Background

Calls to “break up” the big banks, once muted, are now common, bi-partisan, and growing.¹ A prominent FDIC vice chairman, presidents of several Federal Reserve Banks, Sandy Weill and even former Fed chairman Alan Greenspan, along with many others² have expressed grave concern over the ongoing menace that large financial institutions pose to the well being of the financial system and to the real economy. These calls, however, stop short of making specific

¹ “Republicans join liberals to control rise of the ‘megabank’”, Financial Times, January 11, 2013, p. 4; http://www.ft.com/intl/cms/s/0/de39ae8-5a84-11e2-b60e-00144feab49a.html#axzz2Hfvz5RPO
² “[T]he risk of failure of ‘large, interconnected firms’ must be reduced, whether by reducing their size, curtailing their interconnections, or limiting their activities.” – Paul Volcker, former Chairman of the Federal Reserve
“An often heard statement by many policymakers and financial market experts over the past couple of years has been that if a financial firm is too big to fail, then it is too big. I couldn’t agree more.”
– Thomas Hoenig, vice chairman of the FDIC and former President of the Kansas City Federal Reserve Bank
“It would surely be in the government’s interest to downsize megabanks… The public-policy benefits of smaller, simpler banks are clear. It may be in the enlightened self-interest of shareholders as well.”
– Sheila Bair, former Federal Deposit Insurance Corporation Chairman
“But giant banks, operating on the belief that they are backed by government, turn these otherwise manageable episodes into catastrophes. Is there a better alternative? Yes, reducing the size and complexity of the largest banks.”
– Richard Fisher, President and CEO of the Federal Reserve Bank of Dallas
“Downsizing too-big-to-fail institutions and the risks they pose to the financial system could not be worse than taxpayers spending trillions of dollars propping up these firms and federal officials, not the free market, picking winners and losers.” – Cam Fine, President and CEO, Independent Community Bankers of America
recommendations for how to go about right-sizing the TBTFs. Prof. Cornelius Hurley is the director of Boston University’s Center for Finance, Law & Policy. His plan fills this gap by proposing a detailed approach whereby the TBTFs will right-size themselves and will do so at the insistence of their shareholders not in response to arbitrary government caps or break-up plans. The result will be a financial system that is more equitable for taxpayers and is safer and more competitive.

Discussion

The starting point of Hurley’s plan is the subsidy that every TBTF firm receives in the form of lower borrowing costs. Those lower borrowing costs stem from the confidence of the banks’ counterparties that, under duress, the government will intervene as it has done in the recent past. This perception is reinforced by, among other things, credit rating agencies assigning higher ratings to firms based on the likelihood of their receiving government support and by CDS spreads. In a recent press conference, Chairman Bernanke acknowledged the financial implications of the implicit government backing that TBTFs enjoy when he stated, “In other words, a bank which is thought to be too big to fail gets an artificial subsidy in the interest rate that it can borrow at ...” Recently, Fed governor Daniel Tarullo discussed the “…funding advantage derived from the perceived status of such institutions as too-big-to-fail.”

The amount of the subsidy has been studied by many academic scholars and industry experts. Appendix A is a compilation of some of the literature on this subject to date. Suffice it to say that, while the methodologies vary for calculating the subsidy, the conclusions converge on a very large amount. It is important to keep in mind that as stunning as the estimates are, the subsidy is annual and perpetual not a one-time infusion as with TARP. Moreover, unlike TARP, the subsidy is never recouped. At the instruction of a unanimous U.S. Senate, the General Accountability office has undertaken a study to measure the subsidy.

The subsidy is not attributable to sound business models, management expertise, or wise investment decisions. Rather, it is a wealth transfer from taxpayers to the TBTFs and their stakeholders. Simultaneously, the subsidy creates an unfair competitive advantage in favor of the

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3 The plan described in this paper does not necessarily reflect the views of the Boston University Center for Finance, Law & Policy.
TBTFs. This advantage is leading to, on the one hand, massive overregulation of the TBTFs, and, the disappearance of smaller erstwhile competitors to the TBTFs, on the other.

