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UPDATE 1-Fed's Fisher sees need to break up big banks

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(Adds details)

WASHINGTON, Nov 19 (Reuters) - Banks that are considered too large to fail should be dismantled rather than "coddled," Dallas Federal Reserve Bank President Richard Fisher said on Thursday.

Large-scale government bailouts of institutions like insurer American International Group (AIG.N: Quote, Profile, Research, Stock Buzz) have generated widespread controversy following last year's global financial meltdown.

Fisher suggested the only way of ensuring that such financial giants to not pose recurrent problems is by making them smaller.

"This means finding ways not to live with 'em and getting on with developing the least disruptive way to have them divest those parts of the 'franchise,' such as proprietary trading, that place the deposit and lending function at risk and otherwise present conflicts of interest," Fisher said in prepared remarks to the Cato Institute, a libertarian think tank.

It was one of the strongest calls to date from a sitting Fed official for an actual breaking up of large financial institutions.

Fisher also said the too-big-to-fail problem hinders the effectiveness of monetary policy, perverting incentives and contributing to financial volatility.

Even as the central bank cut interest rates sharply to deal with the crisis, the borrowing costs for banks and consumers actually climbed.

"Those banks with the greatest toxic asset losses were the quickest to freeze or reduce their lending activity," Fisher said. "Their borrowers faced higher interest rates and restricted access to funding."