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Way Too Big To Fail

BY PETER BOONE AND SIMON JOHNSON | **November 7, 2010**

Financial reform has a terrifying loophole—and the banks found it.

There were many factors that led us to the financial crisis of 2008—dangerous derivatives, irresponsible ratings agencies, negligent regulators—but one was more important than the rest. We now know it as the "too big to fail" problem. What brought the economy to the edge of disaster wasn't only that financial institutions had made rash bets on lousy investments, but that those institutions were so massive that when their bets went bad, they threatened to take the rest of the economy down with them. That's why Washington was forced to come to the rescue with hundreds of billions of dollars in bailouts for the likes of AIG and Citigroup, and why, when Washington turned to the task of making our financial system safer, President Obama vowed, "Never again will the American taxpayer be held hostage by a bank that is too big to fail."

In late 2009, Jamie Dimon, the CEO of JP Morgan Chase, threw his weight behind what seemed like a sound solution to this problem. Congress, he argued in a *Washington Post* op-ed, should create a "resolution authority"—a government-run procedure to wind down a failing bank. The idea was to avoid a repeat of the chaos that erupted during September 2008, when government officials were forced to make the best of two awful choices. They could let a failing institution go under—but this could trigger panic throughout the financial system, as when Lehman Brothers collapsed and was hit with myriad conflicting claims from its creditors. Or, they could inject vast sums of taxpayers' money into companies that were only in dire straits because of their own recklessness. A resolution authority would, in theory, avoid both of these problems. By creating a process to shut down a failed bank, Congress would signal to bankers that they couldn't count on a bailout—deterring dangerous strategies in the first place. And if a bank did fold, the wind-down process under a resolution authority is run by a government agency under clearly specified rules. It's faster and comes with more certainty for all involved—which would prevent another Lehman mess. The Federal Deposit Insurance Corporation already effectively uses such a procedure for banks with insured retail deposits, but Dimon was suggesting that a similar process be applied to any financial institution.

The idea sounded sensible, and it had already attracted backers from across the political spectrum. Treasury Secretary Timothy Geithner supported it; his predecessor, Henry Paulson, remarked that if a resolution authority had been available in the fall of 2008, much of the damage caused by Lehman's collapse could have been averted. When the Dodd-Frank financial-reform bill finally passed in July, it created an expanded resolution authority, just as Geithner, Paulson, and Dimon had recommended.

But there was an escape clause—a rather beautiful one, if you appreciate this sort of elegance. The resolution authority does not cover global financial activities. In fact, it cannot, because no legislature, including the U.S. Congress, can pass a law that determines what will happen in another country's legal system.

This has major implications for the next time that the financial system melts down. And bankers are well aware that there will be a next time—Dimon himself told the Financial Crisis Inquiry Commission that there is a crisis "every five to seven years," which is a completely sensible assessment of how the world's credit system functions. Before the next crisis comes, however, all a bank has to do to escape the resolution authority is to grow so large that it is vital to not just the U.S. economy, but the entire international financial system. If one of these mega-banks goes under, the government will have no choice but to step in and provide full creditor protection. The resolution authority will effectively be meaningless.

When corporate executives want to protect themselves against potential hostile takeovers, they devise "poison pill" defenses—legal instruments that make it harder for outsiders to get board seats or bring pressure to bear on managers. The hole in this resolution authority is the ultimate poison pill under the new regulatory regime. Already, Dimon and other leading bankers are taking steps to make their banks bigger and more intrinsic to the world economy. It's a loophole so brilliant and so dangerous that it should take your breath away.

Jamie Dimon has long harbored ambitions to make JP Morgan a global bank. Since he took charge in 2004, the bank has sought to become the premier financier for governments, enterprises, and households all over the world—a one-stop shop for asset management and commercial and investment banking. Dimon directed top executives to seek out new opportunities abroad and formed an international network of influential advisers, including former British Prime Minister Tony Blair. In five years, JP Morgan's international profits more than tripled. By 2009, they accounted for 62 percent of the firm's total profits.

This June, Dimon returned from a two-week visit to China, India, and Russia, and announced an even more aggressive expansion. Senior executives were ordered to look beyond Western Europe—where most of JP Morgan's foreign investment banking is focused—and seek opportunities in emerging markets. In addition to Brazil, Russia, India, and China—the emerging powerhouses known as the BRIC countries—JP Morgan is looking at Southeast Asian nations, such as Vietnam and Indonesia, the

Middle East, and parts of Africa. The bank plans to triple its private banking assets in Asia over the next five years and hopes to make Asia the source of half its non-domestic business. "We are going to get the whole company behind [the international strategy]," Dimon told *The New York Times*.

If Dimon is successful, he will create a bank that is not just too big to fail, but too global to fail. There is no conspiracy here: JP Morgan is simply responding to the available incentives. This international push is terrific corporate strategy and completely legal under our reformed financial system. But it also happens to be very dangerous for the rest of us.

If you raise these concerns with people close to the administration, however, the response is invariably, *Why should we worry about Jamie Dimon? He has proven himself to be an astute risk manager*. After all, JP Morgan came through the financial crisis in better shape—both economically and politically—than nearly any other major bank.

The catch is that our financial system is vulnerable to what might be termed the "Chuck Prince problem," after the Citigroup CEO who famously remarked in July 2007, "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing."

