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Breaking Up Big Banks: Right Question, Wrong Answer

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Should the federal government break up America's big banks? Once confined to the populist fringes of policy debate, the idea has developed surprising momentum in recent months, with a number of conservative voices jumping on the bank breakup bandwagon.[1]

Regulators will never allow the biggest banks to fail, supporters say, because of the feared effect of such a collapse on the economy. This puts taxpayers on the hook for future bailouts, and it puts competitors at a disadvantage. Cutting the large banks down to a more digestible size, according to their argument, neatly solves the problem.

The argument is temptingly simple, but it is flawed. Limiting the size of banks would do little to prevent future bailouts while doing much to damage the financial system and the U.S. economy. Too-big-to-fail policies should be ended, but a forced breakup of big banks is the wrong way to do it.

The First TBTF. The idea that a financial institution can be too big to fail dates back at least to 1984, when Continental Illinois, the nation's seventh-largest bank, became insolvent. Fearing that its failure would lead to a chain reaction of failures throughout the financial system, federal regulators bailed out the bank. The action set a precedent for federal intervention to prevent the failure of any financial institution whose collapse might threaten the stability of the financial system.

Too-big-to-fail lay dormant for the next 24 years but came back with a vengeance in 2008, as the financial crisis led to fears of failures throughout out the economy and triggered a massive set of bailouts. In all, some 925 firms received over $400 billion in bailout funds.[2]

Not Fixed by Dodd–Frank. In 2010, the Dodd–Frank financial regulation law was widely touted by its supporters as preventing future such bailouts. Purportedly, it did so in two ways. First, it established a Financial Stability Oversight Council (FSOC), consisting of the heads of each of the major financial regulatory agencies. This board was tasked with developing stringent regulations for so-called systemically important financial institutions (SIFIs).[3] Second, it created a process, essentially run by the Federal Deposit Insurance Corporation, by which large financial institutions would be quickly liquidated if they start to fail.

Few observers, however, believe the too-big-to-fail policy has actually been ended. There is a widespread assumption that, when faced with the next big financial failure, regulators will still rush to save a troubled financial institution rather than let it go under. In fact, as Peter Wallison of the American Enterprise Institute has pointed out, identifying specific firms as SIFIs actually reinforces the doctrine by signaling to the marketplace which firms policymakers consider indispensable.[4] And even the perception that regulators would provide a bailout causes marketplace harm, as it gives the protected firms an edge over their smaller and more fallible competitors.

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Big Not Always Bad. Large banking firms such as Citigroup, JP Morgan Chase, Bank of America, and Wells Fargo serve a critical role in the financial ecosystem. Operating on a global scale, they are especially important to U.S. firms operating worldwide. Large firms can also cut costs for customers domestically by spreading the costs of infrastructure, technology, and other capital expenses over a larger base. If they are broken up, the ability of these banks to provide global services would erode, while costs would rise. The ultimate losers would be American consumers and the U.S. economy.

The implicit guarantee provided by too-big-to-fail, of course, has likely contributed to the growth of these banks. But it is not clear by how much it has done so. There is no consensus among academic studies of the maximum efficient size of banks in a non-distorted marketplace, although some recent studies find that economies of scale have not been exhausted even for the biggest institutions, which manage over $1 trillion in assets.[5]

In any case, given the dynamism of the market, calculating the "correct" size would be an impossible task. Given this uncertainty, it would be reckless to impose an arbitrary size limit—whether it is $50 billion in assets, $500 billion, or $2 trillion.

Perhaps more importantly, limits on bank size would not resolve the concerns that produce the too-big-to-fail doctrine. Despite its catchy phrasing, too-big-to-fail is not purely about size. A small but highly leveraged and interconnected firm can actually present a more serious systemic risk than that of a big bank.[6]

Nor is the concern limited to banks. Non-bank financial firms can be just as systematically important as a bank. In fact, recent history suggests that non-bank institutions present the greater system-wide risk. Former Obama official Steven Rattner has pointed out that "none of the institutions that toppled like dominoes in 2008—the investment banks Bear Stearns and Lehman Brothers, the mortgage-finance giants Fannie Mae and Freddie Mac, the insurance company American International Group—were commercial banks."[7] In fact, FSOC spent much of the past two years trying to define what makes a non-bank financial firm systematically important.[8]

Simplistic proposals to cap the size of banks would be irrelevant to these concerns and therefore would do little to reduce the odds of future bailouts. It would be a feel-good measure providing few if any benefits while damaging the financial system and the U.S. economy.

