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FINANCIAL REGULATION REFORM
AND TOO BIG TO FAIL

BRET H. MCDONNELL†

I. INTRODUCTION

Perhaps the leading critique of the Dodd-Frank Act from the left is that it does too little to address the problem of too big to fail ("TBTF") financial institutions.1 This critique is not unique to the left—many on the right make similar arguments.2 The critique of TBTF institutions has two main components, which I shall call the economic argument and the political argument. The economic argument focuses on a major moral hazard problem. TBTF institutions know they are likely to be bailed out if they near failure because the consequences of their failure to the financial system are dire.3 Knowing this, they take on too much risk, increasing the chances of financial crisis.4 The political argument focuses on the political clout of TBTF institutions.5 Their size and centrality to the financial

†Professor of Law, University of Minnesota Law School. I thank participants at American University Washington College of Law's symposium on Law, Finance and Legitimacy After Financial Reform, especially panel commentators Jose Gabilondo, Lisa Fairfax, and Peter Conti-Brown, for helpful comments.

1 See generally SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN (2010) and JOSEPH E. STIGLITZ, FREEFALL: AMERICA, FREE MARKETS, AND THE SINKING OF THE WORLD ECONOMY (2010) for two of the leading, and best, instances of the sort of critique I have in mind. These are not actually critiques of Dodd-Frank, since they were published before the Act passed. However, the Act clearly falls well short of the actions that both books advocate, and the authors have subsequently made predictable criticisms of the Act, although they are not completely critical. See also Arthur E. Wilmarth, Jr., The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-To-Fail Problem, 89 OR. L. REV. 951 (2011), for a discussion of the Dodd-Frank Act's limited effectiveness in solving the TBTF problem and in ending taxpayer bailouts.

2 See generally RAGHURAM G. RAJAN, FAULT LINES: HOW HIDDEN FRACTURES STILL THREATEN THE WORLD ECONOMY (2010) (discussing the causes of the economic meltdown and the continuing flaws in the current economic system); GARY H. STERN & RON J. FELDMAN, TOO BIG TO FAIL: THE HAZARDS OF BANK BAILOUTS (2004) (warning that not enough has been done to reduce problems of the TBTF problem).

3 Wilmarth, supra note 1, at 954.

4 See generally STERN & FELDMAN, supra note 2 at 2.

5 See infra Part III.

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system gives them immense lobbying power in Washington, both in Congress and among regulatory agencies. The revolving door places many industry insiders at the heart of agency decision-making. The political argument maintains that this revolving door goes a long way towards explaining the excessive deregulation which set the stage for the financial crisis.

There are important truths in both the economic and the political arguments against TBTF institutions. However, there are also important limits to the truth of both arguments. I believe the limits are more central than the truths, and that if anything, Dodd-Frank has gone too far in focusing on TBTF institutions. Part II explores the truths and limits of the economic argument, while Part III does the same for the political argument. Part IV lays out a map for my own preferred approach to the TBTF problem. In the short run, we need relatively modest but firm regulation. Dodd-Frank looks pretty good in many ways, but still needs some important fixes. The longer run is more daunting: we need to find ways to develop alternative financial and other institutions that are smaller and more focused on community and other stakeholder interests.

II. THE ECONOMIC ARGUMENT

The economic argument contains an important truth that almost all analysts have recognized in the wake of the financial crisis. The existence of TBTF financial firms creates a severe moral hazard problem. TBTF firms (many rightly point out that it may be more accurate to speak of firms that are too inter-connected to fail), are tied to many other firms in many other financial markets. If they fail, they put stress on many of those firms and markets. Particularly if such a failure occurs at a time when market participants are already nervous about financial troubles, the failure of one TBTF firm may set off a chain reaction that leads to widespread collapse of many financial firms and markets.

The realistic prospect of such a chain reaction collapse creates the moral

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6 Viral V. Acharya et al., Prologue: A Bird’s-Eye View, The Dodd-Frank Wall Street Reform and Consumer Protection Act, in REGULATING WALL STREET: THE DODD-FRANK ACT AND THE NEW ARCHITECTURE OF GLOBAL FINANCE 1, 9-10 (2011); RAJAN, supra note 2, at 18, 131; NOURIEL ROUBINI & STEPHEN MIHM, CRISIS ECONOMICS: A CRASH COURSE IN THE FUTURE OF FINANCE 68-72 (2010); see JOHNSON & KWAK, supra note 1, at 166-74 (discussing the restructuring efforts made for economic recovery); see also STIGLITZ, supra note 1, at 118 (stating that through explicit or implicit governmental guarantees, banks do not bear the risks they take). See generally STERN & FELDMAN, supra note 6 (arguing that many of the problems inherent in TBTF firms that caused the financial collapse still exist).

