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Breaking Up Four Big Banks

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Almost exactly two years ago, at the height of the Senate debate on financial reform, a serious attempt was made to impose a binding size constraint on our largest banks. That effort — sometimes referred to as the Brown-Kaufman amendment — received the support of 33 senators and failed on the floor of the Senate. (Here is some of my Economix coverage from the time.)

On Wednesday, Senator Sherrod Brown, Democrat of Ohio, introduced the Safe, Accountable, Fair and Efficient Banking Act, or SAFE Banking Act, which would force the largest four banks in the country to shrink. (Details of this proposal, similar in name to the original Brown-Kaufman plan, are in this briefing memo for a Senate banking subcommittee hearing on Wednesday, available through Politico, and in this news release).

His proposal, while not likely to become law immediately, is garnering support from across the political spectrum — and more support than essentially the same ideas received two years ago.

The proposition is simple: Too-big-to-fail banks should be made smaller, and preferably small enough to fail without causing global panic. This idea had been gathering momentum since the fall of 2008 and, while the Brown-Kaufman amendment originated on the Democratic side, support was beginning to appear across the aisle.

But big banks and the Treasury Department both opposed it, and parliamentary maneuvers ensured there was little real debate. (For a compelling account of how the financial lobby works, both in general and in this instance, look for a forthcoming book by Jeff Connaughton, former chief of staff to former Senator Ted Kaufman of Delaware.)

The issue has not gone away. And while the financial sector has pushed back with some success against various components of the Dodd-Frank reform legislation, the idea of breaking up very large banks has gained momentum.

In particular, informed sentiment has shifted against continuing to allow very large banks to operate in their current highly leveraged form, with a great deal of debt and very little equity. There is increasing recognition of the huge and unfair costs that these structures impose on the rest of the economy.

The implicit subsidies provided to too-big-to-fail companies allow them to increase compensation by hundreds of millions of dollars. But the costs imposed on the rest of us are in the trillions of dollars. This is a monstrously unfair and inefficient system, and sensible public figures are increasingly pointing this out.

American Banker, a leading trade publication, recently posted a slide show, "Who Wants to Break Up the Big Banks?" Its gallery included people from across the political spectrum, with a great deal of financial sector and public policy experience, along with quotations that appear to support either Senator Brown's approach or a similar shift in philosophy with regard to big banks in the United States. (The slide show is available only to subscribers.)

According to American Banker, we now have in the "break up the banks" corner (in order of appearance in that feature): Richard Fisher, president of the Federal Reserve Bank of Dallas; Sheila Bair, former chairwoman of the Federal Deposit Insurance Corporation; Thomas Hoenig, a board member of the Federal Deposit Insurance Corporation and former president of the Federal Reserve Bank of Kansas City; Jon Huntsman, former Republican presidential candidate and former governor of Utah; Senator Brown; Mervyn King, governor of the Bank of England; Senator Bernard Sanders, an independent of Vermont; and Camden Fine, president of the Independent Community Bankers of America. (I am also on the American Banker list.)

Anat Admati of Stanford and her colleagues have led the push for much higher capital requirements — emphasizing the particular dangers around allowing our largest banks to operate in their current highly leveraged fashion. This position has also been gaining support in the policy and media mainstream, most recently in the form of a powerful Bloomberg View editorial.

(You can follow her work and related discussion on this Web site; on Twitter she is @anatadmati.)

Senator Brown's legislation reflects also the idea that banks should finance themselves more with equity and less with debt. Professor Admati and I submitted a letter of support, together with 11 colleagues whose expertise spans almost all dimensions of how the financial sector really operates.

We particularly stress the appeal of having a binding "leverage ratio" for the largest banks. This would require them to have at least 10 percent equity relative to their total assets, using a simple measure of assets not adjusted for any of the complicated "risk weights" that banks can game.

We also agree with the SAFE Banking Act that to limit the risk and potential cost to taxpayers, caps on the size of an individual bank's liabilities relative to the economy can also serve a useful role (and the same kind of rule should apply to nonbank financial institutions).

Under the proposed law, no bank holding company could have more than $1.3 trillion in total liabilities (i.e., that would be the maximum size). This would affect our largest banks, which are $2 trillion or more in total size, but in no way undermine their global competitiveness. This is a moderate and entirely reasonable proposal.

No one is suggesting that making JPMorgan Chase, Bank of America, Citigroup and Wells Fargo smaller would be sufficient to ensure financial stability.

But this idea continues to gain traction, as a measure complementary to further strengthening and simplifying capital requirements and generally in support of other efforts to make it easier to handle the failure of financial institutions.

Watch for the SAFE Banking Act to gain further support over time.