Policy Memo

To: John Delaney
From: Huafeng Zhang
Re: Questions about the Fed's Policy on Increasing the Threshold for Bank Merger Assets
Date: April 19 /2017

Dear John Delaney,

This policy memo describes the background of how small but complex banks play an important role in the U.S. financial system. What the Fed did recently affects the financial system. Then I suggest a question for you to ask, and discuss what information we can learn from Chair Yellen's answers.

Background

Many people blame the Great Recession on financial institutions that had become "too big to fail." However, complexity is as important as size. Bank structures, instruments, and relationships with each other have all become more complex over the last few decades.

As a result, the failure of a relatively small financial institution that has complex activities and relationships with giant banks can lead to a financial crisis. For example, the bankruptcy of Lehman Brothers in 2008, a relatively small bank compared to the truly giant ones (see Figure 1 in the Appendix)[1] had enormous impact throughout the entire global financial system[2] and contributed to the recession of 2008, the worst financial crisis since the Great Depression.

This financial crisis resulted in an unstable economy, where both the GDP and the gross national income (GNI) growth rate became negative and yet continued to decrease, while more and more people became unemployed. Figure 2 in the Appendix shows these trends.

The Glass–Steagall legislation (1933), a response to the Great Depression, separated investment and commercial banks,[3] which helped avoid complexity in banking systems. However, this Act was repealed by the Gramm–Leach–Bliley Act (GLBA) of 1999. Some economists have argued that the GLBA' s abolishment of Glass–Steagall may well have been one of the major causes of the financial crisis in 2008.[4] In the wake of that crisis, the Dodd Frank Act was passed in 2010. However, it focuses on "too big to fail," instead of providing a balanced regulation of both size and complexity.

Recent indicators (see Figure 2) suggest that the U.S. economy has largely recovered from the recession. The GDP and GNI growth rate were 2.1% and 1.8 % respectively in 2016, and as of March, 2017, the unemployment rate was 4.5%, the lowest since the 2008 financial crisis. These numbers suggest that the current U.S. economy is stable and robust, which is leading the Fed to be less conservative in its policies.

One of those policies involves rules that regulate bank mergers. Recently, (March 16, 2017), the Fed has made it easier for small banks to merge without having to submit an application, by raising the total allowed combined assets of the banks from $25 billion to $100 billion.[5] It appears that size is the only criteria that the Fed considers in permitting smaller banks to merge.

Questions

The question below is the one that I suggest you to ask Janet Yellen first:

"About a month ago (16th March, 2017), you raised the regulatory threshold for bank mergers from $25 billion to $100 billion. The resulting banks clearly don't qualify as "too big to fail", though you might plan to raise the threshold again. However, the issue I want to focus on is complexity. As the example of the Lehman Brothers bankruptcy shows us, the failure of a smaller but relatively complex bank may have a significant impact on the financial system. It appears that your policy on mergers doesn't take into account the complexity of the financial institutions involved. So here is my question: will you take complexity into consideration when setting the regulatory threshold? If so, how will you balance size and complexity; if not, why not?"

The reasons for asking this questions include the following:

Janet Yellen's answer to this question can help us know what the Fed will do next in terms of this policy. Her explanation also gives us insight into why the Fed took the recent action, which in turn helps us to assess how risky her policy is and will be. There are two variables here: whether Yellen and the Fed take complexity into consideration, and how they balance size and complexity. Yellen can answer in one of three possible ways:

- She might tell us that she doesn't take complexity into consideration. This is risky because it can help small banks to grow into bigger banks, potentially leading to "too big to fail." Also, since she doesn't account for the complexity of small banks, she may be underestimating the risks they pose. However, her explanation can give us the means to assess how reasonable her position is.
- She may tell us that she does consider complexity, but her strategy on balancing size and complexity may not be adequate. In this case, we will know that her policy still poses potential risk to our financial system because either size or complexity might be undervalued.
- She may tell us that she does consider complexity, and she may have a good strategy for balancing it with size. In this case, we understand and feel comfortable with the policy, and can move on to other issues.

