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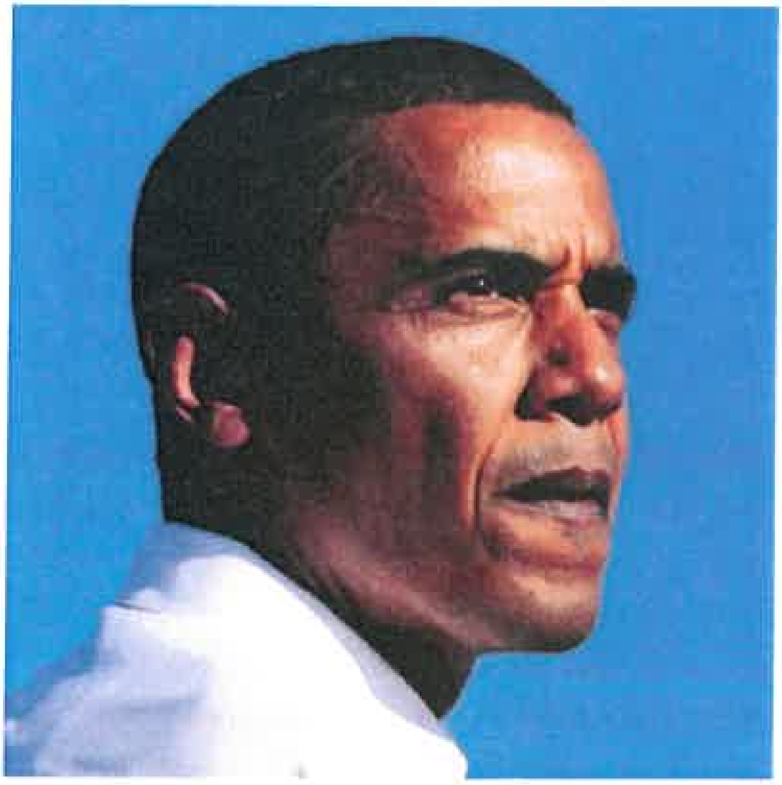
Shooting Banks

BY PETER BOONE AND SIMON JOHNSON | **February 24, 2010**

Obama's impotent assault on Wall Street.



On January 21, in an abrupt change of policy, President Obama announced his intention to take on the big bankers who have brought us so much trouble. "If these folks want a fight, it's a fight I'm ready to have," he said with a clenched jaw at a press conference.

The president's conviction seemed genuine in no small part because at his back, figuratively and literally, the president had Paul Volcker, the former Fed chairman and economic éminence grise. Arguably the most respected man in all of finance--and a lion held at bay (or in a far away office) over the past year by the president's closest advisers--Volcker has devised two simple rules to defang our financial system. First, no bank would be allowed to engage in "proprietary trading," in which it takes risks using its own capital in ways that are completely separate from services provided to clients. Second, there would be a cap on the size of our largest banks, relative to the size of total liabilities in the banking system. "Too big to fail" would finally become "too big to exist."

After a long struggle, it would seem the president has become convinced that our financial sector has grown dangerous and needs to be reined in. It has long been clear that the framework in which bank executives are rewarded for taking huge risks during boom times, and taxpayers are punished for such excesses during bad times, is not sustainable. And now, the hubris of top bankers--spurning audiences with the president and paying themselves huge bonuses, despite White House protests--has finally caught up with them. Even Wall Street cannot moon the giant and get away with it. The course of financial-sector reform is corrected.

Yet, for all of Volcker's good analysis, his presence does not necessarily change anything. To determine if the Obama administration is serious about solving the underlying crisis in finance, we need to get past Volcker's totemic visage and examine the substance of his rules. Burrowing a bit deeper, unfortunately, we find out how little would actually change.

