureaucrats can use policy to create incentives for firms to act legally or that expert regulators and bureaucrats can themselves manage and monitor activity to prevent bad consequences.

Technocratic reforms benefit from being incremental, and in theory, they should be less politically controversial. However, they suffer from their reliance on an optimistic view of regulators and policymakers—and from complexity. For technocratic reforms to work, expert regulators must be able to manage the dynamic changes in markets on an ongoing basis. As a corollary, such reforms are more likely to be technical and specific to a certain context. Structural reforms benefit from not putting so much faith in regulators and as a result are likely to be simpler.

Reform policies

Proposals for addressing TBTF are ubiquitous. The goal here is not to explore each proposal in detail—something that scholars, commentators, industry participants, and regulators have done—or to identify every specific proposal or variation on a proposal. Rather, the goal is to identify the main categories of reforms, discuss some of their shared characteristics, and identify the concerns that they address.

Resolution

A variety of reforms can be grouped together as resolution: bankruptcy; orderly liquidation authority, or OLA; living wills; and Federal Deposit Insurance Corporation, or FDIC, resolution.³⁶ While there are many differences between these policies, they share important similarities. These processes seek to provide an orderly resolution to the institution's life and operations, thus contributing to market confidence.³⁷ They also aspire to create incentives to change behavior: A well-developed process for resolution should—in theory—make bailouts less credible as a policy solution because resolution is more easily available.³⁸ As a result, big financial institutions should change their operations to avoid activities that might result in failure.

As a category, resolution is an ex-post technocratic reform designed to address bailouts, moral hazard problems, and implicit subsidies. To be sure, all resolution policies have ex-ante effects by changing ex-post practices. Some might also categorize living wills as an ex-ante policy because the work of writing the will takes place before the firm is in trouble.³⁹ In any event, by making failure more plausible, resolution hopes to make bailouts, moral hazard, and implicit subsidies less likely. Resolution does not directly address firm-level concerns or political-control concerns, but it might indirectly address both by giving firms an interest

in changing their practices and by making government actors less fearful of the too big to fail phenomenon. In addition, resolution might help alleviate certain systemic risks. On the one hand, resolution mitigates systemic risk because market actors know there is a reliable process in the event of a firm's failure, which in turn should reduce the risk of contagion. However, some have argued that in the event of multiple simultaneous failures, it is unlikely the government will put all failing firms through a resolution process because of the instability that would create in the financial system.⁴⁰

Size caps

Some have proposed capping the size of the largest financial institutions—an *ex-ante*, structural reform designed to end TBTF altogether.⁴¹ Putting aside the implementation questions—how to measure size and where to set the cap—this approach seeks to address a variety of concerns with size. Most directly, it aims to end TBTF's moral hazard, bailout, and implicit subsidy problems through an *ex-ante* structural approach. If no firms are big enough to jeopardize the economy upon failure, then there would be no need for bailouts and no moral hazard or implicit subsidy.

Size caps address the size-based systemic-risk problem, and they also mitigate some of the concerns about too big to manage, regulatory failures, and legal accountability. In smaller firms, managers should have an easier time implementing internal controls and oversight, and regulators should have an easier time supervising activities. Prosecutors will also be less likely to fear prosecuting smaller-sized firms because the risk to the system would be reduced.

The downside to size caps is that they do not address concerns stemming from interconnectedness and complexity. Smaller firms might still be interconnected, such that the failure of one influences the financial system as a whole. Similarly, complexity within firms might make it difficult for managers and regulators to supervise firm activities. At the same time, scholars have argued that size caps might mitigate the systemic risk of information effects. With more firms, the follow-the-leader effect should diminish, creating diversity within financial firm practices.⁴²

Glass-Steagall

A number of proposals can be grouped together under the rubric of Glass-Steagall: returning to Glass-Steagall, a new Glass-Steagall,⁴³ ring fencing,⁴⁴ and the Volcker Rule.⁴⁵ Despite frequent commentary, there is a great deal of confusion about these proposals. The central principle underlying all of them is that different kinds of activity should take place in different financial institutions.

The Glass-Steagall regime—which included the 1933 Banking Act and the Bank Holding Company Act of 1956—forced the separation of three types of financial services: depository institutions, investment banking, and insurance underwriting. Calls for a new Glass-Steagall are not focused solely on returning to the old regime’s delineations, but are inspired by the underlying idea of separating different financial activities from one another.⁴⁶ Both ring fencing and the Volcker Rule are weaker versions of this renewed concept of separation. The Volcker Rule separates fewer activities, limiting banks and their affiliates from proprietary trading. Ring fencing addresses many activities but does not fully separate them, relying instead on walls *within* each institution between the different activities. These proposals are all *ex ante* and structural, though the Volcker Rule is arguably *ex ante* and technocratic.

