Perspectives on “breaking-up-the-big-banks”

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Big picture

- Banks help shape economic prosperity.
  - Allocate credit to firms and households.
  - Exert corporate governance over firms to which they lend.
  - Provide risk management and liquidity services.
  - These services matter for people who rarely use banks because they affect the dynamism of job market.
- Regulatory reforms should be assessed in terms of their likely impact on these services.
- Breaking-up-the-big-banks proposals do not do this.
  - It sounds good: “If banks are too big to fail, make them smaller.”
  - But, where is the evidence that breaking-up-the-big-banks enhances banking services and economic prosperity?

Outline: 4 Questions

I. Is there still a TBTF problem? If so, should such a core failure in Dodd-Frank be treated in isolation?
II. What is the primary problem with TBTF?
III. Would breaking-up-the-big-banks fix this problem?
IV. Is breaking-up-the-big-banks the best way to fix TBTF?

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I. Is there still a TBTF problem?

- I.A. One argument: D-F effectively fixed TBTF.
  - TBTF in particular:
    - Living Wills and orderly liquidation resolution process.
    - Fed can only provide assistance through "broad-based" programs to solvent institutions, not individual firms.
    - Eliminates FDIC's authority to assist banks outside of receivership.
    - Prohibits taxpayers from bearing ***ANY*** losses from a government resolution of failed institutions.
  - Risk in general:
    - Risk-based capital requirements, supplemental leverage ratios, surcharges on capital/liquidity for systemically important banks
    - More aggressive supervisory oversight, etc.
- I.B. A second argument: D-F helped, but breaking-up-the-big-banks is an additional safeguard against TBTF.

I. Should we treat a core failing in D-F in isolation?

I.C. A third argument: D-F and Basel have failed

- Some have argued that D-F and Basel have failed
  - Additional reforms have increased compliance burdens.
  - But, have not improved the quality of prosperity-enhancing banking services and might have even reduced them.
- If D-F and Basel have failed,
  - Is starting with breaking-up-the-big-banks best?
  - Or, will focusing on this distract efforts from addressing more systemic deficiencies with regulation/supervision?

What is the primary problem with TBTF?

II.A. Is the primary issue protecting taxpayers?

- This is a concern.
- But it seems secondary.
  - Policymakers often argue that banks paid back, with interest, more than all official assistance.
  - D-F focuses on protecting taxpayers.
  - The recession and tepid recovery were not caused by taxpayer losses.
- Indeed, the crisis and its long-lasting repercussions:
  - Seem unrelated to taxpayer losses from assisting big banks.
  - Seem to reflect the misallocation of credit,
    - which in my view was driven by regulations and supervisory practices that permitted, and even encouraged, excessive risk taking.

II.B. Is the primary problem with TBTF that big banks influence regulators?

- This is a concern.
- But do big banks exert a larger influence than coordinated smaller banks?
- They might, but no evidence is presented in this regard.

II.C. Is the primary problem with TBTF that it distorts incentives?

- TBTF reduces monitoring by debt holders.
  - With insufficient monitoring by creditors, owners and executives have greater latitude to increase risk taking.
  - This will lead to an inefficient allocation of society's savings, reduce the quality of banking services, and hurt economic prosperity.
- This distorting of incentives is the primary problem with TBTF.

Would breaking-up-the-big-banks resolve this key TBTF problem?

III. Would breaking-up-the-big-banks resolve the TBTF problem?

- It might.
  1. If it reduces expectation of a government bailout of debt holders, so that debt holders monitor more, and
  2. If this stronger monitoring improves the governance of banks and hence the incentives shaping the decisions of bank executives,
  - ➢ Then, this would boost prosperity-enhancing banking services.

- It might not.
  - Let's go through these two conditional statements …

III. Would breaking-up-the-big-banks resolve the TBTF problem?

① It might not reduce expectations of a government bailout and induce debt holders to monitor more.

- There might be many banks with highly correlated assets, so that they are too many to fail (e.g., S&Ls in 1980s).
- There might be many small, highly integrated banks, so that they are too interconnected to fail.
- Regulators might fear cascading, contagious failures, so that debt holders figure hardly any banks will be allowed to fail.
- Indeed, smaller banks will strategize on how to make themselves more correlated, interconnected, and complex to maximize investor expectations of a public bailout?

III. Would breaking-up-the-big-banks resolve the TBTF problem?

② Even if it boosts monitoring by debt holders, breaking-up-the big banks might not improve the governance of banks.

- Bank executives might raise funds through mechanisms that circumvent monitoring by the only group of debt holders that can effectively monitor them … large debt holders, who themselves might not have proper incentives.
- Since large U.S. banks have few/no owners with the incentives and ability to oversee managers, the impact of more monitoring by debt holders depends on the overall governance of banks.

- Thus, it is not clear that breaking-up-the-big-banks would improve the incentives of bank executives and the quality of banking services.

Is breaking-up-the-big-banks the best way to fix the primary problem with TBTF?

IV. Is breaking-up-the-big-banks the best fix?

- It does not seem so.
- Breaking-up-the-big-banks might hurt banking services:
  - There is evidence of economies of scale and scope.
  - There is evidence that bigger banks are more diversified and less risky.
  - The proposal ignores that banks provide key services to the economy.
- If the problem with TBTF is that it distorts the incentives of bank executives, then address that problem:
  - claw backs provisions.
  - forcing, rather than prohibiting, the existence of a large shareholder, etc.
  - Breaking-up-the-big-banks does not directly fix the primary problem.

Summing up

- Banks are crucial for improving living standards.

- Before designing & adopting any banking reform, it is crucial to:
  - Define precisely the problem that needs addressing.
  - Develop reforms that directly fix the problem.
  - Assess the impact of the proposed reform on banking services.

- The current proposal offers no evidence on whether, if implemented, would:
  - Improve the incentives of bank executives.
  - Reduce excessive risk taking.
  - Improve the quality of banking services.