DOC. N.º 32

The New York Times

How Big Is Too Big?

By Peter Boone and Simon Johnson November 26, 2009 7:18 am

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As legislation on restructuring the banking industry moves forward, attention on Capitol Hill is increasingly drawn to the issue of bank size. Should our biggest banks be made smaller?

Senator Bernard Sanders, an independent from Vermont, introduced the "Too Big To Fail Is Too Big to Exist" bill in early November; this helped focus attention. Since then, in the legislative trenches where the detailed crafting takes place, Representative Paul E. Kanjorski — the Pennsylvania Democrat who is chairman of the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises — proposed an amendment to the Financial Stability Improvement Act (currently before the House Financial Services Committee) that

> would empower federal regulators to rein in and dismantle financial firms that are so large, inter-connected, or risky that their collapse would put at risk the entire American economic system, even if those firms currently appear to be well-capitalized and healthy.

In a major step forward, this passed the committee on Nov. 18.

The Kanjorski amendment recognizes that the systemic and societal danger posed by banks can be hard to recognize, and it proposes a number of potential objective criteria that could be used by the Financial Services Oversight Council (to be created by legislation in progress) to determine when banks need to be broken up, including the "scope, scale, exposure, leverage, interconnectedness of financial activities, as well as size of the financial company."

The Kanjorski amendment does not impose a hard size cap on banks, but lawmakers in the House are discussing amendments that would do so.

There is, of course, a strong precedent for capping the size of an individual bank: The United States already has a long-standing rule that no bank can have more than 10 percent of total national retail deposits.

This limitation is not for antitrust reasons, as 10 percent is too low to have pricing power. Rather, its origins lie in early worries about what is now called "macroprudential regulation" or, more bluntly, "don't put too many eggs in one basket."

This cap was set at an arbitrary level — as part of the deal that relaxed most of the rules on interstate banking — and it worked well (until Bank of America received a waiver).

Probably the best way forward is to set a hard cap on bank liabilities as a percent of gross domestic product; this is the appropriate scale for thinking about potential bank failures and the cost they can impose on the economy.

Of course, there are technical details to work out — including how the new risk-adjustment rules would be enacted and the precise way that derivatives positions would be regarded in terms of affecting size. But such a hard cap would be the benchmark around which all the specifics can be worked out.

What is the right number: 1 percent, 2 percent, or 5 percent of G.D.P.? No one can say for sure, but it needs to be a number so small that we all agree any politician who cares about our future would have no qualm letting it fail, and when doing so have confidence that our entire financial system is not at risk as it fails.

So to us, 2 percent of G.D.P. seems about right. This would mean every bank in our country would have no more than about $300 billion of liabilities.

A large American corporation would still be able to do all its transactions using several banks. They would even be better off — competition would ensure that margins are low and the banks give the corporates a good deal. This would help end the situation where banks take an ever-increasing share of profits from our successful nonfinancial corporations (as seen in the rising share of bank value added in G.D.P. in recent decades).

Indeed, the whole world would soon realize that our banks are more competitive and offer better pricing than others.

If, as might occur, the Europeans subsidized their big banks with cheap finance and implicit subsidies, we should let our nonfinancial corporates benefit and understand that our banks may become ever smaller. We can let Europeans subsidize banking because we all get better deals through their taxpayer subsidies, and then our corporates will have more profits to bring back to America.

Today our politicians and regulators lack credibility. They have bailed out too many banks and need to show they have truly regained the upper hand — by showing that they are installing such a hard size cap rule without exception.

The litmus test is simple.

Does Goldman Sachs continue to grow, and continue to be regarded as almost as good a risk as the United States government (Goldman's Credit Default Swap spread is only 70 basis points above that of the United States today), because it has demonstrated it is too big to fail? Or, will the government impose a cap on the size of such institutions and require Goldman Sachs to find sensible ways to break itself into pieces – becoming small enough so that it will not be bailed out again next time?

We'll see. Indeed, by the midterm elections, we will have an opportunity to decide. Is the Obama administration in favor of the status quo or, by November 2010 will they have sent a message that "too big to fail" has become "fail if you remain too big"?

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