



Policy Note

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OBSERVATIONS ON THE PROBLEM OF “TOO BIG TO FAIL/SAVE/RESOLVE”

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The current approach to the financial crisis has been to resolve small- and medium-size banks through the Federal Deposit Insurance Corporation (FDIC), while banks that are considered too large to fail are given direct and indirect government support. Many of these large government-supported banks have been allowed to absorb smaller banks through FDIC resolution, creating even larger banks. As these banks repay their direct government support, the problem of “too big to fail” is simply aggravated. The current thrust of government regulatory reform—increased capital and liquidity requirements, and further legislation—aims to make these large banks as safe as possible or to allow dissolution through insolvency without creating system disruption.

However, there are (at least) three separate problems associated with bank size that suggest such reform may not reduce the systemic risks of large financial institutions that contributed to the current crisis.

The Brandeis Problem

Multifunctional banking leads to a conflict of interest that produces fraudulent, anticompetitive behavior. This has nothing to do with the absolute size of the institution or its interconnectedness with other institutions; rather, it has to do with inherent conflict of interest in serving the fiduciary interests of different clients. Louis D. Brandeis argued that a system that allows financial institutions

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to combine “the four distinct functions of banks (commercial banking, trust and insurance, corporate underwriting, and brokering)” (Brandeis 1914, 5–6) would not be conducive to market competition that serves the best interests of clients. He asked: “Can there be real bargaining where the same man is on both sides of the trade? The investment banker, through his controlling influence on the Board of Directors, decides that the corporation shall issue and sell the securities, decides the price at which it shall sell them, and decides that it shall sell the securities to himself” (11).

Brandeis also noted that investment bankers’ control of bank and trust company deposits was essential to their securing “large profits from promotions, under-writings and securities purchases,” which “led to a revolutionary change in the conduct of our leading banking institutions ... [and] a departure from the legitimate sphere of the banking business, which is the making of temporary loans to business concerns” (Brandeis 1914, 26). If banks no longer provide financing to the real productive sector of the economy, the basic reason is that profits are higher in capital market and trading activities allowed by multifunctional banking.

This argues in favor of limiting the scope of financial institutions, irrespective of size. Even China cannot provide walls sufficient to prevent osmosis across banking functions.

The Market Concentration Problem

Bank concentration reduces the ability of market competition to ensure efficiency in providing banking services and allocating credit. In the regulatory sphere this is an antitrust problem concerning absolute size and market control. The size of U.S. financial institutions has been limited by the precedence of state branching restrictions, the Bank Holding Company Act (1956), and limits on the deposit share of acquiring banks (10 percent) specified in the Riegle-Neal Interstate Banking and Branching Efficiency Act (1994), which, paradoxically, encouraged mergers by authorizing interstate branching. Some states still maintain (somewhat higher) deposit caps. However, exemptions to the federal deposit cap have been routinely granted during the recent crisis.

The monopoly over deposits granted by the 1933 Banking Act to insured commercial banks has led to antitrust legislation based on identifying the particular functions of a commercial bank according to their dominance over defined geographical

areas. Even before the Financial Modernization Act (1999), commercial banks’ main competitors were not one another but noninsured providers of banking services. After the 1999 Act allowed integration of diverse banking functions, it became clear that this approach, or even the idea of a confined local market, was no longer relevant. Finally, the drafters of the Bank Holding Company Act were more interested in limiting the intersection of banking and commerce than in limiting the concentration of banking functions and supporting competition. Just as banking regulations have failed to keep up with the 1999 Act, antitrust legislation is equally ill adapted to deal with these problems.¹ Resolving the issue of bank size and concentration on market competition will thus require new antitrust regulations.

This argues in favor of a revised antitrust approach to assess the appropriate size of financial institutions, but does not suggest that there is an absolute size limit.

The Interconnectedness Problem

This problem has to do with the ability of the regulatory agency to rapidly resolve an institution that is exposed to a wide range of unrelated financial institutions operating in different financial markets. There seems to be no necessary linkage between large bank size or market concentration and interconnectedness. Rather, large size has been linked to synergy in providing a variety of financial services within a single institution or holding company. Synergy and efficiency are presumed to justify large size. There is thus a clear connection between multifunctional financial institutions and interconnectedness both within and across financial institutions.

A related issue is the absence of formal resolution procedures for noninsured, nonbank financial institutions, which are excluded from the FDIC’s resolution process. On the one hand, this is just a legal restriction created by the limited access to deposit insurance, and can easily be remedied by legislation. Yet, in order for it to be effective, it would have to be coordinated across national regulatory jurisdictions, as demonstrated by the problems created by the London subsidiary of Lehman Brothers.

On the other hand, the real problem is the size of the insurance fund relative to the cost of resolving very large financial institutions. This is the result of confusing the FDIC’s role as an insurer of deposit liabilities held by the public and its role as a provider of system stability in the event of bank failure. The latter role is not appropriate to the insurance-fund role of the FDIC.

