Some Observations on How to Deal with 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 FDIC (Federal Deposit Insurance Corporation), while banks that are considered too large to be wound up 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 an even smaller number of even larger banks. As they repay their direct government support the problem of banks that are too big to fail is simply aggravated. The current thrust of government regulatory reform to deal with the problem aims to make these large banks as safe as possible through increased capital requirements, liquidity requirements and through the legislation that would create the means to allow their dissolution through insolvency without creating system disruption.

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

1. **The Brandeis problem.** Multifunction banking leads to a conflict of interest that produces fraudulent, anti-competitive behaviour. This has nothing to do with the absolute size of the institution, or with its interconnectedness with other institutions; it has to do with inherent conflict of interest in serving the fiduciary interests of different types of clients. Brandeis argued that a system than allowed financial institutions to combine "the four distinct functions of banks (commercial banking, trust and insurance, corporate underwriting, and brokering)" would not be conducive to market competition that would serve 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 securities, decides the price at which it shall sell them, and decides that it shall sell the securities to himself."[1]

Brandeis also noted that "control by the investment bankers of the deposits in banks and trust companies was an essential element in securing … large profits from promotions, underwritings and securities purchases," which "led to a revolutionary change in the conduct of our leading banking institutions" inducing them into "departure from the legitimate sphere of the banking business, which is the making of temporary loans to business concerns".[2] If banks no longer provide financing to the productive real sector of the economy, the basic reason is that profits are higher in capital market and trading activities allowed by multifunction banking.

[1] Louis Brandeis (1914), *Other People's Money and how Bankers use it*, New York: Frederick Stokes Company, pp. 5-6 & 11.
[2] Ibid., p. 26.

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

2. **The market concentration problem.** Bank concentration reduces the ability of market competition to ensure efficiency in the provision of banking services and the allocation of credit. In the regulatory sphere this is an anti-trust problem and as such does concern absolute size and market control. In the US the size of financial institutions had been limited by the precedence of state branching restrictions, the Bank Holding company Act, and limits on the deposit share of the acquiring banks (10 per cent) specified in the 1994 Riegle-Neal Act, which paradoxically encouraged mergers by authorizing interstate branching. Some states still maintain their own deposit caps, usually somewhat higher. However, in the recent crisis exemptions to the Federal deposit cap have been routinely granted.

However, the monopoly over deposits granted to insured commercial banks by the 1933 Banking Act led to anti-trust legislation that relies on identifying the particular functions of a commercial bank according to their dominance over a defined geographical area. Even before the 1999 Financial Modernisation Act, commercial banks' main competitors were not other commercial banks, but non-insured providers of banking services. After the 1999 Act, the approach clearly is no longer relevant. Equally, after the generalization of branching, the idea of a confined local market also has little relevance. Finally, the Bank Holding Company Act was more interested in limiting the intersection of banking and commerce than in limiting concentration and supporting competition. Just as banking regulations have failed to keep up with the 1999 Act, anti-trust legislation is equally ill-adapted to dealing with these problems.[3] Resolving the problem of bank size and concentration on market competition will thus require a new anti-trust regulation.

This argues in favour of a revised anti-trust approach to financial institutions to assess appropriate size, but does not suggest that a limit on absolute size is appropriate.

3. **The interconnectedness problem.** This has to do with the ability of the regulatory agency to rapidly resolve an institution that has exposure to a wide range of unrelated financial institutions

[3] 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 continues 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 half-century ago construed a section of the country, or relevant geographic market, as being the local community of the bank's customers. See, Edward Pekarek and Michela Huth (2008) "Bank Merger Reform Takes an Extended Philadelphia National Bank Holiday", *Fordham Journal of Corporate and Financial Law*, Vol. 13, p. 595.

operating in different financial markets. There seems to be no necessary linkage between large size or market concentration and interconnectedness. Rather, large size has been linked to synergy in the provision of 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 the existence of interconnectedness both within and across financial institutions.

An associated problem is the limitation on FDIC resolution procedures to non-insured, non-bank financial institutions. On the one hand, this is just a legal restriction created by the limited access to deposit insurance and can be easily remedied by legislation. On the other, the real problem is the size of the insurance fund relative to the costs of resolving very large financial institutions. This problem is the result of confusion between the role of the FDIC as the insurer of the deposit liabilities held by the public, and its role in providing system stability in the presence of bank failure. This latter role is not appropriate to the insurance fund role of the FDIC.

This argues in favour of limiting the scope of activities of financial institutions, rather than seeking more efficient methods of resolution and extending them to non-bank financial institutions. The FDIC's role should be the stability of depositors' claims, not of financial institutions or the financial system.

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

1. **Banks have to be large in order to service the needs of large multinational corporations.** It is some time since a corporation kept a special relationship with a bank. The introduction of shelf registration broke the relationship banking model and created a competitive market for investment banking and other financial services. There is no evidence that US multinational firms have suffered because bank size was limited by regulatory restrictions. However, they currently may be hampered by a lack of choice due to the concentration that has recently occurred.

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 services needs of large corporations.

2. **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 services needs. They often also 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 client base and to provide services to businesses outside their local market.

3. **Banks have to be big because they need a large capital base to provide the liquidity required for a successful primary issue of securities to raise capital for firms**. It is true that a

bought deal requires the underwriter to commit capital, but it is a long time since there have been large scale bought deals, and when they did occur the underwriter usually engaged in full hedging. The classic example was the IBM issue hedged by Salomon as Volcker was shifting monetary policy in his Saturday night surprise. It is the ability to lay off the risk, not to have capital to cover it that is important. Finally, it is the size and liquidity of the capital market that is important, not the size of the underwriter that is of importance.