7 Acharya et al., supra note 6, at 2-6; ROUBINI & MIHM, supra note 6, at 200.

8 Acharya et al., supra note 6, at 2-5.
hazard problem. History\(^9\) and political common sense strongly suggest that the government and central bank will not stand back and face the threat of such a collapse. Rather, they will step in and rescue the TBTF firm. But, those running such a firm know this. It gives them incentive to take on too much risk.\(^{10}\) If that risk pays off, they are sitting pretty. If it doesn’t, then taxpayers will bail them out.\(^{11}\) Moreover, TBTF firms will face a lower cost of raising capital,\(^{12}\) as investors also anticipate a bailout if things go wrong. Thus, more resources flow to TBTF firms which are taking on high risk, which will tend to drive the financial system towards the very crises which regulators hope to avert. Clearly the experience of the many bailouts in the latest crisis should make persons in the financial markets anticipate bailouts the next time around.

This economic critique comes from all sides of the political spectrum. Economists of all stripes can easily spot the moral hazard threat.\(^{13}\) And for politicians of the left and right, TBTF institutions make tempting targets—on the left, because bailouts help rich financiers while doing nothing (directly) for common folk, and on the right because they represent Big Government distorting private markets. So politicians from Al Franken\(^{14}\) to Michele Bachmann,\(^{15}\) just to focus on my own state, can gleefully take aim at the bailouts.

But those on the left and right tend to disagree on how to solve the moral hazard problem. Many on the left would like to cap the size, and maybe also the complexity, of financial institutions, so that companies are not allowed to become too big (or too inter-connected) in the first place.\(^{16}\)


\(^{10}\) Stern & Feldman, supra note 2.

\(^{11}\) See Stiglitz, supra note 1, at 118.


\(^{13}\) See supra notes 6–8 and accompanying text (discussing the origins and effects of moral hazard).


\(^{16}\) Johnson & Kwak, supra note 1, at 208-13; Roubini & Mihm, supra note 6, at 226-30; Stiglitz, supra note 1, at 164-68.
Analysts on the right tend to be skeptical of that degree of regulation. They believe it is likely either to have unintended consequences or to be evaded (or both). Instead, they either call for lighter regulation that limits the risk TBTF institutions can take on, or else call for limits on the ability of the government to intervene in failing companies. Those on the left think that lighter regulation (such as Dodd-Frank) is unlikely to solve the problem and they are skeptical that we can credibly commit to limit intervention in a crisis.

But there are reasons to doubt the strong emphasis of many on TBTF as the main cause of the crisis. For one thing, it is not clear that large and complex financial institutions are, on balance a bad thing. Size and diversity of institutions can arguably increase stability. Larger, more diverse financial institutions may be better able to weather economic storms. That indeed would seem to be one of the lessons of the Great Depression, where the banking system was highly decentralized and quite unstable. The more concentrated Canadian system weathered the recent storm better.

Furthermore, other problems besides TBTF may have played at least as great a role in the financial crisis. In my opinion, the true core lesson from our latest crisis should not be the problem of TBTF institutions, but rather the problem of the shadow banking world, where unregulated institutions and markets are economically very similar to banks, and similarly subject to contagious panics, but they are not regulated like banks. Panics can occur in these markets as many mid to small sized institutions following similar strategies face similar stresses. Key examples during the latest crisis included the panics in the money market fund and

17 RAJAN, supra note 2, at 171-72.
18 Id. at 168-69, 171-76.
20 Id. at 211; RAJAN, supra note 2, at 172.
21 See, e.g., RAJAN, supra note 2, at 172 ("[I]arger banks may be better at diversifying and attracting managerial talent (including risk managers).”).
24 See McDonnell, supra note 12, at 8.
commercial paper markets. And the Great Depression remains the leading example of panics caused by a series of failures in relatively small, lightly regulated financial institutions. We have now regulated institutions we label "banks," but not many similar ones. These shadow banks need greater regulation to reduce the chances of future panics.

Moreover, there are many causes of financial firms taking on too much risk and leverage beyond the moral hazard problem on which the economic argument focuses. These include corporate governance failures (including compensation schemes that encourage too much risk-taking), herd behavior, and a tendency towards over-optimism caused by short memories after economies recover from a crisis. Human beings seem quite able to convince themselves that this time things will be different, and that they do not need to protect themselves against the chance of a financial crisis. Other problems revealed by the crisis include various incentive failures within the mortgage-backed securitization chain and governmental policies that encouraged a housing bubble as a way of avoiding coming to grips with the pain of economic stagnation for the middle class.

