

Too-Big-to-Fail Takes Another Body Blow

By Matt Taibbi



Minds are changing on Too Big to Fail. A month ago, it was just something in the air. Now, it looks like we're headed for a real legislative confrontation. And man, is the finance sector freaking.

Last week, on April 24th, Democratic Senator Sherrod Brown of Ohio and Louisiana Republican David Vitter introduced legislation called the "Terminating Bailouts for Taxpayer Fairness Act of 2013 Act," or the "Brown-Vitter TBTF Act" for short. The bill is a gun aimed directly at the head of the Too-Big-To-Fail beast.

During the Dodd-Frank negotiations a few years ago, Brown teamed up with Delaware Democrat Ted Kaufman to introduce an amendment that would have physically capped the size of the biggest banks. The amendment was bold and righteous but was slaughtered on the floor by a 61-33 margin, undermined by leaders of both parties - 27 Democrats voted against it.

Brown-Vitter offers a different and, in a way, more elegant solution to the problem than Brown-Kaufman. Rather than impose size limits, it simply insists that banks with over \$500 billion in assets maintain higher capital reserves than are currently required. Companies like J.P. Morgan Chase, Wells Fargo, Morgan Stanley, Goldman Sachs, Citigroup and Bank of America will have to keep capital reserves of about 15 percent, about twice the current amount.

The bill only has such tough requirements for just those few megabanks, which sounds unfair, except that the aim of the bill, precisely, is to level the playing field. Right now, the biggest U.S. banks enjoy a massive inherent market advantage in that they're able to borrow money far more cheaply than other banks, because everybody on earth knows the government will never let them fail and will always bail them out in a pinch, making their debt essentially U.S.-government guaranteed. Studies have shown that these banks borrow money at about 0.8 percent more cheaply than other banks, and that this implicit government subsidy is worth about \$83 billion a year just to the top 10 banks in America. This bill would essentially wipe out that hidden subsidy and make the banks bailout-proof.

As soon as Brown-Vitter was introduced, a very interesting thing happened. The Independent Community Bankers of America, or ICBA, issued a press release boosting the bill. "ICBA strongly supports this legislation," the release read, "and urges all community banks to join the association in advocating passage of legislation to end too-big-to-fail."

This was a big thing. It was the first time since the crisis that a prominent financial industry group opposed the will of the TBTF banks. I remember covering Dodd-Frank and being told by a number of members in the House and the Senate that the sentiment of many community bankers was for breaking up or at least curtailing the power of companies like Chase and Bank of America, but that the community banking lobby was not yet prepared to take that step.

But now, after the London Whale, the LIBOR scandal, the outrageous HSBC settlement and nearly five years of rapacious market-dominating behavior by these state-backed banks, the community banks have finally split off from TBTF.

This is another in a series of defections on this issue that in the past year has included many Republican politicians, numerous important financial regulators (even the New York Fed has taken a semi-stand against TBTF) and, hilariously, the creator of Too-Big-To-Fail himself, former Citigroup CEO and legendary lower-Manhattan raging asshole Sandy Weill. Weill was the man for whom the Glass-Steagall Act was repealed back in the nineties, so that his already-completed Citigroup merger could be legalized. But even he came out last year and said we have to break up the banks.

Naturally, there was going to be a response to Brown-Vitter from Wall Street. And we got it last week, shockingly not from one of the banks or a lobbying firm connected to the banks, but from the Standard and Poor's ratings agency - supposedly a strict, humorlessly conservative auditor that should always abhor risk and look favorably upon greater safety and security. The very fact that such a company came out against a bill forcing banks to have safer balance sheets is in itself absolute proof of how completely fucked and corrupt our current system is.

The S&P report, entitled "Brown-Vitter Bill: Game-Changing Regulation For U.S. Banks", is so incredibly hysterical in its tone that, reading it, one cannot help but deduce that people on Wall Street are genuinely afraid of this bill. The paper essentially hints that forcing banks to retain more capital could lead to world financial collapse, the onset of a new Ice Age, mammoths roaming Nebraska, etc. "The ratings implications of the Brown-Vitter bill, if enacted, for all U.S. banks would be neutral to negative," the report read. In the second paragraph, it reads:

If congress enacts the bill as proposed, Standard and Poor's Ratings Services would have concerns about the economic impact on banks' creditworthiness stemming from the transition to substantially higher capital requirements.