Several mechanisms of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) are aimed at the systemic risks posed by individual firms (FSOC, living wills, enhanced regulation, orderly liquidation, SIFIs, etc.). However, the threat of these firms being bailed out by the government persists and the policy prescriptions of Dodd-Frank are clearly inadequate.⁷

The plan at hand focuses on the subsidy and uses it as leverage for incentivizing the banks to right-size themselves. In this way, it addresses the TBTF disease, not just its symptoms. It is driven by shareholders’ interests not by arbitrary government prescriptions. Because it is shareholder driven, the resulting financial organizations will not only be smaller and less threatening to the financial system, they will be more efficient and more competitive.

**How the Subsidy Reserve Plan Works**⁸

*I. Establishing the Subsidy Reserve*

The Office of Financial Research (Research and Analysis Center), a unit within the Treasury Department created by Dodd-Frank, will be instructed to develop a statistically valid methodology for calculating the subsidy based upon independent research and its own analysis. See Appendix A for an example of the research that has already been done quantifying the subsidy.

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⁷ The following passage from Dodd-Frank describes the central purposes of FSOC, the lynchpin of the law’s systemic risk structure:

**SEC. 112. COUNCIL AUTHORITY.**

(a) PURPOSES AND DUTIES OF THE COUNCIL.—

(1) IN GENERAL.—The purposes of the Council are—

(A) to identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace;

(B) to promote market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the Government will shield them from losses in the event of failure; and

(C) to respond to emerging threats to the stability of the United States financial system. (emphasis added)

The subsidy reserve plan captures the essence of Section 112(a)(1)(B). It promotes market discipline in the form of shareholder pressure for the right-sizing of TBTFs and, in so doing, leads to the elimination of expectations regarding future bailouts of the TBTFs.

⁸ See Appendix B for a draft bill implementing the Subsidy Reserve Plan
OFR then submits its findings to FSOC and to the Fed. The Fed confirms OFR’s methodology and, after notice and opportunity for comment, issues regulations applying the subsidy methodology to each systemically significant firm with assets in excess of $500 billion and to all Systemically Important Financial Institutions (SIFIs) so designated by the Financial Stability Oversight Council.

Each firm that, according to the methodology, is receiving an annual subsidy is required to establish a capital account on its balance sheet to be called “Subsidy Reserve” in the amount of that subsidy.

II. Rules for the Subsidy Reserve

The Subsidy Reserve counts as capital for bankruptcy purposes but does not substitute for Basel III capital. The Subsidy Reserve cannot be used to pay dividends, for share buy-backs, or for executive compensation. Critically, the Subsidy Reserve accretes year-over-year indefinitely (this is key).

The Subsidy Reserve can only be returned to shareholders of the TBTF firms via the sale of assets, divestiture of subsidiaries or divisions, spinoffs of subsidiaries, etc. in which cases a pro rata proportion of the Subsidy Reserve is allocated to the asset, subsidiary, or division being sold, divested or spun off. The Federal Reserve may issue regulations that allocate Subsidy Reserve funds according to the risk weightings of the assets being divested.

III. The Subsidy Reserve Dynamic

Because of the size of the annual subsidy and the accretion factor, the Subsidy Reserve will have near-term impacts on the TBTFs’ performance ratios (ROE, EPS, etc.). The Subsidy Reserve will also serve as a buffer in the event of liquidation of the TBTF firm and reduce the government’s resolution costs in the case of a TBTF experiencing stress.

TBTFs will be faced with two choices. First, they may choose to continue to accrete reserves and in so doing adopt a “fortress balance sheet” strategy. Over time, firms choosing this route will become so well capitalized that they will no longer be TBTF. Second, to more effectively deploy their capital, more enlightened firms will choose to down-size through asset sales and the

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9 FSOC has been struggling to carry out its task under Dodd-Frank of designating certain nonbank financial firms as SIFIs. Calculating the subsidy for these firms may be a more pragmatic way of designating which firms qualify as SIFIs, i.e., the higher the subsidy amount as determined by the markets the more compelling is the case for SIFI status.

10 Allowing the Subsidy Reserve to count toward Basel III capital requirements would defeat the purpose of this plan. The subsidy reserve would, however, function in most respects like Tier I capital.