In its focus on new regulations for TBTF institutions, Dodd-Frank does too little to regulate smaller shadow banking institutions. The two most crucial sections of the Act are its first two titles. Title I extends capital requirements and other regulatory controls to systemically significant financial companies. Such extended regulation is needed for shadow banking generally, but Title I's language would seem to include only TBTF institutions. Title II creates a new resolution authority, whereby the FDIC can quickly dispose of systemically significant non-banks that are

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27 See Schmitt supra note 22 and accompanying text.
28 See McDonnell, supra note 12, at 9-10 nn. 24-34 and accompanying text.
29 See REINHARDT & ROGOFF, supra note 9, at 208-13.
30 McDonnell, supra note 12, at 8-9. See also GORTON, supra note 26, at 39-41, 138-41 for a discussion on problems with mortgage-backed securitization chains.
31 See RAJAN, supra note 2, at 85 (stating that the government and Federal Reserve encouraged the housing bubble "[i]n an attempt to induce recalcitrant firms into creating jobs.").
32 See McDonnell, supra note 12, at 38-42.
34 Id. I have suggested that creative interpretation might extend this language. McDonnell, supra note 12, at n. 183. However, initial rulemaking does not suggest regulators are inclined to such creativity. E.g., Financial Stability Oversight Council, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 76 Fed. Reg. 4,555 (proposed Jan. 26, 2011) (to be codified at 12 C.F.R. pt. 1310).
financially troubled and pose a threat to the financial system.\textsuperscript{35} If well-used, this authority can help stop contagious panics while still punishing the main decisionmakers in a way that reduces the moral hazard problem. The resolution authority created by Title II is thus an important mechanism for reducing the TBTF economic problem. But, it could also have provided a tool for dealing with panics in smaller shadow banking institutions. However, here again the language appears limited to TBTF companies.\textsuperscript{36}

Indeed, Dodd-Frank may channel more resources into smaller unregulated shadow banks as investors find ways to avoid the new regulations by moving money to more lightly-regulated entities.\textsuperscript{37} Because it buys into the economic argument against TBTF, Dodd-Frank may actually increase the risk of future crises, precisely because it focuses mainly on a few large institutions that on their own create large systemic risk.

More likely than not, though, TBTF institutions do on the whole pose a greater risk than others in the shadow banking world. Thus, tougher regulations for TBTF institutions, as contemplated in Dodd-Frank, do make sense. However, the ambiguity as to this point, combined with the difficulty of drafting blanket prohibitions that would not be evadable, suggests something short of the complete assault on the existence of TBTF institutions that some suggest. Rather, we should have stricter regulations, and/or possibly a tax for TBTF firms, whose level depends on the degree of risk posed, while extending some regulations to a broader class of companies. Part IV will consider this idea further, and assess how well Dodd-Frank fits it.

\section*{III. The Political Argument}

Like the economic argument, the political argument against TBTF firms expresses some important truths. Large institutions with big pots of cash have some real advantages in political organization. A few large companies can more easily overcome free rider problems than many smaller companies.\textsuperscript{38} Large TBTF banks and their executives have much prestige. That prestige can cause politicians and regulators to look to hire them as regulators—consider the flow of Goldman Sachs officers into high levels of government.\textsuperscript{39} The prestige and high compensation of jobs at the

\textsuperscript{35} 12 U.S.C. §§ 5381-5394.
\textsuperscript{36} 12 U.S.C. § 5383.
\textsuperscript{37} McDonnell, supra note 12, at 49; ROUBINI & MIHM, supra note 6, at 212-13.
\textsuperscript{39} Most obviously including Treasury Secretaries under both Presidents Clinton (Robert Rubin), Robert E. Rubin - About, U.S. DEPARTMENT OF THE TREASURY,
large banks also work in the reverse direction, luring regulators into private employment. Prospects of such employment may influence their actions as regulators. Agency problems may also allow the managers of large companies to use resources to their own advantage, including in lobbying for legal rules. Note, though, that this last argument suggests that some rules achieved through lobbying by TBTF executives may not be in the best interests of the firms themselves.

The political argument is interrelated with the economic argument; they support each other. On the one hand, capture of the political process by TBTF institutions makes bailouts more likely, worsening the moral hazard of the economic argument. On the other hand and more subtly, the economic argument points to an inherent power for TBTF institutions. Should they collapse, they threaten genuine calamity for the economy as a whole. That gives them the power to go to politicians asking for help, with the real threat that if they do not get it, the economy could tumble down with them. Indeed, I believe this, more than any sort of corruption or influence peddling, explains most of the bailouts of 2007-08.

The political argument has been around for a long time. American distrust of large financial institutions goes back at least to Andrew Jackson's battle with the Bank of the United States. The argument resonates on both the political left and right. On the left it fits well with concerns about the entrenched power of a wealthy elite. On the right, it fits well with standard public choice stories of capture by concentrated economic interests. The financial industry has many companies with a strong interest in weakening financial regulation, whereas the general public which could be protected by such regulation has no persons or organizations which individually stand to gain a lot from such regulation.

