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Too Big to Fail: End Run around a Bank Run

A startling feature of Dodd-Frank is the impression it gives that "Too Big to Fail" - otherwise known as "TBTF" - has been legislatively fixed. The impression is quite misleading. Sort of like the impression that some bank executives are Too Big to Jail! They aren't; but nobody's in jail, last time I looked.

Dodd-Frank is a beast that chomps submissively at the rancid remains of a decomposing TBTF bank.

What is TBTF anyway, but a hypothetical, counterfactual, arbitrary assemblage of somewhat dubious allegations based on the effect of a bank's failure perpetrated on the entire financial system?

The public screams, "save us from another repeat of the recent financial crisis;" politicians twist and twitch fretfully over a re-occurrence, though they have no idea really how to figure out how big is "Big;" lobbyists for the banks write the legislation that primes the TBTF bizarre spectacle of wondering what metrics to use to quantify systemically explosive financial entities; and Congressman Barney Frank, whose eponymous legislation seems to offer some solace, leaves Congress and rationalizes his decision to join the Board of Signature Bank – appearances be damned!

Maybe there is a tentative solution if we wind up in the midst of a long term financial crisis. Perhaps a proposal, suggested on Tuesday by the FDIC and the OCC, might be worth considering. The proposal would require the biggest banks to retain sufficient assets to be convertible into cash if there is a financial crisis. The tool is known as the "net stable funding ratio." This ratio requires banks to balance the use of short-term funding sources – the type of sources that come under intense pressure in a financial crisis, such disruption typified by a run on a bank – with more stable funding sources, for instance, deposits and regulatory capital tools, such as equity.

The proposal forces a bank with more than $250 billion in assets and $10 billion in foreign exposures to maintain enough easily convertible capital to allow it to cover any liquidity needs for up to a year. The FRB is also working on a liquidity proposal for banks with between $50 billion and $250 billion in total assets.

The net stable funding ratio, which is often referred to as the NSF, is really a creature of the 2008 financial crisis. As bank failures or near failures abounded, regulators felt

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that even the then-currently maintained capital levels could be in danger if there were too much reliance on the repo market and other wholesale funding sources. The big fear was that banks would not maintain enough liquid assets to withstand a run on the riskier entries on their balance sheets.

Functionally, the NSF works this way: it requires banks to measure their capital levels along with consumer and small business deposits – traditionally considered stable funding sources - against less stable funding mechanisms. Other assets, such as gold and loans, carry different risk weights in the way they count toward the ratio, based on a Basel Committee release in 2014 involving banking supervision.

So, banks are expected to carry a 100% funding ratio, which means they should be able to handle a short term run by either (A) paying out cash, or (B) quickly converting assets into cash. Hence, the FDIC, FRB, and OCC are devising their own adaptation of the Basel findings. Their NSF endeavors to be consistent with the Basel's NSF.

Wonk ON!

Now to get a bit wonkish. The proposal would rate a balance sheet's asset stability on such categories as the type of funding, including regulatory capital, long-term debt and deposits, its maturity horizon and the counterparty to the asset. Insured deposits would be given the highest stability "rating" while short term wholesale funding would be considered significantly less stable.

Assets with a maturities greater than one year would also get the highest stability rating, while funding with maturities of less than six months would get lower stability ratings, thereby causing banks to increase their liquidity provisions.

From the regulatory monitoring perspective, banks with greater than $50 billion in assets would have to report their compliance with the ratio each quarter. Banks with between $50 billion and $250 billion in assets would only have to do so at the bank holding company level. Larger banks would report at both the holding company level and at the insured depository level.

The FDIC, FRB, and OCC believe that at least 15 banks would be forced to comply with the ratio, while an additional 20 banks would be subject to the FRB's proposal for banks between $50 billion and $250 billion in assets.

Wonk OFF!

The NSF is one of two preventative maneuvers to maintain liquidity. In September 2014, the FRB and the FDIC released a Final Rule establishing the liquidity coverage ratio, which forces banks to hold enough easily convertible, high-quality liquid assets (viz., "HQLA"), examples being Treasuries and certain high-quality corporate debt and equity, in order to cover their cash needs for 30 days in case of a sudden crisis.

Think of these two liquidity ratios as the Tweedledum and Tweedledee of crisis management. From my conversations with regulators, these metrics seem to be viewed as complementing each other, affording ways to avert bank runs and financial instability in the banking system. Unfortunately, the success of the ratios comes in the actual challenge of a crisis itself. Not exactly the best time to test their viability!

Tweedledum and Tweedledee do not contradict each other. Ever. In "Alice in Wonderland," they agree to battle each other, but they don't. When they see a "monstrous crow, as black as a tar-barrel," they are so scared they forget why they're battling in the first place.

Will these ratios work to thwart a financial meltdown? I am not quite convinced that they will.

"Contrariwise," as the Tweedle brothers would say.

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And so Tweedledee declares, “Contrariwise, if it was so, it might be; and if it were so, it would be; but as it isn't, it ain't. That's logic.”

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