Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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An Alternative to Breaking Up the Banks[*]

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I recently read a plan for shoring up the stability of the U.S. banking system that could serve as an alternative to breaking up the nation's largest banks. This plan was written shortly after the Great Recession of 2007, and it has the following features:

Increase Capital — Require the nation's largest banks to double the amount of equity capital held at the start of the Great Recession of 2007, and to meet additional capital surcharges based upon risk;

Limit Contagion — Limit the amount of credit that can exist between and among the nation's largest banks;

Conduct Stress Tests and Limit Capital Distributions — Require the nation's largest banks to undergo stress tests that are at least as severe as the Great Recession of 2007 and prohibit them from making dividend payments to shareholders if they do not pass the tests;

Limit Federal Support — Prohibit the Federal Reserve from providing liquidity support to individual companies, as they did with AIG, and require the FDIC to gain the permission of Congress before it can provide support for insured depository institutions;

Develop Liquidation Plans that do not Rely Upon Federal Support — Require the nation's largest banks to develop plans to unwind all operations and activities without any support from the Federal Government, and force them to restructure if the plans are not credible;

Limit Risky Trading Activities — Place strict limits on the ability of the nation's largest banks, and any of their affiliates, to engage in proprietary trading activities or make investments in hedge funds, and establish a comprehensive examination and reporting structure to ensure compliance with the limits;

Enhance Liquidity — Impose liquidity requirements on the nation's largest banks to ensure that their balance sheets are capable of withstanding deposit runs and asset devaluations associated with economic downturns;

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Focus on Risk Management — Require the nation's largest banks to establish risk management frameworks that ensure that senior management and directors are attentive to the risks associated with the bank's activities and operations;

Reform Mortgage Underwriting — Impose underwriting standards for consumer mortgage loans made by the nation's largest banks to require the bank to evaluate a borrower's ability to repay the loan;

Control Derivative Activities — Subject the derivative activities of the nation's largest banks to margin requirements and centralized clearing; and

Protect Consumers — Subject the nation's largest banks to targeted consumer protection examinations to ensure that the products and services that they offer are not unfair, deceptive or abusive to consumers.

Does this plan sound familiar? It should. All of the features of this plan are taken from the Dodd-Frank Act, and the regulations mandated by that Act. Before we engage in an effort to break up the nation's largest banks, should we not see how this plan works?

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