Advocates of the political argument can point to many possible examples of industry capture, both during the long boom leading up to the crisis and during and after the crisis. Industry pressure led to extensive financial deregulation, including removal of limits on interest rates, barriers to entry,


40 See JOHNSON & KWAK, supra note 1, at 18-22.
41 Id. at 18-22; STIGLITZ, supra note 1, at 291.
limits on new financial products, and the end of the Glass-Steagall Act.\textsuperscript{43} During and after the crisis, opposition to new regulation was strong, limiting what was included in Dodd-Frank.\textsuperscript{44} Now that Dodd-Frank has passed, industry lobbyists are working hard, and in many cases effectively, to de-fang the new rules that regulators must promulgate.\textsuperscript{45}

But, it is far from clear that the political successes of the financial world are due to the size and influence of a few big banks. Smaller financial institutions have some political advantages of their own. They are more widely distributed around the country,\textsuperscript{46} and hence may be able to effectively lobby in more congressional districts. They are also seen as more politically legitimate—taking money from Goldman Sachs is quite attractive for politicians in ordinary times, but can become an embarrassment when times get tight. At many periods in U.S. history, big banks have had quite a toxic political reputation—consider the Second Bank of the United States.\textsuperscript{47} Small local banks, in contrast, have generally had real clout in both state capitals and D.C. The populism of Andrew Jackson is admittedly distant in the past, but even today we see real echoes of it in the reaction to the recent bailouts. Tea partiers and progressive activists share a deep antipathy to the bailouts, an antipathy which was widely expressed across the political spectrum. Of course, that didn’t stop the bailouts from happening.\textsuperscript{48}

Two of the strongest proponents of the political argument against TBTF institutions, Simon Johnson and James Kwak, illustrate the past power of many smaller companies in a telling quote concerning the savings and loan debacle of the 1980s:

But at the time, the S & Ls—not the Wall Street investment banks—and their lobbying organization, the United States League of Savings

\textsuperscript{43} See JOHNSON & KWAK, supra note 1, at 64-87.
\textsuperscript{46} JOHNSON & KWAK, supra note 1, at 66-67.
\textsuperscript{47} JOHNSON & KWAK, supra note 1, at 18-22, 33.
\textsuperscript{48} That they did happen, of course, in part, reflects the political power of TBTF firms, but I also suspect it reflects the reality recognized in the economic argument: not doing the bailouts would have led to disaster.
Institutions, were a powerful political force with influence on both sides of the political aisle. Although individually small, they had a favorable public image (in a country that professes to live by small-town values), they were located in virtually every congressional district, and they benefited from the disproportionate representation of rural states in the Senate.49

It is not clear which set of effects is stronger, and thus it is not clear whether the financial industries really have more clout when they are more or less concentrated. For many areas of financial regulation, it may well not matter very much. For most regulation, the interests of large and small financial firms may be more or less the same, and it is often (though not always) the case that there will be little opposition to the financial industry position because those on the other side (generally consumers) are a very large, ill-organized group where each person has relatively weak interests. Standard public choice arguments suggest likely industry capture of regulation in such circumstances. Where opposition is weak, either the more or less concentrated version of the financial industry will be able to organize well enough to be able to impose its will.50

Brute political capture is not the only, and quite possibly not the most important, variant of the political argument against TBTF institutions. A deeper problem may be intellectual or cultural capture. A varied set of economic, political, intellectual, and cultural forces have come together to create a general mindset that private market actors are good and dynamic while regulation is generally bad and stultifying.51 Here too, though, it is not clear that the issue is TBTF institutions specifically as opposed to private market financial actors generally. Note too that while many left and right commentators may agree on the standard political capture argument, they diverge on the cultural capture argument—what leftists see as illegitimate and misguided cultural capture, conservatives will instead see as sensible intellectual advances. This again points to differing solutions to the political argument, similar to the differing solutions we saw to the economic argument.52 Strong leftists want to eliminate TBTF institutions in order to eliminate their political influence, while conservatives want to heavily limit the ability of governments to act in order to limit the ability of TBTF institutions to influence governments.

49 JOHNSON & KWAK, supra note 1, at 66-67.
50 OLSON, supra note 38; Stigler, supra note 42 and accompanying text.
51 See e.g. James Kwak, Cultural Capture and the Financial Crisis, in PREVENTING CAPTURE: SPECIAL INTEREST INFLUENCE IN REGULATION, AND HOW TO LIMIT IT (Daniel Carpenter, Steven Croley & David Moss eds., forthcoming 2011) (unpublished manuscript) (on file with author).
52 See supra text accompanying notes 16–20; see also JOHNSON & KWAK, supra note 1, at 208-13; RAJAN, supra note 2, at 168-69, 171-76; ROUBINI & MIHM, supra note 6, at 226-30; and STIGLITZ, supra note 1, at 164-68.
There is also another and deeper problem with the leftist call for regulation as a response to the political argument against TBTF institutions: it rarely offers a plausible political story for how such regulation is supposed to happen. After all, if the political argument is true, we can expect fierce opposition to strong regulation of TBTF institutions. Who will provide the political will to overcome that opposition? Anyone who wants to be more than an ineffectual Cassandra should ponder whether they have any sort of answer to that question. There is a certain naive moralism to much writing and speaking on the need for reining in TBTF institutions, as if speaking out with the right degree of self-righteous indignation should be enough to get politicians and regulators to see the light and fall in line.\textsuperscript{53}