The president is absolutely correct that our priority should be to limit the size of our largest banks and to reduce substantially the risks that can be taken by any financial entity that is backed, implicitly or explicitly, by the federal government. As a result of the crisis and various government rescue efforts, the largest six banks in our economy now have total assets in excess of 63 percent of GDP (based on the latest available data). This is a significant increase from even 2006, when the same banks' assets were around 55 percent of GDP, and a complete transformation compared with the situation in the United States just 15 years ago, when the six largest banks had combined assets of only around 17 percent of GDP. If the status quo persists, we are set up for another round of the boom-bailout-bust cycle that the head of financial stability at the Bank of England now terms a "doom loop."

Unfortunately, the specifics of the so-called Volcker Rules wouldn't address this problem. For one thing, proprietary trading is but a small part of what these banks do. For most of the major banks, such activity accounts for less than 5 percent of total revenue--even at Goldman Sachs, which is, in some senses, the largest hedge fund in the world (backed by the U.S. government through its access to the Fed's discount window), proprietary trading accounts for only around 10 percent of total revenue on average. Even if we could strip this activity from the banks, it would reduce their size only slightly--and the too-big-to-fail banks would find ways to take similar-sized risks because their upside during a boom would still be big, and their downside in a bust would dramatically damage the economy, thereby forcing the government into some sort of rescue.

Implementing the proposed nominal size cap would not make any difference either. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 specified a size cap for banks: No single bank may hold more than 10 percent of total retail deposits. This cap was not related to antitrust concerns, as 10 percent of a national market is too low to imply pricing power. Rather, this was a sensible macro-prudential preventive measure--don't put all of your eggs in one basket. Unfortunately, since 1994, two limitations of Riegle-Neal have become clear: (1) The growth of big banks was not fueled by retail deposits, but rather by various forms of "wholesale" financing (in which financial institutions lend to other financial institutions); (2) The cap was not enforced by lax regulators, so Bank of America, JPMorgan Chase, and Wells Fargo all received waivers in recent years.

Responding to this failure by limiting the size of individual banks relative to total nominal liabilities of the financial system does not make sense, as this would not be "bubble proof." For example, if housing prices were to increase tenfold, the nominal assets and liabilities of the financial system would presumably also increase markedly relative to the size of the real economy--as was the case in Japan during the 1980s. When the bubble bursts, it is the size of individual banks relative to GDP that is the more robust indicator of the damage caused when that bank fails--hence the degree to which it will be regarded as too big to fail.

Even in the most generous interpretation, the administration is proposing only to freeze the size of our largest banks, not to reduce their scale. The evening after the announcement of the Volcker Rules, when Treasury Secretary Timothy Geithner appeared on "NewsHour" and was asked whether the new rules implied that the largest banks would be "broken up" as they divested their proprietary trading operations and complied with the size cap, his response was clear: "No, this does not propose that." And a senior administration official explained, "The liability cap will be structured in such a way that it constrains future growth that leads to excessive concentration in our financial system. It's not designed to reduce the share of any existing firm."

Why would anyone regard 20 years of reckless expansion, a massive global crisis, and the most generous bailout in recorded history as the recipe for creating "right-sized" banks? There is absolutely no evidence, for example, that the increase in bank scale since the mid-'90s has brought social benefits. (There are no economies of scale for banks above $100 billion in total assets, but our biggest banks are now in the $800 billion$2 trillion range--and those figures do not properly account for their holdings of and potential losses on derivatives.) By contrast, the huge social costs are readily apparent--in terms of direct financial rescues, the fiscal stimulus needed to prevent another Great Depression, and the appalling number of lost jobs (eight million gone since December 2007, and still counting). Volcker Rules or no, the president apparently still doesn't get this.

Unfortunately, even if he did, it might not make much difference. The banks understand that if they are large enough and all get into trouble in a roughly similar manner at about the same time, there will be incredibly generous bailouts. When forced to choose between global economic collapse and expensive financial system rescue, they reckon that no government will really let them fail. And they have every basis for this belief--the people who run our mega-banks have, with very few exceptions, kept their jobs, their bonuses, their pensions, and most of their social prestige.

