Economic Policy Program

Financial Regulatory Reform Initiative

The Big Bank Theory:

Breaking Down The Breakup Arguments

Introduction

The 2008 financial crisis threw into sharp relief the issue of “too-big-to-fail” (TBTF), the challenge posed by financial institutions that were rescued due to concerns their failure would damage the overall economy. In response, policymakers established a series of measures as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) to ensure both that these firms operate more safely and that market participants, and not taxpayers, bear the costs of interventions to stabilize the financial system.

Have these sweeping reforms gone far enough? If not, then further measures—potentially including breaking up or shrinking the size of large financial institutions—should be considered. However, these actions would impose additional costs on the economy on top of the costs imposed by the current set of financial reforms. These actions must be understood and weighed against any benefits to financial stability.

What are the costs, benefits, and consequences of breaking up the country’s biggest banks? What would dramatically shrinking their size mean for the U.S. economy, the financial sector, and the customers of these institutions? And how would such a strategy work? This paper addresses these fundamental questions. We conclude that the reforms undertaken since the financial crisis have made considerable progress in addressing the TBTF issue and that breaking up major financial institutions would be challenging, costly, and counterproductive.

Analysis

First, Dodd-Frank has already made considerable progress in addressing the TBTF problem. Dodd-Frank created a new legal authority that established a pathway to resolve large and complex institutions, setting up a system designed to allow any institution to fail without damaging the broader economy. It also put in place higher capital standards and liquidity requirements, while enhancing oversight of large institutions and the broader financial system. Along with steps taken in international forums, such as the Basel III Accord, these reforms have transformed the financial landscape for large institutions, both by making large banks operate more safely and by lowering market expectations of future government rescues.

Second, breaking up the country’s largest financial institutions would impose significant costs on the economy by reducing the value that these firms provide for businesses and consumers. Recent research points to significant economies of scale and scope at large financial institutions, which contributes to economic growth, including by promoting international trade. In addition, we highlight new research on consumer banking behavior in the wake of the crisis, showing that most of the largest banks significantly increased the number of customer accounts even as a wave of anti-bank populism gripped the country. Americans' actions suggest that they value the services provided by large banks.

This is not to say that some concerns regarding large institutions are without merit. There are, for example, legitimate worries that large, complex institutions could be "too big to manage," and a number of large banks were among those that engaged in dangerous activities and practices in the run-up to the crisis. We believe, however, there are credible and less costly alternatives to address these problems. Furthermore, the U.S. banking sector is substantially less concentrated than in other developed countries and even when compared with other industries in the United States.

Third, the reality is that breakups would be hard to do. A range of complex issues would need to be addressed for any breakup plan to succeed, such as how to divide the company's assets, debts, and customers among its successor institutions, and how such a transition would occur. Moreover, the transition costs of any breakup proposal would be significant, including costs arising from disruptions to existing customer relationships and higher borrowing costs for customers.

Finally, there is little reason to believe that breaking up the largest institutions would reduce risks in the financial system over the long-term. Several breakup proposals have attracted bipartisan support—including plans that would place strict limits on size, impose significantly higher capital requirements on large institutions, or reintroduce a separation between commercial and investment banking. But each has significant drawbacks, from implementation hurdles to competition and cost concerns. And regardless of what alternative is considered, breaking up an institution with $2 trillion in assets would not result in many easy-to-resolve small institutions. Rather, it would result in a smaller number of successor entities, engaged in similar activities as their larger predecessor, but still operating at an impressive scale. It is not clear that breaking up the biggest banks would make the financial system more stable.

Conclusion

Our analysis suggests that the Dodd-Frank framework represents a middle-ground approach between plans to break up the banks and a return to the pre-crisis status quo. Its reforms achieve many of the goals of the alternative proposals described above: they require firms to operate with more capital to absorb unexpected financial shocks; they provide regulators with the authority and tools necessary to restrict the size and activities of large firms; and they impose additional costs on large institutions, which serve a disincentive to size and complexity. Taken together, these reforms reduce the likelihood of a big bank failing, limit moral hazard, and reduce the risk of future taxpayer bailouts. At the least, we should give them time to work before policymakers consider more radical changes.

Find the full report at http://bipartisanpolicy.org/library/report/big-bank-theory-breaking-down-breakup-arguments

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