Too Big to Handle

By Editor Test *Wed, Oct 31, 2012*

"Every time the CEO of [a megabank] is forced to resign, the evidence mounts that these organizations have become impossible to manage in a responsible way that generates sustainable value for shareholders and keeps taxpayers out of harm's way," writes Johnson, an MIT economist.

In the discussion of whether America's largest financial institutions have become too big, a sea change in opinion is underway.

Two years ago, during the debate about the Dodd-Frank financial-reform legislation, few people thought that global megabanks represented a pressing problem. Some prominent senators even suggested that very large European banks represented something of a role model for the United States.

In any case, the government, according to the largest banks' CEOs, could not possibly impose a cap on their assets' size, because to do so would undermine the productivity and competitiveness of the US economy. Such arguments are still heard – but, increasingly, only from those employed by global megabanks, including their lawyers, consultants, and docile economists.

Everyone else has shifted to the view that these financial behemoths have become too large and too complex to manage – with massive adverse consequences for the wider economy. And every time the CEO of such a bank is forced to resign, the evidence mounts that these organizations have become impossible to manage in a responsible way that generates sustainable value for shareholders and keeps taxpayers out of harm's way.

Wilbur Ross, a legendary investor with great experience in the financial services sector, nicely articulated the informed private-sector view on this issue. He recently told CNBC,

"I think it was a fundamental error for banks to get as sophisticated as they have, and I think that the bigger problem than just size is the question of complexity. I think maybe banks have gotten too complex to manage as opposed to just too big to manage."

In the wake of Vikram Pandit's resignation as CEO of Citigroup, John Gapper pointed out in the *Financial Times* that "Citi's shares trade at less than a third of the multiple to book value of Wells Fargo," because the latter is a "steady, predictable bank," whereas Citigroup has become too complex.

Gapper also quotes Mike Mayo, a leading analyst of the banking sector: "Citi is too big to fail, too big to regulate, too big to manage, and it has operated as if it's too big to care." Even Sandy Weill, who built Citi into a megabank, has turned against his own creation.

At the same time, top regulators have begun to articulate – with some precision – what needs to be done. Our biggest banks must become simpler. Tom Hoenig, a former president of the Federal Reserve Bank of Kansas City and now a top official at the Federal Deposit Insurance Corporation, advocates separating big banks' commercial and securities-trading activities. The cultures never mesh well, and big securities businesses are notoriously difficult to manage.

Hoenig and Richard Fisher, the president of the Federal Reserve Bank of Dallas, have been leading the charge on this issue within the Federal Reserve System. Both of them emphasize that "too complex to manage" is almost synonymous with "too big to manage," at least within the US banking system today.

George Will, a widely read conservative columnist, recently endorsed Fisher's view. Big banks get a big taxpayer subsidy – in the form of downside protection for their creditors. This confers on them a funding advantage and completely distorts markets. These subsidies are dangerous; they encourage excessive risk-taking and very high leverage – meaning a lot of debt relative to equity for each bank and far too much debt relative to the economy as a whole.

Now these themes have been picked up by Dan Tarullo, an influential member of the Board of Governors of the Federal Reserve System. In an important recent speech, Tarullo called for a cap on the size of America's largest banks, to limit their non-deposit liabilities as a percentage of GDP – an entirely sensible approach, and one that fits with legislation that has been proposed by two congressmen, Senator Sherrod Brown and Representative Brad Miller.

Tarullo rightly does not regard limiting bank size as a panacea – his speech made it clear that there are many potential risks to any financial system. But, in the often-nuanced language of central bankers, Tarullo conveyed a clear message: The cult of size has failed.

More broadly, we have lost sight of what banking is supposed to do. Banks play an essential role in all modern economies, but that role is not to assume a huge amount of risk, with the downside losses covered by society.

Ross got it right again this week, when he said: "I think that the real purpose and the real need that we have in this country for banks is to make loans particularly to small business and to individuals. I think that's the hard part to fill."

He continued, "Our capital markets are sufficiently sophisticated and sufficiently deep that most large corporations have plenty of alternative ways to find capital. Smaller companies and private individuals don't have really the option of public markets. They're the ones that most severely need the banks. I think they've kind of lost track of that purpose."

Hoenig and Fisher have the right vision. Tarullo is heading down the right path. Ross and many others in the private sector fully understand what needs to be done. Those who oppose their proposed reforms are most likely insiders – people who have received payments from big banks over the past year or two.