11 A side benefit of the subsidy reserve approach is that, while the reserve does not count as Basel III capital, having this additional cushion widens considerably the margin of error for the Basel III Tier I percentages. See, discussion of the G-SIB capital buffer (below).
accompanying off-loading of the Subsidy Reserve. This process will result in firms achieving the size and complexity level whereby they are no longer TBTF and no longer need to maintain the Subsidy Reserve.

Expect shareholders, especially institutional shareholders, to play a meaningful role in the decision process for choosing the fortress strategy or the divestiture strategy.

The plan summarized above is characterized by transparency, taxpayer fairness, and is largely self-executing. Because it relies heavily on market discipline it is consistent with this core driver of capitalism and is in furtherance of the statutory directive of Section 112(a)(1)(B) of Dodd-Frank to “promote market discipline”. Similarly, because it does not necessarily involve new taxes or fees it is budget neutral. It will result in more vibrant and competitive financial firms. Most significantly, it strikes at the heart of the TBTF problem which is the very existence of TBTF firms and the distortive effects they are having on the financial system.

* * *

Finally, it will be argued that adopting the Subsidy Reserve plan would prostrate U.S. banks before their global competitors. This is a time-worn argument that is used to counter any creative regulatory approach. The short answer to this argument is that global banks should be able to compete on a nonsubsidized basis and, in fact, did so pre-crisis when the subsidy was a fraction of what it is today.

Recently, the Financial Stability Board released its analysis of the percentage of additional loss absorbing capital that should be maintained by the 28 firms that it has designated as global systemically important banks (G-SIBs). The levels of additional capital to be required of these banks range from 1% to 2.5%. The phase-in period for the new buffers commences in 2016. The Fed has signaled that it will follow suit with a “congruent” capital surcharge as required by Section 165 of Dodd-Frank.

The problem with the capital surcharge is that it is a negotiated target and not a target based on rigorous analysis. In this regard, it is admittedly arbitrary as policy makers have been unable to agree on whether its purpose is to minimize the chances of a TBTF bank failing, on the one hand, or to compensate for the systemic consequences of such an event, on the other. The Subsidy Reserve, if implemented as described above, could replace or supplement the static G-SIB buffer

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12 It has been suggested that the divestitures occasioned by the plan should be subject to tax on the TBTF firm to the extent that the proceeds of the divestitures involve recognition of the gain on the sale of the subsidy reserve that is traceable to the taxpayers’ perceived support of the TBTFs. In this regard, a low tax would in all likelihood accelerate the right-sizing process while a higher tax on divestitures would likely retard that process. For the moment, the tax issue is left unaddressed.

with a dynamic, accreting account that will motivate firms to reexamine their size, complexity and interconnectedness in the best interest of their shareholders.

In this regard, the Subsidy Reserve plan is readily adaptable by any country that hosts its own TBTF firms. The Subsidy Reserve should be considered by the G-20 and the Financial Stability Board as a best practice to be adopted on a global basis.

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Appendix A

Calculating the Subsidy for the TBTF Banks

- Review & Outlook, “Still Too Big, Still Can’t Fail,” *The Wall Street Journal*, March 5-6, 2011, A14. (“The funding advantage enjoyed by banks with more than $100 billion in assets over those in the $10-100 billion range rose from 71 basis points in the first quarter to 78 basis points in the third quarter, which began with President Obama signing the bill and proclaiming an end to too-big-to-fail. The advantage increased to 81 in the fourth quarter.”)

- David J. Lynch, “Banks Seen Dangerous Defying Obama’s Too-Big-to-Fail Move,” *Bloomberg*, April 16, 2012, [www.bloomberg.com/news/2012-04-16/obama-bid-to-end-too-big-to-fail-undercut-as-banks-grow.html](http://www.bloomberg.com/news/2012-04-16/obama-bid-to-end-too-big-to-fail-undercut-as-banks-grow.html) (“In 2011, funding costs for banks with more than $10 billion in assets were about one-third less than for the smallest banks, according to the FDIC. That gap was only slightly narrower than the 37 percent advantage the largest banks enjoyed when Dodd-Frank was signed.”);


- Andrew G. Haldane, Executive Director, Financial Stability, Bank of England, “The $100 Billion Question,” Comments at the Institute of Regulation & Risk, Hong Kong, March 30, 2010, [www.bis.org/review/r100406d.pdf?frames=0.3](http://www.bis.org/review/r100406d.pdf?frames=0.3). (“For the sample of global banks, the average annual subsidy for the top five banks was just less than $60 billion per year.”)

