SAN DIEGO BUSINESS JOURNAL

Too Big To Fail... Five Years Later

FINANCE: Not All Agree Policy Exists or Is Needed

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Monday, November 25, 2013

As of the end of September, the nation's four largest banks held nearly $8 trillion — that's trillion with a T — in combined assets.

Looking at it another way, those assets are equivalent to about half the size of the nation's gross domestic product this year, and are greater than every nation's GDP except for the U.S. and China.

Each of the big four megabanks has grown substantially since the recession, in large part because of acquisitions of failed or failing institutions that were made with the blessing of federal regulators as the financial crisis of 2008 unfolded. That year, JPMorgan Chase & Co. acquired Bear Stearns and Washington Mutual Bank; Bank of America Corp. took over Countrywide Financial and Merrill Lynch; and Wells Fargo & Co. acquired Wachovia Bank.

Citigroup Inc. (NYSE: C), previously the largest bank in the nation, was technically insolvent in 2008 and would have collapsed were it not for a $45 billion capital infusion from the Treasury Department.

Preventing Economic Chain Reaction

Today, these banks, as well as some 20 other banks, each holding more than $100 billion in assets, aren't likely to be seized by regulators should their balance sheets erupt in a sea of red ink. That's because of the government's implicit policy — commonly called "too big to fail" — to keep them afloat, many bankers say.

Essentially, the economic theory behind the policy is that these megabanks are so large and intertwined in so many different business lines, and with each other, that a failure of one could set off a chain reaction that could devastate a still sluggish economy.

Rick Sanborn, CEO at Seacoast Commerce Bank, agreed the policy exists and that it's there for good reason.

"Unfortunately, due to the size and complexity of the largest of the large banks and how interconnected they all are, they really are too big to fail," Sanborn said. "A failure of one of them would have too much of a ripple impact across global financial systems."

The government's implicit policy of excluding the biggest banks from failing was solidified in 2008 when the federal government enacted the Troubled Asset Relief Program, or TARP, which allocated $700 billion to stabilize the financial system. Under the program, all of the biggest banks were forced to take federal money — hundreds of millions to tens of billions — whether they needed it or not. The idea was not to single out the weakest banks to take the money because that would identify them as weaker and cause a run by scared customers.

Along with the massive intervention, federal regulators arranged to have the best-capitalized banks assume the assets of failed or imperiled institutions.

Wells Fargo's Assets Doubled

Hence, when Wells Fargo Bank (NYSE: WFC) bought Wachovia Bank, it more than doubled its asset size from nearly $600 billion to more than $1.4 trillion.

The deal has worked well for Wells. In the most recent quarter, it recorded a record profit of $5.6 billion, compared with $4.8 billion for the like quarter of last year.

Brian Lee, Wells Fargo regional president for the North San Diego retail segment, said his company has made it clear on numerous occasions that no bank should be considered too big to fail.

"But if you're just looking at size and saying that large is not good, we respectfully disagree with that viewpoint," Lee said. "Banks of every size have a place."

While most agree the federal government's strategy to provide bailout funding to the banks was necessary, some say it's underscored the government's intention not to let the biggest banks fail.

"The Federal Reserve and the U.S. Treasury essentially bailed out these institutions," said Tony Cherin, professor emeritus of finance at San Diego State University. "It was sort of a Catch-22 situation. We stabilized the system with the bailout, but now the government and taxpayers are also on the hook."

New Rules Affect All

In reaction to the financial crisis and its foundation in many banks making mortgages to unqualified borrowers, Congress passed a major reform law commonly referred to as Dodd-Frank to ensure such activity would be less likely to occur.

Among the new rules that all large banks must comply with are meeting stress tests, showing how their various business units would react if the economy fell into another prolonged recession. In addition, all banks, even the smallest, had to comply with higher capital ratios that were adopted several years ago.

Many of the biggest banks say they have been increasing their capital reserves all along, as well as changing past practices that have significantly reduced the risk of future failures.

Suzanne Ryan, a spokeswoman for JPMorgan Chase (NYSE: JPM), said changes implemented in the wake of the financial crisis have resulted in a safer financial system.

"Many of the root causes have been addressed," she said. "Most off-balance sheet vehicles are gone, standards are in place to improve mortgage underwriting, leverage everywhere in the system is lower, and very few risky and exotic derivatives are being used."

Influential Banking Lobby

Cherin, a longtime director for San Diego-based USE Credit Union, said what started out as a fairly tough reform agenda has been largely watered down as a result of pressure from the powerful banking industry on elected federal officials.

"One of the biggest lobbyists in Washington is the bank lobby," he said. "They're in legislators' offices every day."

Gary Cady, CEO at San Diego's Torrey Pines Bank, said while many of the biggest banks benefited from TARP and continue growing bigger, they're also feeling more heat from regulators these days.

“Most people forget that the largest banks are the most heavily regulated and scrutinized institutions in the world,” Cady said. “There’s no free ride for these guys.”

Cady and other community bankers said despite their relatively miniscule size in comparison to megabanks, they are growing too, and do a better job when it comes to providing service to their customers. The size of these megabanks make it impossible for them to provide the same level of personal access to

decision-makers and other professionals who can help business owners better manage their enterprises, they said.

Megabanks said being big, rather than being a bad thing, provides huge advantages. Because of their size and breadth, these banks can offer a wider and deeper array of services to customers, who tell them that’s what they desire.

“Our growth, our mission today, is to do more for our customers and clients and be more meaningful to them in their lives,” said Rick Bregman, San Diego market president for Bank of America (NYSE: BAC). “The reality is that’s what our customers have asked for.”

When asked whether the megabanks enjoy an implied guarantee to pursue exotic and possibly dangerous lines of business through the too-big-to-fail policy, Bregman said he wasn’t aware of such a policy.

Nevertheless, while there is a lot of talk in Washington on how to reduce the size of megabanks, many believe that won’t happen because of the enormous influence they wield.

“It’s hard to say what will happen in the future,” Cherin said. “The banking lobby is so powerful, [the banks’ growth] will continue. I don’t see it subsiding.”