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Robert Feinberg: Milken Institute Debates Big Bank Break Ups

By Robert Feinberg - Tuesday, 16 Oct 2012 11:19 AM

The Milken Institute's Center for Financial Markets, whose aim is "to make markets more efficient and stable, broadening access to capital," sponsored a debate Monday on the hot topic of whether, how and why the biggest banks should be broken up. Some industry leaders and commentators have suggested breaking them up, while others have warned of dire consequences if this course is adopted. If this debate had occurred a day later, no doubt there would have been comment on the shakeup at Citigroup, probably to the effect that this shows that boards of directors can take effective action to change the direction of a major bank when it is needed.

The debate was framed as a question of protecting taxpayers from the risk posed by the fact that the five largest banks hold more than 50 percent of the assets in the industry, which poses systemic risk to the global economy. Those who disagree argue that markets should determine the appropriate size of banks so as to promote efficient global capital markets and the competitiveness of U.S. banks. Participants in the debate were Harvey Rosenblum, director of research at the Federal Reserve Bank of Dallas; Simon Johnson, professor of global economics and management at MIT; Peter Wallison, Arthur F. Burns Fellow in Financial Policy Studies at the American Enterprise Institute; and Phillip Swagel, senior fellow at the Milken Institute.

Rosenblum and Johnson acted as a team supporting the proposition that banks should be broken up, while Swagel and Wallison argued that this is not necessary and could have adverse consequences for the economy. Rosenblum has co-authored articles in the Dallas Fed Bulletin and on newspaper op-ed pages with his boss, Dallas Fed President Richard Fisher, calling for urgent action to break up the largest banks in order to avert a financial crisis even worse than the one in 2008. Fisher made the case in a presentation last week at the CATO Institute; however, Rosenblum backed off a bit in response to criticism, saying he was misunderstood and that his actual proposal is that the boards of directors of the largest banks should restructure them in order to maximize value to shareholders. Coincidentally, Rosenblum used the same figure I have been using as an estimate of the exposure posed by the “too big to fail” banks: $10 trillion to $20 trillion. This is admittedly quite a wide range and one that approximates the total gross domestic product of the United States.

Swagel responded that the costs of breaking up the largest banks or capping their size would outweigh the benefits. He stated there are better ways to deal with this issue by taking steps before the next crisis to strengthen capital and liquidity standards and, after the next event, by implementing orderly liquidation authority to administer haircuts to investors and secured creditors. Swagel also contended that the economy benefits by having financial institutions of the size and scope of the largest banks, and if U.S. banks were downsized, the business would go to shadow banks and foreign banks, perhaps in Canada, which he suggested could turn out to be less safe and less advantageous to the United States than the current arrangements. He also cited the institution of premium charges for the largest banks on their non-deposit liabilities, even though these are not insured, as a way of mitigating the risk the largest banks pose.

Johnson asked, “How big is JPMorgan really?” He pointed to rankings showing the bank between 5th and 10th worldwide, as measured by Generally Accepted Accounting Principles accounting, at $2.2 trillion, according to the annual report. But under International Financial Reporting Standards, which doesn’t permit generous netting of the huge derivatives book, it is almost $4 trillion and “the largest bank in the world by a long way.” He challenged the notion that orderly liquidation could work, given that promised cross-border implementation arrangements have never been adopted, and nothing is likely ever to be done to put them in place. So Johnson challenged anyone to admit being in favor of subsidizing the largest banks, backed by the Treasury and Fed, so these banks can enjoy a funding advantage of about 50 basis points to engage in excessive risk taking. He concluded that JPMorgan and Goldman Sachs should be taken down to a size of $250 billion, which would still be large enough to enable them to be world-beaters.

Wallison’s first argument against breaking up the biggest banks was that it would cost thousands of jobs. Furthermore, U.S. companies would have to make new banking relationships, and lines of credit would have to be renegotiated or terminated. He then questioned whether even if the biggest banks were pushed down to the $250 billion range, as Johnson proposed, they would not still be too big to fail. He concluded that just because these banks enjoy certain advantages, that is no reason for the government arbitrarily to break them up. In later remarks, Wallison repeated his argument as a member of the Financial Crisis Inquiry Commission that it was the bursting of the housing bubble and not weakness in the banking industry that caused the crisis of 2008.

Participants agreed that the issues debated in this forum need further discussion, and the Milken Institute has plans to conduct more events on this topic.

Robert Feinberg served on the staff of the House Banking Committee for 10 years that encompassed the savings-and-loan debacle and the beginning of its migration to the banking sector. Subsequently, he has consulted on issues related to the crisis for law firms, accounting firms, securities firms, and trade associations.

Feinberg holds a BS.E. from the Wharton School and a J.D. from the Law School of the University of Pennsylvania. He has drafted dissenting views on landmark banking legislation, contributed to a financial blog, and written hundreds of reports for clients to document the course of the financial crisis as it has unfolded over the past three decades.