The banks have the power to preserve this arrangement. While the U.S. financial system has a long tradition of functioning well with a relatively large number of banks and other intermediaries, in recent years, it has been transformed into a highly concentrated system for key products. The big four have half of the market for mortgages and two-thirds of the market for credit cards. Five banks have over 95 percent of the market for over-the-counter derivatives. Three U.S. banks have over 40 percent of the *global* market for stock underwriting. This degree of market power brings with it not just antitrust concerns, which this administration has declined to act on, and a huge amount of economic risk--but great political influence as well.

The banks are going to use that power to block legislation containing any meaningful financial reform. And they are likely to succeed. Their current political donations surpass those given by most other interest groups, and the limit on their future donations has just been lifted by the Supreme Court. These banks and their allies are already targeting at least one member of Congress who supported the 2009 credit card bill. Chris Dodd, chairman of the Senate Banking Committee and long-standing champion of the financial sector, recently railed against the big banks for not cooperating with financial reform; but he is freer to speak out now that he is no longer seeking reelection. Senator Richard Shelby, the committee's ranking minority member, is steadfastly opposed to reform; he and other top Republicans eagerly await the arrival of largesse from big banks. Hill staffers remark that the financial Godfathers' message is quite clear: If you cross us, we will bury you at the polls. Nothing in the Volcker Rules would change this relationship between Wall Street and Washington.

It is still possible that the White House could go all-in against the distorted incentives at large banks and the corrupted regulatory structures that have created our "doom loop," and make this the central campaign issue for November. Branding opponents as supporters of too big to fail could get traction, at least if led by an articulate and impassioned president. The gamble would be that pro-reform representatives and senators could swim against the tide of big bank campaign contributions.

But, even here, there is a problem. After the Volcker Rules announcement on January 21, the White House went all out for the reconfirmation of Ben Bernanke. Bernanke did well during the "rescue" phase of the economic crisis--hence the case for reappointing him. But he was also deeply involved in the disastrous regulatory failures and excessively loose credit policies of 2003-2008, at the Fed and in the White House. And, most disconcerting, in his testimony--and even more in his written answers to follow-up questions--he played down the problem of too big to fail, arguing that regulation could prevent the big banks from getting into trouble.

Unfortunately, solutions that depend on smarter, better regulatory supervision and corrective action ignore the political constraints on regulation and the political power of today's large banks. The idea that we can simply regulate huge banks more effectively assumes that regulators will have the incentive to do so, despite everything we know about regulatory capture and political constraints on regulation. It assumes that regulators will be able to identify the excess risks that banks are taking, overcome the banks' arguments that they have appropriate safety mechanisms in place, resist political pressure (from the administration and Congress) to leave the banks alone for the sake of the economy, and impose controversial corrective measures that will be too complicated to defend in public. And, of course, it assumes that important regulatory agencies will not fall into the hands of people like Alan Greenspan (or Ben Bernanke), who believe that government regulation is rendered largely unnecessary by the free market.

Gently backing away from Bernanke--or at least not being so enthusiastic--would have sent a clearer signal that the president is truly prepared to be tough on big banks and their supporters. Unless Bernanke unexpectedly changes his stripes, his reappointment gives up a major hostage to fortune--and to those Democrats and Republicans opposing serious financial reform. Here lies the crux of the problem: The Obama administration lacks an inner core of smart, well-informed advisers who are deeply skeptical of big banks and eager to do whatever it takes to break a cycle that points to financial and fiscal doom. While Paul Volcker's belated ascension from the basement is an encouraging sign, he remains a lone voice in an otherwise inertial regime.

Rahm Emanuel famously said, "You never want to let a serious crisis go to waste." But, as the White House begins to campaign for the November midterms, what has it done differently than any other administration would have? How will it counter anyone who argues, simply and truthfully, that the crisis is over and we wasted it? The Volcker Rules are not the answer.

Peter Boone is a research associate at the London School of Economics Center for Economic Performance, a principal in Salute Capital Management Ltd., and chair of Effective Intervention. Simon Johnson is a professor at MIT Sloan, a senior fellow at the Peterson Institute, and co-author, with James Kwak, of the forthcoming book, 13 BANKERS.

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