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Can and Will Mega Banks Be Cut Down to Size?

By

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When financial reform legislation is introduced in the Senate any day now, one of the most contentious issues in the Capitol and among observers on Wall Street will be that even after months of hearings and histrionics, even after Congress eventually passes a 1000- plus page bill, even after President Obama proclaims that Washington has given greedy bankers their strongest comeuppance in eighty years -- even after all that, we'll be left with a number of banks that are just too big to fail ,TBTF, in the current vernacular. These banks, the ten largest of which have increased their share of financial industry assets from about 25% to about 60% over the past three decades, will have advantages over smaller ones, both in terms of their ability to attract cheaper funding and their political clout. They will give the public no choice but to bail them out, because the collateral cost of their failing will be so high. They will, for practical purposes, be immune from the full sting of all the new regulations. Can anything be done at this late date to fix this problem?

Those who want to eclipse the financial and political power of the mega banks have advanced a variety of ideas: Simon Johnson from MIT advocates breaking them up into smaller banks. Paul Volcker says, at least don't let them get bigger for god sake, and at least take away some of their more risky trading activities. Sheila Baer, head of the FDIC, wants to close them down when they get in trouble, just like the FDIC does with, say, community banks. Richard Fisher, president of the Dallas Federal reserve, dreams of an international convention down the road.

The administration, Senator Dodd and the House bill deal with the problem by giving the Treasury the ability to seize a big bank, restructure it, or wind it down in an orderly way. All want to tax the banking community itself – either in advance of the event or after it – to finance this costly operation, obviating the need for taxpayer funding.

These are serious issues. If the US and other governments could establish a global banking regime in which all banks face the market discipline of being able to fail, it would be a better world, for sure. But it ain't happening.

In the first place, in the US there is no agreement as to what constitutes “too big.” Is it too big because of assets, stock market valuation, number of lines of business? Is a bank too big even if it isn't so large – Lehman, for example, was small in the overall scope of things – but nevertheless deeply interconnected to other institutions at home and abroad, as Lehman proved to be?

Those who want to shrink Wall Street institutions waive off issues of global competition. There is absolutely no chance that China, Japan or Europe will reduce the size of their mammoth banks, so the assumption of the size-busters must be that multinationals such as IBMs, Toyota, and Seimans will still stick with smaller American banks, relying on a few of them rather than just one -- or that it doesn't make much difference whether they do or not. Whatever you think of Wall Street, it would be dangerous to ignore its role in generating profits and jobs for the American economy. It would be one thing if we were still a massive manufacturing machine and the economic spin offs from financial services were not material. But neither is the case.

At the base of the TBTF problem, however, are two deeply fundamental problems.

The first is what pundits call “moral hazard” -- that is, if a bank knows it can't fail, then won't it behave in a more risky way than it otherwise would? Morgan Stanley, just to take one example, required government funds to survive. It not only did that, but it is on its way to thriving. So why would its executives draw any lesson from the financial crisis other than that there is little penalty for overly

risky behavior except for a temporary drop in stock price, a temporary loss of prestige, and a scary few months of great uncertainty?

The second issue is that Wall Street is global and regulation is national. Banks such as Goldman or JPMorgan Chase may well be gargantuan compared to the US economy, but not in the context of a global economy that is five times the size, and not in a world where the center of economic gravity is fast shifting to China and the rest of Asia, where US financial institutions are nowhere near as outsized as they are in the US. In fact the entire debate over financial reform is being held without anywhere near enough regard for the global context in which banks operate – from the fact that many earn more from outside the US than from within it, and that the most promising markets for them – and hence the arena in which they have the biggest future stake – is in emerging economies.

The problem financial reformers face is that moral hazard and globalization are at odds, unless there were an international institution that could oversee big financial institutions of all countries, and either break them up or wind them down when they get into trouble. (Although even if such an institution existed, it would still be stymied by definitional problems described above.) In the past, I have written about the eventual need for such an international financial regulatory authority, but the chances are nil that we will see one in the next few decades. Indeed, the US, Europe and Japan are right now having difficulty just agreeing on what levels of reserves banks should hold. In addition, an idea for a tax on banking to reduce risk taking is supported by London, France, Germany and Washington but opposed by Canada and Japan. China, which has three of the five biggest financial institutions in the world, isn't even part of the debate yet. So, for all the internationalization of investment and trading, governments and their regulators are acting narrowly and parochially, and there is nothing on the horizon to make us think that would change.

Bottom line: the administration and the Senate bill have advocated the best that can be done under the circumstances. It's far from perfect, but much better than nothing. To focus on the TBTF problem now would require such enormous attention that the rest of the reform effort, including a focus on derivatives and

consumer protection, could collapse. Or, it would result in such a half- baked built that the cure for current financial problems would be much worse than the disease. For now, the debate over TBTF should be put to rest.

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