Chapter 8[*]

Is Breaking Up the Big Financial Companies a Good Idea?

The Current Proposals

Neither the legislation that has been proposed in the House nor the Senate calls for a breakup of today's massive, complex financial conglomerates as a way to reduce the likelihood of future financial crises. Both pieces of legislation, however, do call for standards that prohibit any "financial holding company from having credit exposure to any unaffiliated company that exceeds 25% of the identified financial holding company's capital stock and surplus or such lower amount as the Board may determine by regulation."[†] In fact, this would have done nothing to prevent the recent financial crisis.

The House bill goes further and states that "to mitigate the risks to United States financial stability and the United States economy posed by financial activities and practices" the Federal Reserve Board "shall recommend prudential standards that include prescribing the conduct of the activity or practice in specific ways (such as by limiting its scope, or applying particular capital or risk-management requirements to the conduct of the activity) or prohibiting the activity or practice altogether."[‡] This presumably involves carving out, into independent firms, specific risky activities that could cause systemically important financial conglomerates to fail – simply put, no more casinos inside public utilities.

The House bill also proposes that if, even after new prudential standards have been implemented, a financial firm is deemed to represent a threat to the system, activities that constitute the source of that threat could be terminated or carved out or sold to separate unaffiliated financial firms. Specifically, some of these activities include the following: terminating one or more activities; imposing conditions on the manner in which a financial holding company subject to stricter standards conducts one or more activities; limiting the ability to merge with, acquire, consolidate with, or otherwise become affiliated with another company; and; and restricting the ability to offer a financial product or products.[§] This part of the bill includes two qualifiers. The first allows for judicial review of the regulator's decision. The second requires that any decision made by the regulator must take into account the international competitiveness of the United States financial services industry in the context of comparable regulatory developments taking place elsewhere. We assess this section of the bill as recommending a breakup based on *activities* of financial firms, but there is a big loophole. The bill leaves wide open the likelihood that firms can lobby successfully against any interference on the grounds that it affects their competitiveness.

Paul Volcker, the highly respected former Fed Chairman, has also urged that the scope of any implicit federal guarantee be limited to a relatively small number of important banking

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[†] H.R. 4173, Sec. 1104. Senate bill, Sec. 112.
[‡] H.R. 4173, Sec. 1107. Senate bill, Sec. 119, includes similar language.
[§] H.R. 4173, Sec. 1105.

institutions, rather than extended across the spectrum of financial intermediaries. In exchange for the banking safety net, Volcker would recommend banks be allowed to engage in the full range of commercial and investment banking functions but not be permitted to engage in such nonbanking activities as proprietary trading, principal investing, commodity speculation, and hedge fund management.[*] These other activities would be spun off to asset management firms and would be subject to whatever regulation is necessary for those types of institutions. The surviving banks would have no economic interest in the spun-off entities.

Perhaps, in response to this suggestion, the House bill also calls for a potential curb in proprietary trading – defined as the trading of stocks, bonds, options, commodities, derivatives, or other financial instruments with the company's own money and for the company's own account.[†] These restrictions would be placed on systemically important firms, and only if the proprietary trading activity was determined to be a "foreseeable threat" to the soundness of the firm and not being used for either market making or hedging risk. Of some note, the bill calls for the financial regulatory agencies to issue regulations to carry out this particular section of the bill.

The only mention of an outright breakup of any financial institutions comes through an amendment to the Senate legislation. Senator Bernard Sanders (I-VT) has proposed the notion of "Too Big to Fail, Too Big to Exist Act." Under the Sanders amendment, the Secretary of Treasury must submit within three months of enactment a list of too-big-to-fail financial companies, and then within a year, "the Secretary of the Treasury shall break up entities included on the Too Big to Fail List, so that their failure would no longer cause a catastrophic effect on the United States or global economy without a taxpayer bailout."[‡] Our reading is that the Sanders Sanders amendment recommends a breakup based on the *size* of financial firms.

In terms of international activity so far, the Group of Twenty (G20), Bank of England (BoE), Financial Services Authority (FSA), European Central Bank (ECB), Bank for International Settlements (BIS), Financial Stability Board (FSB), International Monetary Fund (IMF), Organization for Economic Cooperation and Development (OECD), and European Commission (EU) have considered the regulatory options and the need for international coordination, but given the universal banking traditions in most other countries, there is little appetite for reductions in the scope of systemic financial firms. The one exception is the EU Commissioner for Competition, who is mandating carve-outs by bailed-out financial conglomerates (the Dutch bank, ING, being a case in point) in order to restore a more competitive playing field – in contrast to the Antitrust Division of the U.S. Department of Justice, which has been conspicuously silent on the issue.