This argues in favor of limiting the scope of financial institution activities rather than seeking more efficient methods of resolution and extending them to nonbank financial institutions. The FDIC's goal should be the stability of depositors' claims, not the stability of financial institutions or the financial system.

In addition, there are a number of justifications for large bank size that also need to be evaluated:

Banks have to be large in order to service the needs of large multinational corporations. The era in which big corporations kept a special relationship with a sole investment bank came to an end in the late 1970s. A watershed was the 1979 IBM bond issue,² in which co-lead underwriters were appointed in place of IBM's "sole" investment bank (Arenson 1979). Securities and Exchange Commission Rule 415 allowing shelf registration for bond issues further eroded the relationship investment banking model and created a competitive market for investment banking and other financial services. There is no evidence that U.S. multinational firms have suffered because bank size was limited by regulatory restrictions. However, they may be hampered by a lack of choice due to bank concentration that has occurred recently. Indeed, most investment banks were of relatively small size prior to their incorporation as publicly quoted limited-liability companies.

The prohibition of fixed commissions in stock trading also created new competitors for traditional broker-dealers that produced substantial consolidation in the industry, but this was clearly independent of the capital market and financial service needs of large corporations.

Banks have to be multifunctional to meet the complex needs of large corporations. There is no evidence of synergy across financial services (see below). Nor do large global companies rely on a single bank for all their financial service needs; they often refer to local banks to gain insight and presence in local conditions. Rather, it seems more likely that banks operating globally have done so in order to expand their foreign client base and to provide services to businesses outside their local market.

Banks have to be big because they need a large capital base to provide the liquidity for successful primary issue of securities. It is true that a bought deal requires the underwriter to commit capital, but large-scale deals arranged by individual banks no longer appear to be standard practice. The IBM bond issue mentioned earlier was priced for distribution just before Paul

Volcker's "Saturday night surprise," in which he announced that the Fed would follow restrictive money supply targets until inflation was arrested. The rise in interest rates that ensued caused substantial losses to most underwriters of the issue, with the exception of one co-lead underwriter that (it was rumored) hedged its position over the weekend. If an underwriter chooses to assume risk by taking a position or guaranteeing an outcome, then it is crucial that the underwriter has the ability to hedge that risk rather than have sufficient capital to cover it. Indeed, the size and liquidity of the capital market and the cost of hedging are important, not the size of the capital that can be committed by the underwriter.

The Global Competitiveness Problem

The original Basel process was a response to the globalization of banking, as exemplified by the Herstatt bank failure in 1974 and the fact that the capital of U.S. banks was inadequate relative to the size of the bank's losses in the Latin American debt crisis of the 1980s. The process was also driven by the belief that the risks of the banks' derivatives business should be appropriately priced and their exposure reported on the banks' balance sheets. The introduction of capital standards was also motivated by the need to restore a level playing field globally. The largest distortion to competition at that time was the ability of Japanese banks (which were expanding their operations in the London market) to operate with capital standards approximately half those of European and U.S. banks. The appreciating yen exchange rate offered them another advantage (see Solomon 1995, 415).

U.S. banks had expanded into global banking after the credit crunch of 1965–66 in an attempt to escape Fed restrictions on domestic expansion. They raised deposits in the London eurodollar market and then engaged in other (U.S.-restricted) capital-market activities such as underwriting eurobonds and trading equities in London in order to avoid New York Stock Exchange regulations on block trading—what came to be known as the "London cross." Thus, banks' global expansion and their increased size were more the result of extending operations into activities forbidden by U.S. regulators than attempting to compete globally. It was never a question of U.S. banks' losing their domestic competitiveness in spite of the penetration of Japanese banks in the U.S. market. Rather, it was the competitiveness of the U.S. financial market that seems to have

been the major consideration in the 1980s,³ just as it was in last year's Treasury report on U.S. financial regulation (Department of the Treasury 2008).

But, the most important justification for large bank size is that it provides the necessary returns to equity. The most pervasive argument in support of large size is so that banks gain efficiency and produce competitive returns for shareholders. Here there are also a number of different arguments that need to be evaluated:

The Financial Modernization Act (product diversification). The argument here is that multifunctional banking diversifies risk and earnings from various activities that stabilize income. However, there is little evidence to support a low correlation between activities that produce bank holding company earnings. The recent improvement in some banks' trading activities seems to be due to increased spreads as a result of a lack of competition and the ability to substitute market funding with zero-cost funding from the Federal Reserve. (Some critics have suggested that allowing investment banks to operate as financial holding companies with access to the Fed window is the equivalent of creating government-backed hedge funds.)

The justification for multifunctional banking—that it provides synergies and thus cost savings and higher returns through the banking equivalent of supermarkets—does not seem to be borne out by institutions such as Citigroup that were created on this basis. The idea of bank-insurance companies has also gained some currency in European financial markets without providing any positive evidence of either higher returns or lower costs.