Having a ratings agency bent to monopolistic bank influence give a bad rating to a piece of legislation designed to . . . curb monopolistic bank influence is a bad surrealistic joke, like a Rene Magritte take on lobbying - Ceci n'est pas une Too-Big-To-Fail!

Remember, one of the primary causes of the financial crisis in the first place was the corruption of the independent ratings agencies. In the crisis years, companies like S&P and Moody's and Fitch were so desperate to avoid losing business from the big investment banks (who paid the ratings firms to rate products like mortgage-backed securities) that these companies often gave embarrassingly overenthusiastic grades to a generation of toxic assets.

The Financial Crisis Inquiry Commission in its final report placed blame for the crisis squarely on the shoulders of these firms. "The three credit rating agencies were key enablers of the financial meltdown. The mortgage-related securities at the heart of the crisis could not have been marketed and sold without their seal of approval," the FCIC report read. "This crisis could not have happened without the rating agencies."

So intellectually compromised ratings agencies were guilty before, because they were too quick to help Too-Big-To-Fail banks sell bad products into the world marketplace.

Now, an intellectually-compromised ratings agency is helping sell the very Too-Big-To-Fail system in an attempt to beat back a reform bill - an agency that once stated explicitly that it does not take public positions on legislation.

Years ago, Standard and Poor's was involved a similar situation. In the mid-2000s, the Senate was considering creating a regulatory body with receivership powers that could have oversight over Fannie Mae and Freddie Mac. S&P, seemingly doing the bidding of Fannie and Freddie (which wanted no part of any new regulatory oversight), warned that such legislation might lead to a downgrade of the so-called Government-Sponsored Entities, or GSEs. In other words, if you pass this bill, we're going to take a financial axe to Fannie and Freddie.

When then-Senator John Sununu asked then-S&P president Kathleen Corbet if it didn't seem to her like the ratings agency was meddling in the legislative process by issuing such a dire warning, Corbet testily replied in the negative.

"First of all, Senator," she said. "Standard & Poor's does not advocate positions on any legislation."

With that in mind, here are some of passages from S&P's new report, "Brown-Vitter Bill: Game-Changing Regulation For U.S. Banks":

If the requirements force banks to deleverage, a credit crunch could ensue and the U.S. economy might be thrown off course . . . the U.S. banking industry could become less competitive in

world financial markets . . . All in all, the bill's goal of ending TBTF could lead to unintended consequences - a destabilized financial system.

So Standard and Poor's does not advocate positions on any legislation, mind you. It just thinks the world as we know it will end if this particular bill passes.

In reality, of course, about the only things that would be "destabilized" if TBTF ended would be the compensation packages for a small group of overpaid banking executives like Jamie Dimon. Another consequence might be that ratings agencies would actually have to work for a living, and earn reputations for honesty and integrity in the market, instead of getting endless streams of free money from big banks to give sparkly AAA ratings to every half-baked security or derivative instrument their obese, Fed-fattened clients cranked out.

Some of the other arguments in the report were amazing. Standard and Poor's seemed particularly concerned about the effect such a bill would have on banks' ability to raise money, either by borrowing or by selling stock:

We see broad implications for investors in bank-funding instruments, both debt and equity. For instance, so far, bank equity investors have not been totally enthusiastic about the pace and scope of financial regulation, particularly in relation to expected returns on equity. The draft legislation is hardly making it more attractive, in our view, and the prospect of lower returns and considerable dilution is likely to turn equity investors away.

This doesn't sound like it, but it's really an extraordinary passage. The ratings agency here is admitting that banks that have the implicit support of the United States government and have virtually unlimited access to free cash from the Federal Reserve are still having trouble getting people to invest in their futures.