Better Ways. There are far better ways to fix the system. Foremost among these is developing a mechanism by which firms can fail without causing unacceptable damage to the rest of the economy. This was the intent of the "orderly liquidation authority" created as part of the Dodd–Frank law.

This process, however, gives nearly unconstrained discretion to regulators to determine how the liquidation will take place.[9] It would be far better to employ a modified version of existing bankruptcy

1. See, for example, George F. Will, "Time to Break Up the Big Banks," *The Washington Post*, February 8, 2013.
2. Propublica.org, "Bailout Tracker," http://projects.propublica.org/bailout/ (accessed April 9, 2013). Most of the money was eventually paid back, with a few notable exceptions, including Fannie Mae and Freddie Mac.
3. Dodd–Frank designates banks with assets above $50 billion as SIFIs, but delegates the task of identifying non-bank SIFIs to FSOC.
4. Peter J. Wallison and Cornelius Hurley, "Too Big to Fail Has Become a Permanent Bailout Program," *Forbes*, June 14, 2012, http://www.forbes.com/sites/realspin/2012/08/14/too-big-to-fail-has-become-a-permanent-bailout-program/ (accessed April 9, 2013).
5. See, for example, David C. Wheelock and Paul W. Wilson, "Do Large Banks Have Lower Costs?," Federal Reserve Bank of St. Louis, October 2009, http://research.stlouisfed.org/wp/2009/2009-054.pdf (accessed April 9, 2013).
6. See David C. John, "Dodd's Bill Fails to Fix 'Too-Big-to-Fail,'" Heritage Foundation *WebMemo* No. 2881, April 26, 2010, http://www.heritage.org/research/reports/2010/04/dodd-bill-fails-to-fix-too-big-to-fail.
7. Steven Rattner, "Regulate, Don't Split Up, Huge Banks," *The New York Times*, July 31, 2012, http://www.nytimes.com/2012/08/01/opinion/sanford-weills-glass-steagall-distraction.html?_r=0 (accessed April 9, 2013).
8. Some have argued that the scope of bank activity should be limited by restoring the Glass–Steagall ban on bank ownership of securities firms, but such a step would likely *increase* risk by limiting banks' abilities to diversify risk. See James Gattuso, "Meltdowns and Myths: Did Deregulation Cause the Financial Crisis?," Heritage Foundation *WebMemo* No. 2109, October 22, 2008, http://www.heritage.org/research/reports/2008/10/meltdowns-and-myths-did-deregulation-cause-the-financial-crisis.
9. See David S. Addington, "Congress Should Promptly Repeal or Fix Unwarranted Provisions of the Dodd–Frank Act," Heritage Foundation *Backgrounder* No. 2615, October 13, 2011, http://www.heritage.org/research/reports/2011/10/congress-should-promptly-repeal-or-fix-unwarranted-provisions-of-the-dodd-frank-act.

law, with the legal protections and independent judges it provides.[10]

A Simplistic Solution. Breaking up the banks is a simple answer to a complex problem. And like many simple answers, it is the wrong one, likely to do much harm for little or no benefit. Too-big-to-fail should be ended, but breaking up banks is not the way to do it.

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10. See David C. John, "Using Bankruptcy and Capital Standards to Address Financial Institutions That Are 'Too Big to Fail,'" Heritage Foundation *Backgrounder* No. 2343, November 2, 2009, http://www.heritage.org/research/reports/2009/11/using-bankruptcy-and-capital-standards-to-address-financial-institutions-that-are-too-big-to-fail.