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Break Up Big Banks? Here's a Better Solution

By Suzanne McGee

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"Break up the big banks!"

As a rallying cry, this remains a pretty powerful one for Wall Street's harshest critics. Even among some of those who understand the banking system very well – like former FDIC Chairwoman Sheila Bair – it's an idea that is difficult to dismiss. Does anyone really like the idea that 70 percent of the banking system's assets are controlled by 0.2 percent of the banks in that system? Or the fact that the balance sheet of JPMorgan Chase – the same bank that has reportedly reached a tentative $13 billion settlement with the Justice Department over bad mortgage loans sold to investors – is about a quarter the size of the GDP of the United States?

Richard Fisher, president of the Dallas Fed, and economist Simon Johnson brought up those figures about the size of big banks last Wednesday evening as the two men argued in favor of a motion to make the country's banks less of a systemic risk by breaking them into smaller pieces. The forum for this debate was Intelligence Squared U.S., which hosts an annual series of Oxford-style debates (roughly, one every three or four weeks) over some contentious question, such as "Abolish the Minimum Wage," "The U.S. Drone Program is Fatally Flawed" or "For a Better Future, Live in a Red State."

For my money, these debates are some of the best and most thought-provoking entertainment you can have. (And you don't need money to participate: They're available via live streaming online.) The debaters – two on each side of the evening's question – are usually smart, well informed, civil, on point and occasionally even acknowledge the merits of their opponents' argument. (Would that we could say the same of our elected leaders….)

But last Wednesday night's debate showed just how difficult the "too big to fail" question is for even the most knowledgeable debater to address in a convincing way. The usual Intelligence Squared methodology is to poll the audience before the debate begins to see what their opinions are on the question, and then again when the debate is over to gauge how much the arguments of both parties have affected those views. Before the debate, 37 percent were in favor of breaking up the banks, 19 percent were opposed, and a whopping 44 percent couldn't make up their minds. Afterwards, 49 percent were in favor and 39 percent were opposed to the idea, with 12 percent still on the fence.

Here's where it gets interesting. If you look at those numbers, you'd say the arguments in favor of breaking up the banks were strong enough to carry the day – a full ten percentage points divide them. But what the host group measures is the difference between the two scores,

meaning that the winners were those who argued *against* breaking up the banks. So, that group – Brookings Institute fellow (and former J.P. Morgan banker) Douglas Elliott and Paul Saltzman, president of the Clearing House Association – carried that battle. But they still only won the votes of a minority of the audience.

And that's typical of the conundrum facing anyone discussing breaking up the banks. There are valid arguments and myths on both sides, and whatever course of action we pursue will lead us into untested waters. If last week's debate and the laws of physics permitted a third option – break them up but then have the option to go back in time if it turns out we made a big mistake – I am almost certain that would have won the support of everyone at the debate, including the 12 percent of the audience who are still dithering.

The "against" side is right to argue that smaller banks are no guarantee that the financial system will be safe or that taxpayers will not end up on the hook for their losses in a bailout. The risk management resources at small banks are almost certainly scarcer than those at JPMorgan Chase, which nevertheless failed to halt the disastrous London Whale trade. If those small banks end up behaving foolishly, the collective impact could be as significant as that of the collapse of a large bank. Remember that the banking crisis of the 1930s and the savings and loan crisis of more recent memory involved smaller institutions.

But the "pro" break-up side is correct to argue that our ability to compete effectively in a global banking market doesn't hinge on having massive institutions. Size doesn't equate to enhanced wisdom (see, again, the London Whale scandal) or even the ability to serve all clients (see JPMorgan Chase's decision to get out of the student loan business). American companies did just fine obtaining the financing they needed from the capital markets via U.S. and other financial institutions before the banks were as immense and concentrated as they are today. Moreover, syndication and credit derivatives make it possible for banks today to make larger loans and manage the risk associated with them.

Meanwhile, both sides indulged in unprovable scenarios of what would happen if their opponents' worldview triumphed. The big banks are "a dagger pointed at the heart of the American economy," argued Fisher, while Elliott suggested that breaking them up would make loans and other services more costly and more difficult to get. The first is hyperbole; the second unlikely.

Despite the myths and exaggerations trotted out on both sides of the debate, it's the conclusion – the poll results – that I find most interesting. On the one hand, a majority of those voting clearly believed, even after hearing the two sides make their case, that it would be a good idea to go forward with more and smaller banks at the top of the system. On the other hand, the arguments of those opposed to breaking up the banks won over more listeners.

All of which probably means than in the view of some informed folks, policymakers might need to stop thinking in such binary, black-and-white terms. Instead of an either/or strategy, perhaps the discussion should shift to finding ways to minimize the potential downside of big banks? (And no, living wills aren't good enough. In the heat of a crisis, if JPMorgan Chase were about

to collapse, does anyone truly believe that it would be politically possible to do anything but bail it out, regardless of the blow that would deliver to the nation's finances?)

Anyone thinking rationally has to concede that big banks *could* pose a systemic threat to the financial system because of their size. Similarly, a rational thinker has to acknowledge that breaking them up is a radical measure and one that almost certainly will have unanticipated consequences that will result in the next generation of hotly debated conundrums.

The only solution, it seems to me, is to heed the message that is spelled out in the poll results and move beyond black-and-white "solutions" that, while they make for great headlines and debate topics, don't help us to think creatively about the best course of action to follow.