It is true that during the height of a crisis, financial regulation may become a salient issue, and a populist attack on TBTF institutions may be popular. Fear of retribution at the polls may actually prod politicians to listen to the eloquent jeremiads of TBTF critics at such moments. But that populist moment passes quickly, and the TBTF institutions should be able to weather the storm by lobbying for vague legislation which appears to address the problem, but which can be weakened to nothing in the quiet after the storm has passed.\textsuperscript{54} Progressive opponents of TBTF institutions must identify counter-forces which are informed and patient enough to win a long war. They must be able to pass meaningful legislation during or soon after a crisis, and then translate that legislation into meaningful regulation as the economy recovers and starts to grow again, and popular attention turns elsewhere. To date, progressives do not seem to have found a winning answer within the contemporary political and regulatory system.\textsuperscript{55}

\textsuperscript{53} E.g., JOHNSON & KWAK, supra note 1, at 208-13; Paul Krugman, The CONSCIENCE OF A LIBERAL http://krugman.blogs.nytimes.com/; see also STIGLITZ, supra note 1.

\textsuperscript{54} Scott Baker & Kimberly D. Krawiec, The Penalty Default Canon, 72 GEO. WASH. L. REV. 663, 673-75 (2004); DAVID EPSTEIN & SHARYN O’HALLORAN, DELEGATING POWERS: A TRANSACTION COST POLITICS APPROACH TO POLICY MAKING UNDER SEPARATE POWERS 7-9 (1999).

\textsuperscript{55} A partial answer is the rulemaking bureaucracy. If it can be motivated to pursue rules that give real teeth to legislation, then it can extend the principles established during a brief populist reform period. But the bureaucracy itself is subject to industry capture. One can try to find ways to prod the bureaucracy to resist capture, and to continue to explore systemic problems within the financial system. Indeed, Dodd-Frank continues a number of mechanisms which may do just that. In another paper with Dan Schwarcz, I explore those mechanisms. \textit{See generally} Brett McDonnell & Daniel Schwarcz, Regulatory Contrarians, 89 N.C. L. REV. 1629 (2011). \textit{See infra} note 56.
IV. RESPONDING TO TBTF

I argue for a different sort of response from the left\textsuperscript{56} to the TBTF problem, rather than simply forbidding financial institutions above a certain size, as some recommend.\textsuperscript{57} My response has two main prongs: implementing modestly stricter regulation of TBTF institutions in the short run, and developing alternative financial, economic, and political institutions in the long run.

A. Modestly Stricter Regulation of TBTF Institutions Should Be Implemented

The first prong is modest but firm regulation. Regulation should cover all shadow banking institutions, but larger, potentially TBTF institutions should face stricter rules. All shadow banking institutions need to be covered because, as we have seen, even smaller companies can collectively cause big trouble.\textsuperscript{58} We should not prohibit overly large financial companies altogether both because of the possible advantages of bigger, more diversified companies, and also because such rules are an invitation to evasion. But stricter rules are appropriate for such companies, and they will help reduce the moral hazard problem by forcing TBTF institutions to take on less risk. Dodd-Frank already gets part of this right—TBTF institutions will face stricter rules, although much still depends upon implementing regulations.\textsuperscript{59} Prudential standards and disclosure requirements for nonbank financial companies may get stricter as companies get larger, more complex, or riskier.\textsuperscript{60} Bank holding companies that “pose a grave threat to the financial stability of the United States” may be restricted in their ability to acquire companies or offer financial products.\textsuperscript{61} Financial companies may not merge if the resulting entity

\textsuperscript{56} But I hope to appeal to some on the right as well. Hardcore libertarians would prefer less regulation combined with stronger commitments to keep the State from intervening in financial markets. I have argued against this elsewhere; laissez faire ignores the real threat to economic stability that comes from leveraged financial institutions, and there appears no good, credible way to commit to keep the government out of financial markets. See McDonnell, supra note 12. Moderate libertarians and conservatives should find much to like in Dodd-Frank. See id. The emphasis in my long-term strategy on market and social institutions outside of the State should also have some appeal for libertarians and conservatives.

\textsuperscript{57} See supra note 16 and accompanying text; see also JOHNSON & KWAK, supra note 1, at 208-13; ROUBINI & MIHM, supra note 6, at 226-30; and STIGLITZ, supra note 1, at 164-68.

\textsuperscript{58} See supra notes 24-27 and accompanying text.


\textsuperscript{60} 12 U.S.C. §§ 5325(a), 5365(a).

