The Winning Case Against Megabanks

By Simon Johnson

Oct 18, 2013 10:16 AM ET

There continues to be a forceful economic debate about the cost of financial companies that are regarded -- by officials and by credit markets -- as "too big to fail."

There is no doubt that, during the severe crisis of fall 2008, the executives running these companies felt intense pressure and that responsible officials felt these institutions required huge amounts of government support.

The question is: What has really changed since September 2008, when Goldman Sachs Group Inc. and Morgan Stanley became bank holding companies, giving them better access to funding from the Federal Reserve? Or since October 2008, when the first injections of new capital were provided to banks that faced big potential losses? Or since November 2008, when Citigroup Inc. received a big additional dollop of support (mostly in the form of downside guarantees)?

There are three responses from the big banks that were ably represented this week at an Intelligence Squared debate in New York. (The topic was "Break Up the Big Banks." I was in favor of the motion, supporting the ideas of Richard Fisher, president of the Federal Reserve Bank of Dallas; our side received 49 percent of the final audience vote. Opponents got 39 percent, with the rest of the public undecided.)

The banks' first argument is that the Dodd-Frank financial-reform legislation of 2010 fixed the problem. This is an ironic stand for them to take, given how hard they worked to weaken the legislation and that they continue to try to delay its implementation in every way possible.

Orderly Resolution

One of our opponents in the debate, Doug Elliott, a fellow at the Brookings Institution, suggested that we are a "couple of years" away from being able to manage the collapse of a global megabank in an orderly fashion. Given that the insolvency of any one of these entities would have to be handled through a cross-border resolution mechanism (sharing losses across countries) and that such a mechanism is a political impossibility, I would suggest "never" is a more realistic timeline.

Our other debate opponent, Clearing House Association President Paul Saltzman, argued that the "living wills" process has forced banks to simplify and become smaller, making them easier to resolve if necessary. That is the intent of the legislation, but Fisher and I couldn't think of a single instance in which the living wills have made a significant difference.

In fact, the living wills submitted by the banks to the Fed in the first round were deemed inadequate.

The megabanks' second argument is that they need to be at their current scale to maintain the productivity and efficiency of the broader economy. This is hard to believe. The best work on the topic, by Andrew Haldane and his colleagues at the Bank of England, finds no economies of scale and scope in the megabanks, once the correct adjustment is made to account for the subsidies they receive.

Our largest banks have scaled up enormously in the past 20 years. What improvements in service have you experienced, as a retail or corporate customer, during this period? As one member of the audience pointed out, if JPMorgan Chase & Co. (JPM) (the biggest U.S. bank by assets) is really so great, why isn't it the low-cost provider of mortgages in New York, and why does it -- in his view -- have trouble conducting even simple international transactions at low cost? It isn't that great at managing large complex derivatives positions, either, to judge by the bank's admission of market manipulation this week.

Subsidy Dispute

For their third argument, the big banks insist they receive no implicit subsidies, an assertion they say is buttressed by a slew of industry-sponsored studies (some by employees and others by academics). But the best independent work on this topic shows the exact opposite: The subsidies were very high during the crisis and remain substantial today.

When the pressure comes back, as it always does, will big banks again seek and receive support?

Look at their political access. In September, JPMorgan Chairman Jamie Dimon sought and received a meeting with Attorney General Eric Holder to discuss the terms of a potential legal settlement of myriad allegations. According to the Justice Department, no chief executive officer in recent memory has been accorded such access.

If Dimon's bank didn't have $4 trillion in assets (measured using international accounting standards), but rather a much more moderate $250 billion or $500 billion, do you think he would have the same access?

David Meister, the Commodity Futures Trading Commission's head of enforcement, recently referred to JPMorgan's actions in the infamous London Whale transaction as "dumping a gargantuan, record-setting, volume of swaps virtually all at once, recklessly ignoring the obvious dangers to legitimate pricing forces."

Risk management failed at every level -- both within the corporate bureaucracy and among the board of directors. The primary consequence has been fines that impose costs on JPMorgan's shareholders, but they do very little to change incentives and reduce the capacity for taking reckless risks on a macroeconomic scale.

Regulators and prosecutors have gone very easy on management and have avoided requiring any significant structural changes, precisely because they are concerned about the potential impact on the economy. It is safe to assume that regional banks, let alone community banks, wouldn't be treated the same way. The many different forms of protection and subsidies enjoyed by the big banks are a major reason that the playing field has become so tilted against smaller financial companies.

JPMorgan Chase is simply too big.

Simon Johnson, a professor at the MIT Sloan School of Management as well as a senior fellow at the Peterson Institute for International Economics, is co-author of "White House Burning: The Founding Fathers, Our National Debt, and Why It Matters to You."