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Break Up the Banks - It's politics, not economics, that made them behemoths

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Big banks are bad for free markets. Far from being engines of free enterprise, they are conducive to what might be called "crony capitalism," "corporatism," or, in Jonah Goldberg's provocative phrase, "liberal fascism." There is a free-market case for breaking up large financial institutions: that our big banks are the product, not of economics, but of politics.

There's a long debate to be had about the maximum size to which a bank should be allowed to grow, and about how to go about breaking up banks that become too large. But I want to focus instead on the general objections to large banks.

The question can be examined from three perspectives. First, how much economic efficiency would be sacrificed by limiting the size of financial institutions? Second, how would such a policy affect systemic risk? Third, what would be the political economy of limiting banks' size?

It is the political economy that most concerns me. Freddie Mac and Fannie Mae represent everything that is wrong with the politics of big banks. They acquired lobbying prowess, their decisions were distorted by political concerns, and they were bailed out at taxpayer expense. All of these developments seem to be inevitable with large financial institutions, and all are deeply troubling to those who value economic freedom. Unless there are tremendous advantages of efficiency or systemic stability from having large banks, their adverse effect on the political economy justifies breaking them up.

If we had a free market in banking, very large banks would constitute evidence that there are commensurate economies of scale in the industry. But the reality is that our present large financial institutions probably owe their scale more to government policy than to economic advantages associated with their vast size. Freddie Mac and Fannie Mae were created by the government, and they always benefited from the perception that Washington would not permit them to fail -- a perception that proved accurate. Similarly, large banks were viewed as "too big to fail," which gave them important advantages in credit markets and allowed them to grow bigger than they otherwise would have. In 2007 and 2008, Lehman Brothers was able to obtain substantial short-term credit from what otherwise would have been risk-averse money-market funds, notably the Reserve Primary Fund, which "broke the buck" after Lehman's collapse, greatly intensifying the subsequent financial panic. It is difficult to view Reserve Primary's large position in Lehman debt as anything other than a bet that the government would engineer a bailout. It probably would have parked its funds elsewhere had Lehman been considered small enough to fail.

Other policies in recent decades have subtly favored big banks. The government encouraged the boom in securitization, for instance, which helped swell the size of

financial firms and was stimulated by banks' desire to skirt capital-requirement rules. And the credit-rating agencies' outsized role in financial markets -- indeed, the very existence of a small, powerful cabal of federally approved rating agencies -- was the work of regulators. Such policies fostered large financial institutions such as AIG, which built its huge portfolio of credit-default swaps on the basis of Triple-A grades from the credit-rating cartel.

Turn now to the question of efficiency: Is bigger better for consumers? Bankers speak mystically about the "financial supermarket" and claim that there are tremendous economies of scope in financial services, meaning that a consumer benefits from being able to have a checking account and a stock portfolio at the same large firm. But in practice, whatever benefits might be derived from such a supermarket are probably more than offset by the diseconomies of managing such a complex entity.

Another unsound argument is that large banks are needed to finance large multinational firms. If large international firms require big capital investments, these can be obtained by issuing securities or by loan syndication, in which the risk of borrowing is spread across several banks. The existence of large non-bank firms does not imply the need for similarly gigantic banks.

There are economies of scale, but small banks can take advantage of them, too. For instance, a small bank can join an ATM network or contract with a third party to develop Internet services. It does not have to build such systems from scratch, and we do not need big banks to make them possible.

Which brings us to the question of systemic risk. Regulation can, of course, make systemic risk worse: The U.S. banking crisis of the 1930s was exacerbated by the fact that banks could not start new branches across state lines or, in many cases, even within the same state. This led to poor diversification of regional risk. The regulation in question was admittedly poor, but we need not return to the banking system of the 1930s to achieve a reduction in the size of America's largest banks.

Some point out that the Canadian banking system performed relatively well during the financial crisis, noting that Canada's assets are concentrated in just five large banks. This is offered as evidence that large banks are conducive to financial stability. But while Canada's big banks have a big share of the country's assets, they still are much smaller than America's largest banks: Bank of America and JP Morgan Chase are three or four times the size of the Royal Bank of Canada, Canada's largest. And while its banking marketplace is dominated by five big players, Canada's population is less than one-seventh that of the United States; even if we concede that Canada is served well by five large banks, the equivalent in the United States would be 35 large banks. In 2008, total assets of the U.S. banking system were about $10 trillion, with the top five bank holding companies in possession of $6 trillion. If the entire $10 trillion had been divided evenly among 35 banks, none would have accounted for more than $300 billion in assets; all of our banks would have been smaller than the fifth-largest Canadian bank.

Overall, there is little evidence that really big banks are necessary to a sound financial system. The financial crisis demonstrated that they are not sufficient for a sound financial system. And it is possible that without very large banks the system actually would be more robust. Certainly, the failure of any one bank would be less traumatic if the size of that bank were small relative to the overall market.

I am not optimistic that there is an easy cure for financial fragility even if we break up the banks. To the extent that they share exposure to the same risk factors, a system with many small banks could be just as vulnerable as a system

with a few large ones. The fundamental sources of financial risk -- including leverage, interest-rate risk, exchange-rate risk, and speculative bubbles -- have a way of insinuating themselves regardless of the banking industry's structure and in spite of the best intentions of regulators. But while no one can promise that breaking up large banks would make the financial system safer, it would without question make it less corporatist. Which returns us to the question of political economy.

In the United States, big banks provide an invitation to mix politics and finance. Large financial firms get caught between public purposes imposed on them by Congress and the interests of private stakeholders. If they do not maintain good relations with legislators, they risk adverse regulation. Therefore, it behooves them to shape their regulatory environment. And they have done so. In recent decades, the blend of politics and banking created a Washington-Wall Street financial complex in the mortgage market. This development, and its consequences, have been well documented. Michael Lewis's 1989 book Liar's Poker includes a portrayal of the political exertions of investment bankers to enable mortgage securitization to take off. "The Quiet Coup," an article by Simon Johnson that appeared in the May 2009 issue of The Atlantic, chronicles the rapid accrual of profits and power by large financial institutions over the past 30 years; during this period, Wall Street firms were able to shape the basic beliefs of political figures and regulators, a phenomenon that Brookings Institution scholar Daniel Kaufmann has dubbed "cognitive capture." Andrew Ross Sorkin's Too Big to Fail, which describes the response of the Federal Reserve and Treasury to the financial crisis, leaves the distinct impression that senior bankers had much more access to and influence over Washington's decision makers than did career bureaucrats.

Notwithstanding the good intentions of policymakers, who no doubt plan to create a stronger regulatory apparatus going forward, large banks will inevitably have too much power for the apparatus to govern them. They will shield themselves from its attentions by making political concessions on lending practices. So long as big banking is conjoined to big government, that is, we risk a return to the regime of private profits and socialized risk.

I would prefer a completely hands-off policy when it comes to financial markets, but the political reality is that deposit insurance and regulation are not going away. Given that they are not, the worst possible outcome is that the marriage of politics and finance evolves into outright corporatism, as it did with Freddie Mac, Fan nie Mae, and the rest of the nation's largest financial institutions. And that evolution is directly attributable to the influence that comes from banks' being big enough to achieve real political power. To expand free enterprise, shrink the banks.

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