The Riegle-Neal Act (geographical diversification). The argument is that large size through branching provides geographical diversification of assets that reduces risk as well as the procyclical provision of liquidity. However, there is little evidence of low correlations of asset earnings across geographical regions, particularly in the United States. Indeed, one of the basic principles of structured mortgage assets was the presumed low correlation of house prices across geographical areas, which has clearly not been confirmed. As Hyman P. Minsky pointed out, one of the advantages of securitization was the ability to sell assets whose purchase had been restricted to local markets to a global clientele. This, of course, leads to a higher correlation across international markets and a lower ability to reduce risk through global

diversification. The most important argument against this idea is that (stock and asset) return correlations are strongly influenced by market conditions and converge toward positive unity in conditions of scarce liquidity—the precise condition under which negative correlations are supposed to provide protection.

Large size is necessary to gain the synergy from multifunctional banking. Here the argument is that banks must be sufficiently large to gain the competitive returns necessary to remunerate a capital base that is sufficiently large to meet regulatory requirements and ensure stability. Large size supports the substantial investments in information technology and research that are required to produce financial innovations such as structured securitization and to diversify globally. However, empirical evidence does not show any clear improvement in profitability resulting from either economies of scale or scope. Rather, evidence suggests banks are likely to experience scale economies up to an asset size of approximately \$1 billion, followed by diseconomies of scale thereafter (Shull and Hanweck 2001). Yet large size does seem to allow for higher leverage levels, which may temporarily increase profitability, but only at the cost of higher risk. Moreover, there appears to be no clear evidence that large size is required to produce financial innovations that lead to higher returns. Indeed, the opposite may be true.

A decomposition of multifunctional banks would be too costly and disruptive to the system. It is estimated that over \$10 billion (some estimates are as high as \$23 billion) has been spent to support the large financial institutions. This support has allowed the number of financial institutions to decline and the average size to increase without any appreciable benefits in providing financial services. While no estimates have been given of the costs of decomposing multifunctional banks, the figure would have to be in the range of \$10 billion for the argument to be credible.

Large Institutions or Large, Deep Markets

Much of the argument in favor of preserving large financial institutions appears to mistake the benefits of large institutions with the benefits of broad, deep markets. Broad markets are conducive to both liquidity and stability, yet it is normally argued that this result is achieved by having an ample number of active and competitive financial institutions. In addition,

support for a large number of financial institutions is based on the idea that a multitude of buyers and sellers with diverse opinions is necessary in order to improve market efficiency in price discovery and to provide market liquidity and stability. Large size of financial institutions, however, does not contribute to any of these outcomes.

Conclusion

Financial market reform in 1997 provided the basis for both large and multifunctional financial institutions. Clearly, that legislation has not provided for either the stability of financial markets or the implementation of what Brandeis called “the legitimate sphere” of banking.

While Brandeis suggested that large size and multifunctional banking are linked, there appears to be a basic difference between the two. Past experience suggests that multifunctional banking is the leading source of financial crisis, while large size contributes to contagion and systemic risk. This suggests that resolving large banks will not solve the problems associated with multifunctional banking. This conclusion has been reached following every financial crisis, and it should apply to the present crisis as well. It is important to recognize that past solutions may not be appropriate for present conditions. This means that it will not be sufficient to apply prior solutions, such as those proposed in the 1933 Banking Act, to reform the current financial system. Rather, the challenge is to provide solutions to the problems of multifunctional banking given the financial innovations and changes in banking practices since the beginning of deregulation in the 1970s.

Notes

1. The seminal banking antitrust case *United States v. Philadelphia National Bank* (1963) applies the Sherman Act of 1890 and the Clayton Act of 1914 to commercial banks. The Supreme Court decision established “a long-standing common law bank merger competition analysis, and introduced to the banking antitrust competitive analysis key analytical concepts such as ‘product or services market’ and ‘relevant geographical market,’ which became commonplace in the evaluation of probable competitive effects of a proposed merger. The seminal banking antitrust case contin-

ues to considerably influence the regulatory review paradigm for bank merger analysis.

“The anticompetitive test ... was designed to determine whether the proposed bank merger might lessen competition in any line of commerce in any section of the country. The Court defined ‘line of commerce’ as a cluster of products and services which banks specially provide to customers, also referred to as ‘commercial banking.’ The Court noted that ‘[i]ndividuals and corporations typically confer the bulk of their patronage on banks in their local community; they find it impractical to conduct their banking business at a distance.’ Thus, the analysis created nearly [a] half-century ago construed a section of the country, or relevant geographic market, as being the local community of the bank’s customers” (Pekarek and Huth 2008, 595).

2. It was also the year of the first forex currency swap (arranged by Salomon Brothers for IBM and the World Bank), opening the way for global credit arbitrage and laying the groundwork for off-balance-sheet exposures and a series of swaps instruments that culminated in credit default swaps. See Mayer 1997, 281 ff.
3. “If Glass-Steagall’s strictures remain unchanged, bankers say, the U.S. financial community, with its millions of jobs, could lose business to foreign financial hubs where constraints are fast disappearing... With Japan liberalizing its financial markets and Britain’s Big Bang creating new freedom to compete there, the U.S. can ill afford the rigidities of Glass-Steagall. Money is nothing if not an international commodity, and the business will go where the competition is freest” (Norton 1986).

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