- Kenichi Ueda and Beatrice Weder di Mauro, “Quantifying Structural Subsidy Values for Systemically Important Financial Institutions,” International Monetary Fund, May 2012, [http://www.imf.org/external/pubs/ft/wp/2012/wp12128.pdf](http://www.imf.org/external/pubs/ft/wp/2012/wp12128.pdf) (Claimants to SIFIs receive transfers when governments are forced into bailouts. *Ex ante*, the bailout expectation lowers daily funding costs. … With large worldwide sample of banks, we estimate the structural subsidy values by exploiting expectations of state support embedded in credit ratings and by using long-run average value of rating bonus. It was already sizable, 60 basis points, as of the end-2007, before the crisis. It increased to 80 basis points by the end-2009.”)

available at
http://faculty.chicagobooth.edu/workshops/finance/archive/pdf/Paper_IBG_041611_Final%20%282%29.pdf (finding, based on stock returns, an annual implicit government subsidy to the largest U.S. commercial banks of $4.71 billion per bank)

• Frederic A. Schweikhard and Zoe Tsesmelidakis, “The Impact of Government Interventions on CDS and Equity Markets,” July 2011,


http://www.bankofengland.co.uk/publications/Documents/fsr/fs_paper15.pdf

• Richard Davies and Belinda Tracey, “Too big to be efficient? The impact of implicit funding subsidies on scale economies in banking,” June 2012,

• Andrew Haldane, “On being the right size,” Bank of England, October 2012,
http://www.bankofengland.co.uk/publications/Pages/speeches/2012/615.aspx

• Li, Z, Qu, S and Zhang, J (2011), ‘Quantifying the value of implicit government guarantees for large financial institutions’, Moody’s Analytics Quantitative Research group, January.


• Araten, M and Turner, C (2011), ‘Understanding the funding cost differences between globally systemically important banks (G-SIBs) and non G-SIBs in the United States’, mimeo.
S.

AN ACT

113TH CONGRESS
1st SESSION

To require systemically important financial entities and nonbanks to account for the financial benefit they receive as a result of the expectations on the part of shareholders, creditors, and counterparties of such companies that the Government will shield them from losses in the event of stress or failure.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act is amended by adding after subsection k:

“(l) The Subsidy Reserve

(1) The Board of Governors shall require each nonbank financial company supervised by the Board of Governors and each bank holding company with total consolidated assets equal to or greater than $500,000,000,000 to establish and maintain a capital account called the “Subsidy Reserve”.

(2) In consultation with the Financial Stability Oversight Council and the Office of Financial Research, the Board of Governors shall, after notice and opportunity for hearing, establish a formula for determining the financial benefit received by such firms as a result of the expectations on the part of shareholders, creditors, and counterparties of such firms that the Government will shield them from losses in the event of failure.

(3) The Board of Governors shall require each firm described in subsection (1) to apply the formula of subsection (2) to its financial statements annually and to maintain a minimum amount of capital in its Subsidy Reserve equal to the cumulative results of that formula.

(4) The Subsidy Reserve shall not be used to satisfy any other capital requirements.

(5) Other than as described in subsection (6) the Subsidy Reserve shall not be diminished through dividends, share buybacks, or otherwise distributed to shareholders or diminished through payments to insiders of the firm.

(6) The Subsidy Reserve may be diminished in connection with a firm’s sale of assets, the spinoff of subsidiaries, or other such divestiture in which case a proportion of the Subsidy Reserve will be allocated to the divested property on either a pro rata basis or according to the risk weighting of the divested property as determined by the Board of Governors either by order or regulation.
(7) The Board of Governors may issue such regulations and orders as it considers necessary to implement this subsection.”

Attest:
Secretary.