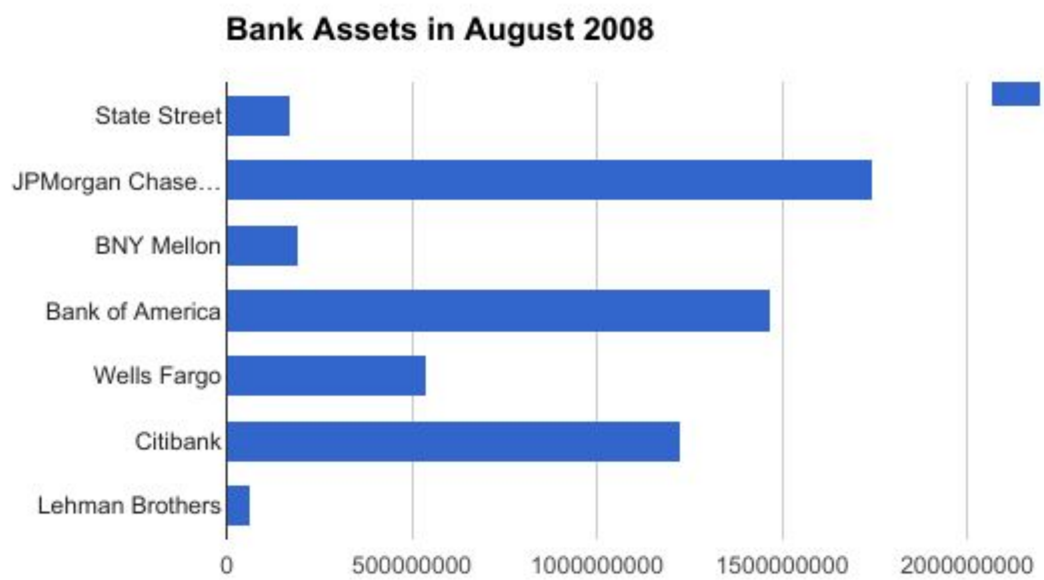
All her possible answers give us information about how risky the merger policy is, which can help you decide what to do to prevent the U.S. economy from suffering another financial crisis.

Hope this helps.

Thank you,
Huafeng Zhang

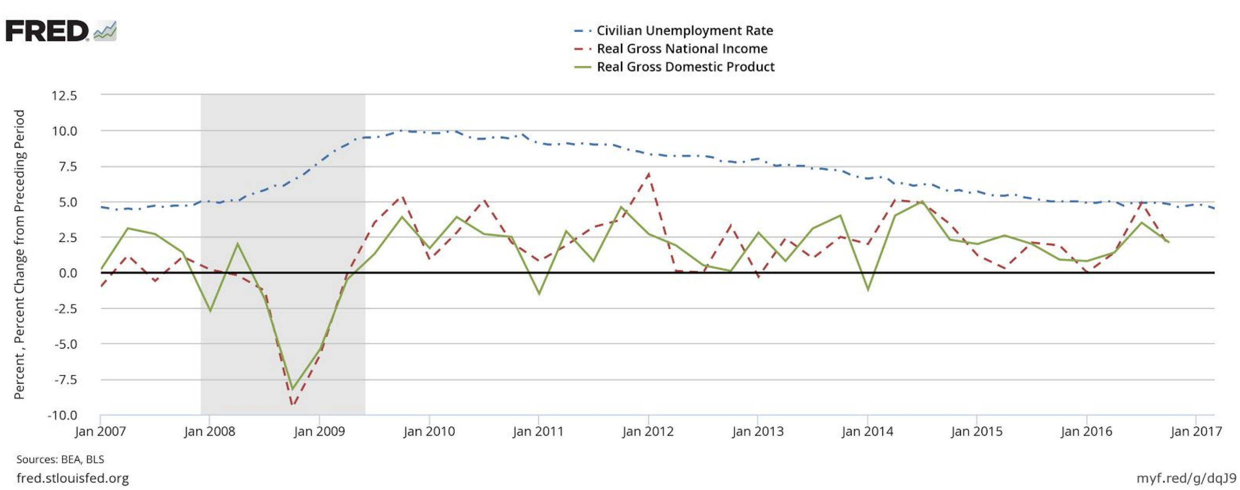
Appendix:

Figure 1



(Source:FDIC: Statistics on Depository Institutions. N.p.,Web. 20 Apr. 2017.)

Figure 2



(Source: "Federal Reserve Economic Data | FRED | St. Louis Fed." *FRED*. Federal Reserve Bank of St. Louis, 2017. Web.)

References:

[1] *FRB: FEDS Notes: Bank Complexity: Is Size Everything?* N.p., Web. 20 Apr. 2017.

[2] Adu-Gyamfi, Mike. "The Bankruptcy of Lehman Brothers: Causes, Effects and Lessons Learnt." *Journal of Insurance and Financial Management*. N.p. Web. 20 Apr. 2017.

[3] "Glass–Steagall legislation." Wikipedia. Wikimedia Foundation, 12 Apr. 2017. Web. 19 Apr. 2017. Apr. 2017.

[4] Oonagh McDonald November 16, 2016, and PDF (328.94 KB) EPUB (164.29 KB) MOBI (430.61 KB). "The Repeal of the Glass-Steagall Act: Myth and Reality." Cato Institute. N.p., 16 Nov. 2016. Web. 19 Apr. 2017.

[5] Cnbc. "The Fed just made it easier for bigger banks to merge." CNBC. CNBC, 17 Mar. 2017. Web. 19 Apr. 2017.