4. **Global Competitiveness problem.** The original Basel process was in part a response to the expansion of Japanese banks into the London Eurodollar market on the basis of extremely low capital ratios. US banks initially expanded into global banking after the credit crunch of 1965-66 in an attempt to escape Fed restrictions on their domestic expansion. They raising deposits in the London Eurodollar market, and then engaged in other capital market activities that were restricted in the US such as underwriting Eurobonds and executing block equity trading in London to avoid New York Stock Exchange regulation 390 through what came to be known as the "London cross". Thus, banks' global expansion and the increased size that accompanied global activity was more the result of the attempt to extend operations into activities forbidden by US regulations than an attempt to gain size sufficient to compete globally. It was not size sufficient to compete in global markets, but rather the drive to escape regulatory restrictions in the US market that provided the driving force. Indeed, given existing US regulations there was never a question of losing competitiveness in the US market.

But, the most Important Justification for Large Size is that it provides necessary returns.

The most pervasive argument in support of large size is that banks need to be large to gain efficiency and to produce competitive returns to shareholders. Here there are also a number of different arguments that need to be distinguished.

1. **Financial Modernization Act (product diversification)**. The argument here is that multifunction banking provides a diversification of risk and earnings from various activities that stabilizes income. However, there is little evidence to suggest that there is a low correlation between different activities that produce bank holding company earnings. The recent improvement in some banks' trading activities seems to have been due to increased spreads due to lack of competitive pressures in these markets and the ability to substitute market funding with zero-cost funding from the Federal Reserve. Some 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 multifunction banking that it provide synergies and thus cost savings and higher returns through banking supermarkets does not seem to have been borne out by the experience of institutions such as Citigroup that were created on the basis of this idea. This idea of Bank-insurance companies has also gained some currency in European financial markets, without any positive evidence of either higher returns or lower costs.

2. **Riegle-Neal (geographical diversification)**. This argument relates to the impact that large size through branching has in providing geographical diversification of assets that should reduce risk as well as the procyclical provision of liquidity to the system. However, there is also little evidence of low correlations of asset earnings across geographical regions, at least within the US, and this has been declining with the US becoming more integrated. Indeed, one of the basic principles of structured mortgage assets was the presumed low correlation of house prices across geographical areas of the US. Indeed, as Minsky pointed out, one of the advantages of securitization was the ability to sell assets that had been restricted to local markets to a global clientele. This, of course, leads to an increase in correlation across international markets and a reduction in the ability of global diversification to reduce risks. However, the most important argument against this idea is that estimates of return correlations suggest that they are strongly influenced by market conditions, converging towards positive unity in conditions of scarce liquidity which is precisely the condition in which negative correlations are supposed to provide protection.

3. **Finally, large size is necessary to gain the synergy from multifunction banking.** Here the argument is that banks must be of sufficiently large to gain the competitive returns that are necessary to remunerate the capital required to meet regulatory requirements and ensure stability. Large size is necessary to support the substantial investments in information technology and research required to produce financial innovations such as structured securitization that allows for global diversification. However, empirical evidence does not show any clear improvement in profitability resulting from either economies of scale or of scope. Empirical research suggests that banks are likely to experience scale economies up to an asset size of around $1 billion, and that diseconomies become prevalent after that level. However, large size does seem to allow for higher leverage levels, which may provide temporary increases in 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, just the opposite may be the case.

4. An additional argument is that a **decomposition of multifunctional banks would be too costly and disruptive to the system**. Yet, it is estimated that over $10 billion (some estimates place the total support at $23 billion) has been spent to support the large financial institutions that operate in the current system. And this has allowed the number of financial institutions to decline, while allowing the average size of financial institutions to increase without any appreciable benefits to the provision of financial services.[4]

Large Institutions or Large, Deep Markets

Much of the argument in favour of preserving large institutions appears to mistake the benefits of large institutions with the benefits of large, deep financial markets. Large markets are conducive

[4] For a more detailed treatment see, Bernard Shull and Gerald A. Hanweck (2001) *Bank Mergers in a Deregulated Environment: Promise and Peril*, Westport, Connecticut: Quorum Books.

to both liquidity and stability, yet it is normally argued that this is achieved by a large number of active, competitive financial institutions. In addition, support for a large number of financial institutions is based on the idea that a large number of buyers and sellers with diverse opinions are necessary not only to the efficiency of the market function of price discovery, but also to the provision of market liquidity. Large size of financial institutions contributes neither to market efficiency in price discovery nor to market stability.

Conclusions

The 1997 financial market reform provided the basis for both large financial institutions and multifunction financial institutions. That legislation clearly has not provided for either the stability of financial markets or the implementation of what Brandeis called "the legitimate sphere" of banking.

While, as Brandeis suggested, large size and multifunction banking appear to be linked, there appears to be basic differences. The experience of the recent financial crisis, as well as those of the past, suggest that it is multifunction banking that is at the source of the crises, and the accompanying large size contributes to contagion and system risk. This suggests that dealing with the efficient and rapid resolution of large banks will not solve the problems associated with multifunction banking. This has been the conclusion reached after every financial crisis in the past. It should also be the conclusion of the present one. But it is important to recognize that in the past, the solutions have always been appropriate to the then prevailing conditions. This means that it is not sufficient to argue that the problems related to multifunction banking can be resolved by a return to prior solutions such as those proposed in the 1933 Banking Act. The challenge is to provide a solution to the problems raised by multifunction banking, given the financial innovations and the financial practices of the 21st century.