\textsuperscript{61} 12 U.S.C. § 5331(a).
would have liabilities exceeding ten percent of the aggregate liabilities of all financial companies. Insured depository institutions may be prevented from inter-state merger if the resulting entity would control more than ten percent of the total amount of deposits for such institutions. The Act also requires large, risky institutions to create “living wills” that will direct how to unwind them in the event of failure.

The new resolution authority of Dodd-Frank should also help address the TBTF problem. In the last crisis, regulators confronted with sick but not yet bankrupt companies faced a hard choice. They wanted to stop failures that could prevent a run, but the managers of those companies would naturally fight any interventions that punished them, even though they were often responsible for the mess. Regulators had no stick other than to let the firms fall into bankruptcy, and everyone knows they didn’t want that, ruining the credibility of that threat. With the new authority, regulators can step in to a firm that is systemically risky and take it over, throwing out the bums who got the firm into trouble if that is the right thing to do. Throwing the bums out is not only satisfying, it helps reduce the moral hazard problem—if the bums know they may well get thrown out, they have good incentive to avoid risks that may get their company into the resolution process. Title II directs the FDIC to punish the officers, shareholders, and perhaps secured creditors of firms resolved under the new authority. The Act specifies that creditors and shareholders will bear the losses of the company. Management responsible for its condition will not be retained. The Act provides for possible actions for damages, restitution, and recoupment of compensation against those responsible for the losses. The treatment of secured creditors is a more difficult question—if they stand to lose a “haircut” when a company fails, they are more likely to act as important monitors, but they are also more likely to start a run. The Act punts on this point, mandating a study on secured creditor haircuts.

The main gap in Dodd-Frank is that it does not attend to smaller shadow

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64 12 U.S.C. § 5365(d).
banking institutions. Banks of course have faced a strict regulatory regime since the New Deal. Dodd-Frank’s Title I extends similar regulation to non-bank financial institutions which pose a systemic risk to the economy. Title II extends resolution authority based on the old authority of the FDIC over banks to such risky non-bank institutions. But, the language in Title I and Title II seems to only contemplate too big (or too interdependent) firms, not smaller companies within the shadow banking world. Yet, as I argue in part II, the mistakes and failure of many smaller firms following similar strategies within a market may be just as big a danger as the failure of a TBTF firm. Dodd-Frank does not seem to recognize that—mesmerized, it would seem, by the TBTF analysis of the crisis. Indeed, as it stands, Dodd-Frank could actually make matters worse by pushing more money into the unregulated smaller shadow banks. Basic safety and soundness regulation and resolution authority need to be extended more broadly, even though the smaller firms should be less strictly regulated than the TBTF firms.

There are, though, some ideas for addressing TBTF firms, short of abolishing them, which are worth considering and not included in Dodd-Frank. The Act does not adopt the interesting and potentially valuable idea of taxing financial institutions for the degree of systemic risk to which they are exposing the economy. A well-priced tax would force firms to internalize that risk. The question, of course, is can and would regulators set the tax at a plausible estimate of the level of risk a firm is creating. Regulators already face a variant of this problem in measuring the riskiness of bank assets in setting capital requirements. They have not been spectacularly successful in solving that problem so far. The tax idea is definitely worth exploring, but even without it, differential levels of capital requirements and leverage limits based on riskiness would accomplish much the same purpose. Dodd-Frank seems to require this, but we shall see how good a job the regulators do. The obstacles are both political (TBTF institutions will fight stricter requirements, of course) and economic or conceptual (measuring the riskiness of a financial firm is truly hard).

71 See supra notes 32–37 and accompanying text.
73 See generally McDonnell, supra note 12 where I discuss this problem more.
76 See Measuring and Managing the Value of Financial Institutions: Integrating
Another idea is trying to make clear that only certain critical parts of TBTF companies will be bailed out. The UK is considering structural separation within TBTF institutions, so that certain risky activities are conducted by a legally separate entity, and only that part of the company not engaged in those activities would be saved during a crisis.\footnote{Wilmarth, \textit{supra} note 1, at 1050-51.}

So Dodd-Frank is missing some worthwhile elements, but does have many good parts, and it basically addresses the TBTF moral hazard problem pretty well. But that will do little good if later on, as memories of the crisis fade, the industry succeeds in having the laws subverted by weak rules or non-enforcement. As noted above,\footnote{See \textit{supra} notes 53–554 and accompanying text.} we, as a society, would like to design the regulatory process to help make financial regulation less procyclical and less prone to complete industry capture. Most of the time, when the economy is not in crisis, ordinary people pay little attention to financial regulation and the only parties who do pay attention, namely those within the financial industry, have undue influence in rule setting and enforcement. The public only pays attention when a crisis hits, and that is when it becomes more possible to pass strong regulation. However, given the relative ignorance and short attention span of the public, the resulting legislation is likely to be either pro-consumer on the surface but vague so that later, when things have quieted down, regulators can pass pro-industry rules,\footnote{See \textit{supra} note 543 and accompanying text.} or else the laws passed in a crisis may have real bite but be crude and often counter-productive, reflecting the ignorance and haste of legislators and the public.\footnote{See Larry E. Ribstein, \textit{Bubble Laws}, 40 Hous. L. Rev. 77, 78, 81-83 (2003).}