Functional separation deals with the interconnectedness and complexity of the financial industry. By separating activities into different institutions, separation should make individual institutions far less complicated, enabling managers to implement better internal controls and regulators to supervise activities. It also creates fragmentation within the financial sector, which may reduce political or regulatory capture. While some forms of systemic risk such as contagion are likely to exist even with separation—because, for example, firms in different sectors may have contracts with each other—separation does mitigate other forms of systemic risk. Panics and informational issues, for example, are more likely to be confined to a specific sector. Of course, functional differentiation cannot guarantee sound practices: Lehman Brothers was not a conglomerate on the scale of Citigroup when it failed in 2008. Still, the interconnectedness risks at Citigroup, for example, remain so significant that two of its former leaders have called for breaking up the institution with Glass-Steagall-like separation.⁴⁷ In addition, separation makes it less likely that a particular firm will fail due to risky activities rooted in internal complexity and cross-subsidization within the firm.

Separation indirectly addresses other concerns as well. Separation of big, complex financial institutions would result in breaking them up along functional lines, creating smaller institutions. Of course, separation does not address size completely—one can imagine Bank of America spinning off its depository business and it remaining extremely large. In addition, separation indirectly addresses bailouts, moral hazard, and subsidies. Separation might lead to a change in the culture of risk-taking in different sectors.⁴⁸ It also enables different treatment for different sectors: Some institutions, such as depositories, could be given a public insurance program as the FDIC currently does, and others, such as hedge funds, could be denied any explicit or implicit bailout or insurance. With separation, both culture and policy may make bailouts, moral hazard, and implicit subsidies less likely.

Prudential regulation

Another category of TBTF remedies can be referred to as prudential regulation. Prudential regulation is the archetype of ex-ante technocratic policy. It assumes that regulators can institute policies that will manage risk within firms, known as microprudential regulation, or within the economic system, referred to as macroprudential regulation.

It is helpful to further divide microprudential regulation into two categories: supervision and regulation. Supervision involves government supervisors monitoring activities from within financial institutions, while regulation involves government establishing rules, standards, and guidance on permissible firm activities. The most prominent microprudential policies are capital requirements, including leverage ratios and contingent capital requirements, and liquidity requirements, both of which require technical judgment in setting the proper levels to adequately manage risk.⁴⁹ Some commentators have advocated for greater reliance on equity finance because it effectively means self-insurance for financial institutions, changes their behavior toward risk, and is not socially costly.⁵⁰ Macroprudential regulation often uses the same tools but it is focused more on addressing systemwide risk than institution-specific risk. The creation of the Financial Stability Oversight Council, or FSOC, is the result of a belief that regulators can do better than they have in the past with respect to macroprudential monitoring and regulation.

The central justification for prudential regulations is that they improve the safety and soundness of financial institutions, preventing them from failing in the first place. A second benefit is that they reduce moral hazard—and in the process should reduce the cost of bailouts if they are necessary.⁵¹ Prudential regulation

should make firms less likely to take on large amounts of risky behavior, which should also improve executives' control over firm activities. In a sense, this reduced risk from firm bets going bad alleviates some of the burdens on regulatory supervision because the limited consequences mean supervisors have less to be worried about. Prudential regulation might also address certain forms of systemic risk, including the effects of panics because, for example, institutions would maintain more capital or have greater liquidity. Finally, many argue that prudential regulation such as leverage requirements should lead to smaller financial institutions, as banks will be encouraged to sell their most risky assets.⁵²

The drawbacks to prudential regulation are less frequently discussed. Foremost, prudential regulation is extremely costly, complex, and intensive. It requires a great deal of effort by expert bureaucrats to design regulatory policies and to keep up with them as the market changes. For those skeptical of the ability of civil servants to oversee the financial sector, prudential regulation may therefore be problematic. In addition, prudential regulation risks regulatory capture. In order to design complex regulations that grapple with the dynamic and varied activities taking place in the financial markets, regulators are more likely to need experience working in the regulated industry. This increases the likelihood of cognitive capture among regulators.

