How Huge Banks Threaten the Economy

Since the early 1970s, the share of assets controlled by the five largest banking institutions in the U.S. has tripled to 52% from 17%. This has to change.

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Our nation is at a fork in the road and the destiny of our financial system depends critically on choosing the correct route. One path leads to a continuation of the status quo, where some financial institutions are ordained by government policy to be "too big to fail" (TBTF) and where the rules of market capitalism are undermined and subverted. The other – the path to long-term prosperity – is the one we'll be on when we truly end TBTF.

Two years ago our lawmakers passed the Dodd–Frank Wall Street Reform and Consumer Protection Act, which was in part designed to end "too big to fail" and "protect the American taxpayer by ending bailouts" through greater oversight and early recognition of systemic risk. Dodd-Frank attempts to do many things, but it does little to roll back a massive increase of U.S. banking industry concentration.

Since the early 1970s, the share of assets controlled by the five largest banking institutions in the U.S. has tripled to 52% from 17%. With size came complexity, magnifying the opportunities for opacity, obfuscation and mismanaged risk.
The phrase "too big to fail" is misleading. It really means too complex to manage. Not just for top bank executives, but too complex as well for creditors and shareholders to exert market discipline. And too big and complex for bank supervisors to exert regulatory discipline when internal management discipline and market discipline are lacking.

TBTF is a misnomer in another way. The phrase creates the impression that these banks cannot fail. Nothing could be further from the truth. Suffice it to say, institutions holding one-third of U.S. banking system assets did essentially fail in 2008-09, surviving only with extraordinary government assistance. They were quasi-nationalized – bailed out, in everyday parlance.

Like a bankruptcy, a bailout is a failure, just with a different label. Creditors get shortchanged and management bears some consequences for its miscalculations. The big difference is that in a government bailout, taxpayers – not the private sector –

provide debtor-in-possession financing. This perverts the fundamental principles upon which the system of market capitalism is supposed to work.

Principles are important, but economic performance counts, too. We know from experience that injured, underperforming banks reduce economic activity. When a few, small, geographically scattered banks are in trouble, there is limited impact on the macroeconomy. But when a handful of banks – each with a nearly national geographic footprint – get in trouble while holding more than half the banking system's assets, the economy faces rough sledding.

Increased concentration dramatically intensifies the impact of distressed banks on the economy and diminishes monetary policy's ability to improve economic performance. Just as TBTF banks were at the epicenter of the origination and distribution of inappropriate mortgage debt and the subsequent foreclosure mess, they also contributed to reducing the impact of the Federal Reserve's accommodative monetary policy.

In 2012 and beyond, once Dodd-Frank is fully implemented, the regulatory environment will likely differ in several ways.

After learning from past mistakes, bank regulators assisted by the newly created Financial Stability Oversight Council are unlikely to permit the more egregious banking practices, especially in residential and commercial mortgage lending, that precipitated the 2007-09 financial crisis.

It is also possible that bank regulators, in an effort to bolster their reputation for toughness and prevent what they see as "systemic risk," will act to suppress risk-taking in general, limiting innovation and dynamism in the economy.

Ultimately, the most likely outcome will be an eventual return to the practice of willful blindness. By that, we mean that after a few years of good economic times, bankers, their customers and creditors, and regulators – believing that Dodd-Frank is working as intended – will fail to fully recognize the scope of the risks undertaken and we will experience another financial crisis. Human weakness will cause occasional market disruptions. But giant banks, operating on the belief that they are backed by government, turn these otherwise manageable episodes into catastrophes.

Is there a better alternative?

Yes, reducing the size and complexity of the largest banks. Though it sounds radical, restructuring is a far less drastic solution than quasi-nationalization, as happened in 2008-09. Admittedly, restructuring can be costly and disruptive. But it can improve

competition and market discipline, important forces that were reduced as the industry consolidated.

American businesses reconfigure their organizational structures all the time, selling divisions that management deems no longer essential to the enterprise's core activities. Mergers and acquisitions of yesterday are followed by divestitures and spin-offs of tomorrow. Investment banks, private equity firms and turnaround managers are among the specialists enabling corporate restructurings.

Since 2008, a few of the largest banking companies have downsized, selling subsidiaries as market conditions allowed. They should be encouraged to better and more quickly complete their efforts to improve shareholder value and to pose less danger to the economy.

After downsizing, the big banks should still have the necessary size to fund large global deals – if not alone, then as part of a consortium, which offers the opportunity for better risk management. Possessing the world's largest banks is no guarantee of success, as Japan has shown. The many European banks that remain nationalized also show the dangers of bigness.

One of the many great things about living in the United States is the abundance of choices we enjoy. In contemplating the issue of dealing with TBTF banks, however, our options are limited. Hordes of Dodd-Frank regulators are not the solution; smaller, less complex banks are.

We can select the road to enhanced financial efficiency by breaking up TBTF banks – now. Or we can continue down the current path, one of increasingly concentrated risk, where we almost certainly will face the prospect of again using taxpayer funds to rescue big banks.

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