What we would like to have happen is for the legislature to pass pro-consumer but relatively vague laws which regulators can flesh out later, but then have the regulators really give some teeth to the rules. Better still, we would like to prod the regulators in good times to be monitoring, and responding to, emerging financial risks. To achieve that, society tries to insulate agencies from too much influence by the political process (where industry capture is a danger), and to provide systematic ways in which consumer interests and independent voices can be heard within the

\textit{External and Internal Valuations}, \textsc{Wharton Financial Risk Roundtable 2003} (May 2003), http://fic.wharton.upenn.edu/fic/0503mow.pdf. Indeed, it may be that the problem with regulation is conceptually inevitable. If regulators attempt to base capital requirements in part on the riskiness of a company's assets, they are likely to underestimate the riskiness of some assets, and the uniformity created by regulations will push all regulated companies to over-invest in those assets, increasing their risk. \textit{See also} Philip Z. Maymin & Zakhar G. Maymin, \textit{Any Regulation of Risk Increases Risk} (Sept. 7, 2011), (unpublished manuscript), \textit{available at} http://papers.ssm.com/sol3/papers.cfm?abstract_id=1587043.
rulemaking process. Notice-and-comment rulemaking, conflict of interest rules, independent agencies, consumer representatives, and Inspectors General are some of the longstanding mechanisms we use to help out.

Dodd-Frank contains a variety of new mechanisms which try to prod regulators to consider consumer interests and explore emerging financial risks even during good times. Some examples include:

- Numerous studies and reports to Congress, which at least force agencies to consider the relevant issues;
- A new Office of Financial Research;
- The new Financial Stability Oversight Council, which will bring together the leading financial regulators and force them to periodically at least discuss potential emerging risks to the financial system;
- The new Consumer Financial Protection Bureau;
- A new Investor Advisory Committee and Office of the Investor Advocate within the SEC; and
- A suggestion program for SEC employees.

These are just some of the highlights; there are a variety of other experiments within the Act. I hope that individually and collectively all this will do some good at resisting industry pressure, including pressure from TBTF institutions.

B. Alternative Financial, Economic, and Political Institutions Need to be Developed

But shoring up the regulatory bureaucracy is not enough, not by a long shot. As long as the basic political balance of forces remains as lopsided as it is now, that balance will ultimately be reflected in the rules no matter

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81 See McDonnell & Schwarcz, supra note 55, at 1670-76 where Dan Schwarcz and I explore some of these mechanisms at more length.
89 McDonnell & Schwarcz, supra note 55, at 1670-76.
how well we design our rulemaking institutions. Ultimately, we need to change the underlying balance of power, and that requires recruiting or creating economic and political institutions outside of the government which can counter the political power of TBTF financial institutions. Where can one find or create such institutions? The second prong in responding to the TBTF problem is a longer term strategy, focused on developing alternative financial institutions that are smaller and more focused on community interests. Progressives for decades have focused too much on regulation and too little on building alternative institutions. Yet ultimately the political clout of TBTF financial institutions can only be countered by alternative institutions with power of their own.

This second prong focuses mainly on the political problem that TBTF institutions pose. However, it also helps address the economic moral hazard problem. The sorts of financial institutions this prong suggests creating are likely to be not too large, and hence less subject to the TBTF moral hazard. Moreover, insofar as they behave and invest rather differently than other kinds of financial institutions, they will create a more diversified financial industry. That should help reduce the spread of contagious panics, and reduce the amount of mimicry that occurs—such mimicry can lead to all companies taking on similar risks, creating problems when that strategy goes bad for everyone.

Traditionally, the main source of power that countervailed the interest of big businesses was unions. These do still matter somewhat as demonstrated by the battle in Wisconsin over the attempts of Governor Scott Walker to neuter public employee unions. But American unions have declined precipitously in unionization rates and political power, and any hopes for a significant revival appear dim. Many factors feed this trend. In part it is a self-reinforcing loop—the political decline of unions allows employers to shape labor laws and enforcement so that they can

more easily fight unionization, which reinforces the decline of unions. In part it reflects a change in the nature of employment from manufacturing to service industries which are harder to organize. In part it reflects a change in business organization and labor markets, as workers stay at jobs for shorter and shorter periods. The trend of union decline is longstanding and extreme enough, and the variety of causes is large and deep enough, that it seems implausible to look to unions as a source for much stronger future resistance to TBTF institutions.

