Breaking Up Megabanks: The Lesser Evil

by Eric Grover

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The Cato Institute's Louise Bennetts worries that "the small flicker of bipartisanship" to break up megabanks will do no good and distract from addressing the real causes of systemic risk ("'Too Big to Fail' Is a Distraction," March 6). To paraphrase Donald Rumsfeld, you have to undertake reform with the Congress and president you have, not the one you want.

I believe government policies were the main causes of the financial crisis (as Bennetts has pointed out elsewhere) and of ongoing and increasing systemic risk. Paradoxically, the best chance we have to mitigate the effects of such policies is another form of state intrusion, admittedly distasteful in and of itself: Breaking up the big banks. Even if still a longshot, it's now plausible.

The main causes of financial crisis and of increasing systemic risk cannot be comprehensively remedied with President Obama in the White House and Harry Reid Senate majority leader. The source of financial-system fragility was and continues to be decision-making concentrated in Washington and financial behemoths nationalized in all but name.

The president and his Fed and cabinet appointments have continued his predecessors' easy-money and housing-finance policies propping up prices and homeownership. Fed Chairman Bernanke is resolved to keep interest rates near zero for the foreseeable future. Nine out of ten mortgages originated in 2012 were owned or insured by the federal government. The Dodd-Frank Act converted banking into a public utility and threw small banks under the bus, notwithstanding their lighter capital requirements and exemption from debit-interchange price controls.

What's to be done?

Eliminating Washington suzerains' vise-hold on financial services, politically, is a nonstarter. In the near term Dodd-Frank cannot be repealed. Nor can government be removed from housing finance. Nor can the Fed's mandate circumscribed to price stability. It brings me no pleasure to say it, but any reform needs Democrat support.

The left detests large financial institutions, still notionally in the private sector, and bailouts. Therein lies the basis for an unusual political coalition to put paid to TBTF doctrine and restore a modicum of market discipline to and level the playing field in banking.

Bennetts suggests TBTF-failure risks can be managed through Dodd-Frank's imperfect FDIC-led liquidation process. While arguably a failing megabank such as Bank of America, JPMorgan Chase or Citigroup could be safely reorganized or liquidated through a bankruptcy process or an inherently more political and therefore less credible and less desirable FDIC-led liquidation, that's beside the point. President Obama, Treasury Secretary Lew, Fed Chairman Bernanke, and the financial-regulatory establishment *believe* they are TBTF. Management believes Washington believes they are TBTF. Markets believe they are TBTF.

Systemic risk is created by concentration of risky assets and decision-making by Washington mandarins and management with no skin in the game.

Restoring Glass-Steagall is a rallying cry for anti-Wall-Streeters. But raising capital and advising companies on M&A are relatively low-risk activities. President Clinton's ending of Glass-Steagall had nothing to do with the financial crisis, but is now a doctrinal litmus test for the left. However, if separating investment and commercial banking were the price to restore market sovereignty in financial services, it would be a price worth paying.

Bennetts scoffs at the idea U.S. banks are dangerously and unnecessarily large. They are dangerously so *because of* TBTF doctrine and because a handful of financial Gargantuas fit and enable the administration's value-destroying crony statism. Even though financial Goliaths suffer diseconomies of scale and complexity that retard innovation and overburden management, these disadvantages are offset by government support, a consequent funding advantage, and greater ability to weather

and influence the regulatory tsunami. That's why they are unnecessarily large.

Reasonable people can debate how large megabanks' funding advantage is, but markets put a price on risk. Debt capital with no perceived default risk will be cheaper than debt capital with credit risk.

That Senator Sherrod Brown and his ideological kin's motives may not be purer than Caesar's wife from Bennetts' perspective should not preclude an attempt to curb TBTF doctrine and banks.

Breaking up financial institutions into pieces each small enough to be permitted to innovate, manage risk, prosper or fail, is probably the only meaningful financial system reform possible in the 113th Congress.

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