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CENTRAL BANKER | SUMMER 2013

Central View

On the "Too Big To Fail" Debate: Implications of the Dodd-Frank Act

By Julie L. Stackhouse

It is common knowledge that the banking industry has become increasingly consolidated over the past 25 years. In 1990, prior to a number of banking law changes, the nation housed around 12,500 charters. Today, there are roughly 6,000 charters, with consolidated assets of the top 10 U.S. banking firms representing approximately 64 percent of U.S. banking assets. The nation's largest banking firm, JPMorgan Chase & Co., alone has more than \$2.3 trillion in consolidated assets and more than 3,300 subsidiaries.

Without question, operations of these large firms magnified the financial crisis, emphasizing their systemic importance. The resulting landmark legislation—the Dodd-Frank Act—is intended to reduce systemic risk and, ultimately, end "too big to fail."

I am often asked whether the Dodd-Frank Act and its hundreds of pages of supporting regulations "will work." I think it is fair to say that it is too early to know. What is clear, however, is that the Dodd-Frank Act, the Basel III capital reforms and other planned regulation will go far to eliminate expected bailouts. This will occur in two ways: by significantly reducing the likelihood of systemic firm failures and by greatly limiting the cost to society of such failures.¹

The legislative and other requirements to reduce the likelihood of a systemic firm failure are many. They include the Dodd-Frank Act's multiple "enhanced prudential standards" and requirements for central clearing of derivatives. Capital of large banking firms is now stress-tested on a regular basis—twice a year for the largest firms—under adverse economic scenarios. All financial firms regardless of size are subject to the new Basel III capital standards, but larger firms will also be subject to the liquidity requirements contained in Basel III. (For more on Basel III, see the [online-only article](#) in this issue of *Central Banker*.)

And the list does not end there. As emphasized by Federal Reserve Gov. Daniel Tarullo in a statement on May 3, four additional rules are planned that will enhance the capital requirements for the eight U.S. financial firms identified as having global systemic importance. These include a regulatory leverage threshold above the Basel III minimum, rules regarding the amount of equity and long-term debt large firms should maintain to facilitate orderly resolution, capital surcharges for banking organizations of global systemic importance, and additional measures that will directly address risks related to short-term wholesale funding.

Beyond efforts to reduce the likelihood of failure, the Dodd-Frank Act also contains provisions to address the cost to society should a failure occur. In this regard, large banking firms are required to submit resolution plans, or "living wills," for their orderly

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resolution under the Bankruptcy Code. The Dodd-Frank Act also contains an Orderly Liquidation Authority, giving the Federal Deposit Insurance Corp. backup resolution authority. The associated single-point-of-entry concept is [discussed separately](#) in this issue of *Central Banker*. Finally, the Dodd-Frank Act forbids acquisitions by any financial firm that controls more than 10 percent of the total liabilities of financial firms in the U.S., and requires banking regulators to consider "risk to the stability of the U.S. banking or financial system" in evaluating any proposed merger or acquisition.

It would be unrealistic to conclude that the Dodd-Frank Act will end "too big to fail." Many of the supporting rules are not yet implemented, and importantly, the provisions of the Dodd-Frank Act have not been tested during a period of financial stress. Although, having said that, the safeguards in the Dodd-Frank Act have already influenced a safer banking system.

Endnotes

1. See also the speech by Federal Reserve Gov. Jerome Powell on March 4. [\[back to text\]](#)

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