A very different existing source for potential support for rules containing TBTF companies is current medium size and community banks. These have an obvious interest in curbing both large TBTF banks and in imposing regulations on a variety of institutions in the shadow banking world. They also have a lot of political legitimacy, and they are spread widely throughout the country. They have much influence over many regional Federal Reserve banks. Thus, they are a rather potent political force whose interests in many ways align with an agenda of limiting the power and scope of TBTF institutions. Progressives looking for as strong a regulatory response as possible in implementing Dodd-Frank may indeed want to explore such an alliance on a variety of measures. However, small town bankers typically have a cultural outlook that may not make them supporters of strengthened regulation, even regulation that applies to competitors. And many of Dodd-Frank’s regulations do apply to all banks, including community banks—they do not like that, unsurprisingly.

Progressives thus need to consider helping to create new institutions that can support their preferred rules in the long run. These institutions need to be more attentive to the needs of consumers, employees, and communities than the institutions which currently dominate financial markets. After all, if public choice problems imply that those groups are unlikely to organize.

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95 See DANIEL H. PINK, FREE AGENT NATION: HOW AMERICA'S NEW INDEPENDENT WORKERS ARE TRANSFORMING THE WAY WE LIVE 47-54 (2001) (discussing the factors involved in the evolution of workers becoming free agents).
96 JOHNSON & KWAK, supra note 1, at 66-67; see supra note 48 and accompanying text.
over financial regulation on their own, so that financial companies will dominate the regulatory process, it will help greatly if those financial companies themselves are internally responsive to a broader set of social needs.  

Also, as noted above, diversity among financial institutions may reduce the risk of failure spreading among companies that have all taken on similar strategies and risks. Past institutional innovations, such as credit unions, mutual insurance companies, community development banks, and the Caja Laboral Popular bank at the center of the Mondragon group of cooperatives in Spain, suggest the kind of direction one could look. Indeed, some of these past innovations are part of the answer for the future as well. Updated versions more in tune with the realities of the modern economy and markets may be needed. Updates are needed because some of these older institutions have taken a beating recently. Many mutual insurance companies have demutualized. The most famous U.S. community development bank, ShoreBank in Chicago, closed in 2010. The most famous international community bank, Grameen in Bangladesh, has faced strong political controversy amid a variety of scandals. Those interested in creating or expanding alternative financial institutions more in tune with social interests will need to study these past problems as well as successes.

In addition to financial institutions, one could also look to innovations in business forms as another way to increase support for strong regulations, and also to lead to companies and markets which undertake less risky financial practices on their own and feature more diversity in investment

98 McDonnell, supra note 92.
103 See Glenn S. Daily, Reorganization Status of Mutual Life Insurance Companies, GLENNDAILY.COM (July 11, 2007), http://www.glenndaily.com/mhctable.htm (providing examples of mutual insurance companies that have demutualized).
strategies. Again there are older forms such as cooperatives and nonprofits as well as newer models of social business enterprises that could prove promising. New institutions in the financial markets and real economy companies should complement each other both politically and economically. Non-traditional companies should find it easier to get financing from non-traditional financial companies that share similar values and business models.

V. CONCLUSION

So, have I set forth a framework that is likely to lead to a solution to the economic and political problems of TBTF financial institutions? Not really, alas. The Dodd-Frank Act does present a potentially useful framework. However, that framework has some gaps—most notably, the lack of a tax on systemically risky companies. Worse, industry pressure to weaken rules and enforcement as memories of the crisis fade is already strong and appears likely to undermine most attempts to impose notably stronger rules on TBTF institutions or to punish them when they get in trouble. I like the various attempts in Dodd-Frank to push regulators in the right direction, and hope they will do some good, but fear that the pressures for complacency and capture are just too strong—the regulatory design experiments may help withstand that pressure to a limited extent, but probably only a quite limited extent.

The call for new economic institutions to provide countervailing economic and political power is at best a very long-term project. It would take quite some time to build an ecosystem of such institutions to the point where they have political power anywhere close to that of today’s big banks. There are all sorts of obstacles, economic and political, to ever succeeding in building up such new institutions. The status quo has many ways of reproducing itself.

Perhaps serious change will be possible only with a crisis more severe than the recent one. That seems right at least for large-scale political

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110 See Acharya et al., supra note 74, at 121-40 and accompanying text.
111 See supra text accompanying notes 81–898.
changes—the last set of truly major political changes in the U.S. came with the Great Depression and the New Deal. Major evolutions in economic institutions, though, may not require such a crisis. Or the most plausible path may lie somewhere in between, with a gradual growth of some alternative economic institutions, followed by a large financial crisis that then makes possible further large political and economic changes, supported by the new institutions that have slowly grown to pose an alternative to today’s financial behemoths. The last time when crisis hit in 2007-08, progressives were not ready with a menu of either legal or economic institutional change. It is unsurprising that their efforts to address the crisis on the fly, especially after Barack Obama took office, were limited and scattershot, with correspondingly limited success. Before the next crisis, (and there will be one), there is much to do to put in place an economic, political, and intellectual groundwork for creating a revised financial system to replace that of today dominated by Goldman Sachs and a few like companies.