Would the Volcker Rule Prevent Banks Too Big to Fail?

Morris Goldstein assesses the prospects for Congress adopting the Volcker Rule and other elements of a financial regulatory reform package.

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Steve Weisman: Congress and the Obama administration are still struggling with what to do about financial institutions deemed "too big to fail." Morris Goldstein, senior fellow at the Peterson Institute for International Economics, has studied that issue more than almost anyone and is here to bring us up to date.

Morris, thanks.

Morris Goldstein: Well thank you, Steve. It's a pleasure to be here.

Steve Weisman: Morris, everybody agrees that we should never again have institutions that are too big to fail. You have proposed several steps, but some new ones have driven up. First, there's the Volcker Rule, which the former chairman of the Fed has proposed. What is it, and is it a good idea?

Morris Goldstein: I think it is a good idea. It essentially would prohibit institutions that receive insurance for their deposits or that have access to the Federal Reserve's discount window from engaging in proprietary trading on their own account.

Steve Weisman: What is proprietary trading?

Morris Goldstein: Risky activities, trading activities, not really done for clients. So the idea is they're getting these funds more cheaply than they would otherwise, and we don't want them using that for very risky activities. Then when they make mistakes, Main Street has to pay for it.

Steve Weisman: When former Chairman Volcker advocated this a few weeks ago, he ran into some complaints that his proposal wouldn't have helped in the current crisis.

Morris Goldstein: I think it will be helpful going forward. We don't just want to look at things that were directly responsible for the crisis. We want to have a wider menu of things that are going to help prevent the next crisis, which may not be identical to this one. Also, the second important element of the Volcker Rule is explicit restrictions on [the] size of institutions. I think that's very, very important and has to be part of the menu for addressing too big to fail.

Steve Weisman: How do you do that?

Morris Goldstein: I think the best way is to limit the size of the institution's assets relative to US GDP. We now have some institutions like JPMorgan Chase, like Citigroup, that have balance sheets that are $2 trillion or so. This is enormous. So when you have a failure in an institution that large, you have a very big bill to pay. If they were considerably smaller, then if they have failures, it would be less of a problem.

Steve Weisman: Some are fighting that, not surprisingly.

Morris Goldstein: Sure. They'd like to remain big. But there really is no evidence that we get economies of scale in banking beyond the hundred billion dollars in assets—and we're way, way beyond that. I think we need to get to something smaller. We don't need to do it overnight. We could give them a reasonable amount of time to get down. But I think that would be the most direct way to confront too big to fail.

Steve Weisman: What about the argument that you need to be big to compete with international rivals?

Morris Goldstein: I don't think that really holds water. Certainly the United States' competitive position in the financial sector has not been enhanced by this crisis. If the US banks are very large and they have a big failure, that doesn't make us more competitive. And the size of institutions doesn't need to be identical across countries. Iceland, Ireland, the United Kingdom, Switzerland—they've all found out that you have big problems when you allow financial institutions to get very large relative to your GDP.

Steve Weisman: You're watching the legislation. The Senate is where the action is now, because the House passed its version sometime back. What are the other things that need to be in the Senate bill?

Morris Goldstein: The other elements that I think are necessary for confronting too big to fail are first: higher capital and liquidity requirements for the systemically important institutions. That's important so they have a bigger cushion against failure. That is in most of the bills. Mandatory wind-down plans for the same institutions that need to be approved by the regulator, so if you can't show that you can wind the institution down in an orderly way, you would have to shrink, and you would have to simplify the business plan. That is also in the bills. Third element: new resolution authority for systemically important nonbanks so that the government can intervene at an appropriate stage. We can wipe out the shareholders, we can change the management and we can give the creditors haircuts, and we can assess the financial sector for the cause of that. So if you do all those things, plus have size limits, and limits on proprietary trading, then I think you have a reasonable approach for confronting too big to fail.

Steve Weisman: One of the other elements that may not address the too big to fail issue, but that is important to some in Congress, is the consumer protection agency. It looks, according to some press reports, like they might be able to resolve differences on that, which might clear the way for these other elements to be approved.

Morris Goldstein: It may well be that we have to have a compromise on consumer protection. I think we certainly need stronger protections. This has really been an orphan mission over the past decade and consumers have been badly hurt. If we were able to get it in an independent agency and that agency were able to enforce tough regulations, I think that's the best. Second best is we have it under some other agency as an identifiable part of that with a strong director. I don't think that would be quite as good, but I would be willing to take that if it meant getting the other things, including all these elements of confronting too big to fail that we've been discussing.

Steve Weisman: It's not our job here to handicap Congress. Still, the prospects seemed very dim even a couple of weeks ago for any kind of legislation that would have any impact. Now they seem to have improved a bit. Is that your sense?

Morris Goldstein: That's my understanding. There are some reports that Senator Shelby is coming back into the negotiations. There are some reports that Senator Corker is working with Senator Dodd to come up with some kind of a compromise bill. And it doesn't have to be perfect, but it does have to have the main elements. And I worry very much that if we don't get it soon, we won't get it at all. So I hope we're going to see something within the next month or two.

Steve Weisman: It would be amazing after the kind of crisis that we've been through if they didn't get something.

Morris Goldstein: It would be amazing and very disappointing.

Steve Weisman: Morris, whatever happens, come back and give us your latest sense. Thanks.

Morris Goldstein: Thank you.