NATIONAL REVIEW ONLINE

MAY 15, 2012 4:00 A.M.

Once Again, Break Up the Banks

J. P. Morgan's loss reminds us that we shouldn't have to worry about such a big bank.

By Arnold Kling

Et tu, Jamie Dimon? The embarrassing announcement of a large trading loss at J. P. Morgan has brought the issue of bank regulation back to the fore.

J. P. Morgan's announcement was particularly shocking because Morgan was one of the few banks to emerge from the financial crisis with its reputation intact, or even enhanced. In *Fool's Gold*, Gillian Tett's narrative of the financial crisis, she singled out J. P. Morgan and its CEO for praise. Supposedly, although Morgan traders had invented some of the synthetic credit instruments that were at the center of the financial crisis, the bank had behaved more conservatively than its competitors, and Dimon appreciated risk better.

Last Thursday, however, it was Dimon who had to announce one of Wall Street's biggest losses in years, a $2 billion trading write-down. Based on the public record, I can't exactly piece together how the loss took place. The losses reportedly were incurred on credit-default swaps owned by J. P. Morgan's chief investment office, which undertakes hedging. I remember in 1986 Freddie Mac suffered an embarrassing loss incurred by the unit that was hedging its multifamily-mortgage commitments. It turned out that the trader was using his judgment about when to hedge: When he thought interest rates were going up, he hedged; and when he didn't, he didn't. What this strategy amounted to was speculation, that is, making bets on positions to which the bank didn't already have exposure — the opposite of hedging. I assume that something similar took place at Morgan: If they were truly hedging, then the loss on their trades would have been offset by a gain somewhere else in their portfolio.

In Washington, the trading loss at Morgan could lead to several possible reactions.

First, policymakers could ignore the loss. It was big enough to hurt Morgan's profits, but not big enough to put the bank in jeopardy. However, this does not guarantee that we will never see a larger loss at Morgan, one large enough to threaten the bank's solvency, or a devastating loss at some other large bank.

Second, policymakers could claim that as Dodd-Frank is fully implemented, regulators will devise means to make it impossible for large banks to fail. This requires confidence in regulators' having God-like powers to perceive everything from the big picture in financial markets down to the details of how banking units operate. All that would be needed in order to make this work is regulators who know more about banking than Jamie Dimon — who might be rather difficult to find.

Third, policymakers could renew the cry for the "Volcker Rule," which would prohibit banks from engaging in speculation. The problem here is that the line between speculative activities and "real banking" is often clear only in retrospect. For example, nobody would have said that the mortgage-lending activity of savings-and-loans in the mid-1970s was speculation, but they suffered large losses when interest rates soared. In words often attributed to Warren Buffett, you find out who is swimming naked when the tide goes out.

A final option is to concede that there is no foolproof way to regulate banks. Modern finance is complex and fast-paced. Try as we might, it is impossible to outlaw errors in judgment, overconfidence, misguided innovation, or unforeseen events.

I believe that our best hope lies somewhere other than making our largest financialinstitutions impossible to break. Instead, I think we need to make our financial system easy to fix. It was with that idea in mind that, writing in NATIONAL REVIEW two years ago, I proposed breaking up the big banks. J. P. Morgan's announced loss serves to reinforce my view.

My biggest objection to large financial institutions continues to be what I see as the inevitable collusion of politics and economics that results. When large banks

have resources, politicians will be tempted to treat them as piñatas, taking whacks at them in order to extract money to distribute to constituents (see the recent "foreclosure settlement," or the pressure being placed on Freddie Mac and Fannie Mae to write down principal on loans). When large banks get in trouble, politicians will be tempted to bail them out.

In my view, we do not need the thousands of pages of regulation represented by Dodd-Frank. We do not need to ask regulators to divine the difference between speculation and "real banking," as envisioned by the Volcker Rule. Instead, we should seek limits on the asset size of individual banks. J. P. Morgan today is about ten times as large as any bank ought to be. The general public should not have to lose sleep worrying about this or any other individual bank's fate, and with smaller banks, they wouldn't have to.

— Arnold Kling is an adjunct scholar with the Cato Institute and a member of the Financial Markets Working Group of the Mercatus Center at George Mason University. He is the author of Unchecked and Unbalanced: How the Discrepancy Between Knowledge and Power Caused the Financial Crisis and Threatens Democracy.