Rather than finding in that fact a shocking and horrific truth that desperately requires public action - that even the awesome advantages of Too-Big-To-Fail no longer outweigh the fear investors have about the big banks' opaque accounting and risk-heavy business strategies - S&P instead concludes that it's somehow worse to fix the problem than it is to allow these cancerous firms to continue to underperform under the current system.

The report goes on to talk about the consequences for such banks in a world where they would have trouble raising the needed cash. "Faced with little to no access to equity markets," S&P writes, "the largest banks would be forced into asset sales, divestitures, or would simply need to break up."

Right. That, or they could reform their compensation structures and freeze dividends during their transitions from casino operations to actual job-creating, business-supporting banks. But since paying themselves less could not possibly be contemplated, executives from the biggest banking firms probably would jump straight to mass breakups if the bill passed.

"They're basically saying, 'How do you expect bankers to keep up their extravagant lifestyles and meet these crazy safety standards?'" is how one analyst put it to me.

There are many other loony arguments in the report. It claims that by going farther than the Swiss Basel III international accords would in demanding bank safety, the U.S. would be "abandoning its seat in global banking reform," which might make the U.S. banking industry "less competitive in world financial markets." But this is exactly the opposite of the truth - by taking these bold steps, the U.S. would very much be acting as a leader in global banking reform, and the increased safety and transparency of our banking system would make our banks more competitive globally, not less.

But the craziest part of the S&P report, to me, is the conclusion. "It is tempting to assume that we would raise credit ratings because higher capital increases creditworthiness to bondholders," the agency writes. "However . . ."

Here the S&P is saying: "You might think, just because we're a ratings agency that's supposed to always think safety and security are good things, that we think increased safety and security for these banks is a good idea. However . . ."

So what's the "However"? Well, it talks about the banks having a lessened ability to lend (although they're not lending now - they're still sitting on over a trillion and a half dollars in excess reserves just in their Fed accounts!), about the growth of shadow banks, about decreased profitability of the big-six banks. But then they come to their big money-shot conclusion:

Under our methodology, we would potentially no longer factor in government support if we believed that once large banks are broken up, we would not classify these banks as having high systemic importance.

Translated into English, what they mean is: If this bill passes, these banks would no longer be Too Big To Fail. So we'd probably have to downgrade them.

Well - duh!

Not only is this an explicit admission that Dodd-Frank didn't fix the Too-Big-To-Fail issue (Wall Street has long insisted that Dodd-Frank was more than sufficient to deal with the "moral hazard" problem), it's a crazy thing to say out loud. S&P writes about having to factor out the implicit government backing of big banks as though that would be a bad thing. But if implicit government support is the only thing keeping the ratings of these companies even as high as they are now, that means they really should be rated lower, in a true free market.

And Standard and Poor's is, what - against admitting that?

It's nuts. A true capitalist auditor would be sick to the point of vomiting at having to upgrade a company based upon its sleazy co-dependent relationship with the government. This report expresses just the opposite, and shows how backwards things have gotten on Wall Street.

I've talked to a number of people on the Hill and in finance in the finance sector in the last week and they all say the same thing. The tone of reports like this S&P thing, and op-eds by other

bank-friendly critics, are more strident and desperate than we've seen previously and suggest a genuine fear that this bill may pass.

There are others who think that the bill isn't designed to pass, that it's more designed to bully the banks into supporting Dodd-Frank and/or the Basel accords, which banks spent fortunes lobbying against but are now, humorously, suddenly being hailed in the finance sector as sensible and perhaps-sufficient solutions to Wall Street's problems.

But even some of those critics admit that there are endgames here where Brown-Vitter makes it out of the Senate Banking Committee (where South Dakota Democratic chair Tim Johnson is currently seen as an obstacle to this bill passing) and goes to a vote, where of course anything might happen. The banks, after all, know that their current level of popular support outside of their cash-buttressed Beltway bubble is hovering somewhere between nuclear waste and bowel cancer. A public referendum on their continued state-sponsored existence is not in any way desirable, even if it's a longshot to pass.

"The prospect already has the industry quaking in its boots," writes Darrell Dellamaide of USA Today.

Things are getting interesting.