Fees and taxes

Some have called for imposing fees or taxes on the biggest financial institutions. Fees and taxes are an ex-ante technocratic approach to reforming bigness. Some proposals take aim at implicit subsidies, moral hazard, and bailouts. They compare the banks' implicit subsidy to a free government insurance plan, and they seek to have the banks internalize the cost for that insurance.⁵³ Fees or taxes could also act as a way to pay for a possible bailout fund in the event that bailouts are necessary. Taking a more comprehensive approach, fees or taxes could be used to require large financial institutions to internalize the full costs of their activities, potentially including lost gross domestic product, or GDP, and effects of unemployment, among other social costs.⁵⁴ Others argue that a tax on the size of financial institutions will help cut the biggest banks down to size, addressing size-based systemic risk.⁵⁵

Fees and taxes suffer from a number of technical challenges, in particular how to determine the amount of the fee or tax. But they also extend to a broader issue: Do we want to put a price on the underlying activity? A set fee or tax would enable financial institutions that are willing to pay to continue engaging in the

underlying risky behavior. As a society, we may simply prefer that the risky activity, even if compensated by a fee, does not take place at all—and this may be particularly true if the fee or tax does not account for all the indirect costs, such as employment losses, of firm failure to the economy.

Internal controls

Some think that instituting better internal controls within financial institutions could help address the riskiness of firm behavior and that firm management can be incentivized to adopt more stringent controls. The most prominent internal control mechanisms are regulating pay of the CEO, executives, or bankers, requiring executive certifications, and regulating risk-management committees.

Scholars have argued that compensation is often tied to short-term results and is frequently structured so that bankers get compensation that is linked to gains but insulated from losses—meaning they are paid highly if all goes well, but are also paid well if things go wrong.⁵⁶ If compensation structures are regulated, the regulations could create incentives for executives to ensure the bank is engaged in less risky behavior. Executive certifications use psychological and legal tools instead of economic incentives, requiring executives to certify that activities are legal and that controls are in place. Advocates argue that these certifications make it more likely the executive will feel responsible for the certified activity because he or she is affixing his or her name to documents attesting to the legality of the activity. As a result, the executive should feel obligated to impose more stringent internal controls.⁵⁷ Certifications are a feature of the Sarbanes-Oxley Act and Volcker Rule regulation, and they have been suggested in other contexts as well.⁵⁸ Finally, pursuant to the Dodd-Frank Act, the Federal Reserve has recently issued rules relating to risk-management committees within financial institutions.⁵⁹ These rules are designed to structure internal management systems in a manner that will prevent excessive risk-taking.

Incentives to create more stringent internal controls are ex-ante technocratic policies that directly address the firm-level concerns with size. Greater internal controls should give management a better handle on the activities taking place in their firms, and regulators should have an easier time supervising firm activities as a result. Internal controls might also mitigate concerns about legal accountability, as certifications and pay incentives should push executives to implement policies that improve legal compliance. In addition, internal controls indirectly affect the riskiness of firm activities, which may combat the informational version of systemic

risk. Recall that under this version of systemic risk, the failure of firm A unveils information about practices within firm A, which when discovered to exist in firms B and C, might lead to those other firms failure. Internal controls, in theory, should make it more likely that firms B and C have different—that is, less risky—practices.

The problems with internal controls are readily visible. First, these mechanisms do not directly confront the risky practices themselves. Rather, they rely on incentives and decision-making processes such as risk committees. The result is that these methods might not be terribly effective. Managers hostile to internal-control mechanisms might not take controls seriously. For example, in a complex financial institution, executives might just sign off on certifications, knowing they will be penalized legally or via public opinion, regardless of the level of internal controls they develop in the company. In addition, these approaches do not address most of the central concerns with TBTF: systemic risk, bailouts, implicit subsidies, and political capture.

Conclusion

The concerns with big financial institutions are varied, ranging from bailouts and implicit subsidies to systemic risk to political, regulatory, and legal capture. The best solution or solutions to adopt will depend largely on which concerns are most at issue. Of course, different people will come to different conclusions on how troubling each of the concerns with TBTF are, and policymakers will therefore prefer different solutions. But the first step is identifying why TBTF is bad for our financial system and the economy as a whole—and then outlining how to address those specific concerns.

TABLE 1
Linking problems and solutions in the TBTF debate

	Resolution	Cap the size	Glass-Steagall	Fees and taxes	Internal controls	Prudential regulation
Moral hazard	●	●	●	●		●
Bailout costs	●	●	●	●		●
Implicit subsidy	●	●	●	●		
Regulatory playing field		●	●			
Size-systemic risk		●	●	●		●
Interconnected-systemic risk	●		●			
System effects- systemic risk	●		●		●	●
Firm-level concerns	●	●	●		●	●
Regulatory challenges		●	●		●	●
Legal accountability	●	●	●		●	
Political and regulatory capture		●	●			
Ex ante		●	●	●	●	●
Ex post	●					
Structural		●	●			
Technocratic	●			●	●	●

● = Directly addresses issue ● = Indirectly or partly addresses issue

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Endnotes

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