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Viewpoint: How Congress Can Get it Right on TBTF

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One of the more difficult issues on the agenda for Congress as it struggles with how to prevent another financial meltdown is how to address the "too big to fail" entities.

A two-pronged approach needs to be taken in order to have a future without "too big to fail" financial institutions: one, prevent institutions from reaching the "too big to fail" size and influence in the future, and two, achieve an orderly reduction in size and influence in the current "too big to fail" institutions.

Congress needs to establish limits on financial institutions to restrict their size and influence on the U.S. economy. The size issue can be achieved by lowering the nationwide deposit cap, establishing maximum dollar amounts of on- and off-balance-sheet assets, requiring diversification of counterparty risk and setting maximum market share for regional and/or nationwide markets.

The nature of relationships and risk sharing as well as portfolio diversification as a function of capital formation also have to be considered. As various analyses of the events leading up to the recent financial crisis are completed, additional prophylactic risk abatement measures may be considered. These limits can be phased in over time, with temporary protections implemented during the transition period.

Congress would also need to establish a framework to reduce the size and influence of the current "too big to fail" institutions. A reduction in size can be accomplished by the obvious methods of selling off the riskiest businesses or portions of the franchise that exceed regulatory maximums. Reducing the influence of the "too big to fail" entities would be more difficult and would require a thorough review of the interconnectedness of these entities with other institutions throughout the country.

A number of commentators have called on Congress to mandate a reduction of these institutions by reinstituting a modern Glass-Steagall Act, which separated traditional banking from capital markets activities. Rather than reinstituting Glass-Steagall, the perceived evil of mixing commercial and investment banking can be addressed through increased deposit insurance premiums and higher capital requirements for those institutions engaging in investment banking. In this way, investment banking activities would not present a source of potential weakness to the capital structure of commercial banks.

Transition periods would be necessary to allow time for the divestment of businesses which banks believe to be too capital-intensive (i.e., capital markets), for coming into compliance with regulatory maximums and to achieve downsizing. During the transition period, Congress should ensure that the "too big to fail" institutions are subjected to certain restrictions and limitations, such as oversight of executive compensation, business plan restrictions, increased capital requirements and greater FDIC assessments to account for the additional risk.

One of the major culprits in the financial meltdown was the lack of regulatory rigor. Regardless of how the regulatory agencies are structured, or whether or not there are new regulatory agencies introduced to address past wrongs, tough government oversight of the financial industry is imperative to prevent the meltdown that occurred. In addition, regulatory agencies need to ensure that they employ examiners in sufficient quantities, compensate them appropriately and train them robustly so that the examiners are able to understand the risks being undertaken by the financial institutions and not be intimidated or blinded by the compensation of those they are examining. Strong ethics policies need to be in place to prevent regulators from influencing their actions in order to protect a regulated entity that they hope will employ them in the future.

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