Prince was admitting that if all your competitors are betting big on a particularly risky market or type of investment, it's almost impossible not to do the same, because your investors will judge you against your rivals. One has to be heroically disciplined to primly stand aside while everyone else is gorging themselves—and the CEOs of major financial institutions do not tend to be heroically disciplined.

The dance that caused the 2008 crisis was the subprime mortgage frenzy. The next dance will take place offshore, as big banks seek hefty profits from emerging markets. While the United States and Western Europe are still struggling to escape recession, most emerging markets are already running hot. China continues to grow by at least 8 percent per year, and India and Brazil are not far behind.

The Obama administration needs to understand that all the large U.S. banks (and many other foreign banks) have ambitions to create global giants that America cannot afford to see fail—and yet cannot afford to bail out, either. Citigroup remains as committed to its global ambitions under Vikram Pandit as it was under Prince. Recently, HSBC and Barclays announced that the heads of their aggressive investment-banking subgroups would be promoted as chief executive officers, sending a message that a new expansion is well underway. Bob Diamond, who is soon to be CEO of Barclays, has extolled the virtues of becoming gargantuan. "If you are one of the top five leading [global] players today, you're in a much more powerful strategic position than three years ago," he noted last year. He's right: According to Diamond, in 2006, the top five players accounted for 25 percent of industry revenues. By 2009, they accounted for 40 percent.

And there are signs that as these banks expand, some are pursuing hazardous strategies of the kind that led to the current recession. Even after the financial crisis, Josef Ackermann, the CEO of Deutsche Bank, has pledged to seek 25 percent returns on capital before tax as he builds his bank into a major global player. In a world where safe assets barely earn a few percent, he can only achieve such returns through significant risk-taking. When a few big banks try to squeeze out others through such methods, they force their competitors to follow them. How long can Dimon compete against more reckless rivals without joining in?

Geithner and others have argued that the U.S. resolution authority will make it easier to negotiate an international agreement providing for a cross-border resolution authority—so that if a global bank failed, a global process could be used to insulate the world economy from the fallout. Perhaps, but there is no indication that this will happen anytime in the next 20 years. Our conversations with G-20 deputies confirm this. The G-20 is the relatively new steering committee for the world's economy. Its members account for 90 percent of the world's GDP and two-thirds of its population.

The deputies are the senior officials from central banks and ministries of finance who tell their governors and ministers what is and is not feasible. None of these people want to tie their hands in the event of a financial emergency, and none would accept the prospect of an intervention by the United States or anyone else. According to the Basel Committee on Banking Supervision's Cross-Border Bank Resolution Group, which can be presumed authoritative on such matters, "There is no international insolvency framework for financial firms and a limited prospect of one being created in the near future."

Dimon and other leading bankers understand this, which makes international expansion a powerful tool. Not only will it help banks evade the resolution authority, it also ensures that regulation will be weaker. With banks doing more business in multiple countries and markets, we will be forced to rely on the capacity of national regulators around the world to ensure that their operations are in sound shape. This is why international expansion is the real action in banking today—not the small changes around the edges of companies induced by the Dodd-Frank legislation.

Fast forward five to seven years. Suppose JP Morgan is in trouble. Every day brings a grimmer headline about its balance sheet, and the perception quickly spreads that the bank is on the brink of insolvency. All over the world, in different countries and different time zones, large lenders panic, triggering a run on the bank. Hedge funds scramble to pull out their funds and move them elsewhere. JP Morgan is forced to post collateral on its transactions, draining its liquid assets. An emergency meeting is called in Washington, where officials must make a familiar choice: bailout or global meltdown? It's September 2008, or worse, all over again.

There was only one way for us to truly fix the "too big to fail" problem and that was to make the largest banks small enough and simple enough to fail. That way, if a bank made bad decisions, it would be forced to deal with the consequences without endangering everyone else. During the debate over financial reform, Senators Sherrod

Brown and Ted Kaufman proposed an amendment to the Dodd-Frank bill that would have taken a major step in this direction. But Treasury opposed this provision, and it died.

Now that we have missed that chance, any bank based in a wealthy economy such as the United States, Germany, or Japan has a strong incentive to become as massive as possible. These nations have taxpayer bases that are sufficiently large and creditworthy to bail out a global bank. And these institutions will be able to access the cheapest funding because their creditors understand that the bank's debt is as good as its sovereign government. No one would dare argue that America's largest banks are so well run that they deserve to be global leaders on merit. Right now, their essential competitive advantage is that they are backed by a government that is unable to ever let their depositors and creditors lose money should the banks flounder.

The next time a huge global bank crashes and burns, causing vast economic damage, you can blame the Chuck Princes of the world if you wish. But the real responsibility will lie with those in the Obama administration who allowed big banks to become behemoths. If the last crisis taught us anything, it was that banks fail and massive banks fail massively. And while some may have the good fortune to be run by a Jamie Dimon for a while, sooner or later they all end up in the hands of a Chuck Prince.

Peter Boone is chair of Effective Intervention, a U.K.-based charity, and a principal at Salute Capital Management Ltd. Simon Johnson is the co-author of 13 Bankers: The Wall Street Takeover and The Next Financial Meltdown, *a professor at MIT's Sloan School of Management, a senior fellow at the Peterson Institute for International Economics, and former chief economist at the International Monetary Fund. This article ran in the November 11, 2010, issue of the magazine.*

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