[*] We would generally add to this list the asset management business. Because of the fee structure in that business, financial institutions own a claim on the underlying assets, making the economics of asset management essentially equivalent to that of principal investing.
[†] H.R. 4173, Sec 1116.
[‡] Sec 3. Breaking up too-big-to-fail institutions.

Evaluation of Current Proposals

Although it is not very specific, the Sanders amendment essentially calls for breaking up large financial institutions into smaller ones, as they would pose less of a threat to the financial system. This may help may solve the too-big-to-fail problem, but it also carries with it potential costs and unintended consequences.* We do not know enough about the optimal size of a financial institution conducting a multitude of activities in our contemporary global financial system. But it does seem that certain activities, like dealer functions and intermediation between large institutions, require a high degree of interconnectedness and scale for firms to compete effectively and reduce risks by diversifying them across a number of counterparties. So blanket size constraints are likely to involve substantial efficiency losses.

The House bill section with respect to proprietary trading is similar to the Volcker proposal, and in our opinion, is more reasonable, calling for a curtailing of certain activities of systemically important financial conglomerates. The supporting argument is mainly as follows. Academic research has found few credible economies of scope, if any, that argue persuasively for investment management (either internal or external funds) to be located inside a financial conglomerate. But there are systemic costs when one activity's failure endangers performance of the other. And a key disadvantage of such combinations from a societal standpoint is the low cost of funding given government guarantees enabling these institutions to take on risky activities that would be unprofitable in the absence of these guarantees.

Hence, from the economic standpoint of addressing excessive systemic risk, we find the approach of limiting government guarantees to core banking activities to be sound. This approach is akin to that of the 1930s, but adapted to the modern financial activities.

In particular, we do *not* favor breaking up of the large, complex financial institutions simply based on size restrictions. We do, however, support some such breaking up based on activities. There are two alternatives here.

- One is to require a complete separation of proprietary trading and asset management business – activities that facilitate high-powered and opaque risk-taking and are also highly cyclical – from commercial banking operations, which have access to government-guaranteed deposits and which lend to the real economy. This approach assesses costs of *any* commingling of these activities as harmful.
- The second is to charge premiums that are commensurate with the systemic risk contributions of different activities – proprietary trading and asset management are likely to face higher premiums – and then let financial firms break up organically if they find it profitable to do so.† This approach assesses assesses that commingling of different activities may be socially desirable for

* Suppose a large bank gets broken up into ten identical smaller banks. It is not clear that the systemic risk of the former conglomerate, and thus the de facto government guarantee, would not carry over in some way to the collection of surviving firms.

† See Chapter 6, "Taxing Too-Big-to-Fail Institutions."

at least some firms but not for others, and faced with higher premiums for riskier activities, the latter group (or its subset) may carve out these activities.

While the commingling of commercial banking with investment banking activities such as underwriting and market making dealer activities was ruled out in the 1930s, such commingling did not contribute to the current crisis. Our recommendation is thus short of “narrow” commercial banking (which would also be stripped of any investment banking activity), but regulators should prudentially observe, and wherever possible, keep under check, likely spillovers from investment banking to the payment system and real lending.

It should be noted that even under our proposals, some systemic risk would likely remain in the system. Along with commercial banking activities, restructured and slimmed-down banking institutions (or hedge funds) will continue to perform normal market- and client-oriented transactions, such as trading in foreign exchange, fixed-income and derivatives, as well as services like bridge financing, prime brokerage, and the like. As such, some of these institutions may need to be subject to conventional micro- and macro-prudential regulation. The key benefit is that their business models would be far simpler and their accounts far more transparent than those of today’s systemic financial conglomerates. This, in turn, would give equally specialized regulators a better shot at understanding and containing the risks that need taxpayer bailouts, and perhaps most importantly, firms’ ability to abuse government guarantees intended for one activity by supporting riskier ones would be limited. Each way, the endemic problem of government guarantees’ compromising market discipline and engendering future crises will have been alleviated.