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Breaking up big banks: As usual, benefits come with a side of costs

Probably the least controversial proposition among an otherwise *very* controversial set of propositions on which financial reform proposals are based is that institutions deemed "too big to fail" (TBTF) are a real problem. As Fed Chairman Bernanke declared not too long ago:

> As the crisis has shown, one of the greatest threats to the diversity and efficiency of our financial system is the pernicious problem of financial institutions that are deemed "too big to fail."

The next question, of course, is *how* to deal with that threat. At this point the debate gets contentious. One popular suggestion for dealing with the TBTF problem is to just make sure that no bank is "too big." Two scholars leading that charge are Simon Johnson and
James Kwak (who are among other things the proprietors at The Baseline Scenario blog). They make their case in the New York Times' Economix feature:

> Since last fall, many leading central bankers including Mervyn King, Paul Volcker, Richard Fisher and Thomas Hoenig have come out in favor of either breaking up large banks or constraining their activities in ways that reduce taxpayers' exposure to potential failures. Senators Bernard Sanders and Ted Kaufman have also called for cutting large banks down to a size where they no longer pose a systemic threat to the financial system and the economy.
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> …We think that increased capital requirements are an important and valuable step toward ensuring a safer financial system. We just don't think they are enough. Nor are they the central issue…
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> We think the better solution is the "dumber" one: avoid having banks that are too big (or too complex) to fail in the first place.

Paul Krugman has noted one big potential problem with this line of attack:

> As I argued in my last column, while the problem of "too big to fail" has gotten most of the attention—and while big banks deserve all the opprobrium they're getting—the core problem with our financial system isn't the size of the largest financial institutions. It is, instead, the fact that the current system doesn't limit risky behavior by "shadow banks," institutions—like Lehman Brothers—that carry out banking functions, that are perfectly capable of creating a banking crisis, but, because they issue debt rather than taking deposits, face minimal oversight.

In addition to that observation—which is the basis of calls for a systemic regulator that spans the financial *system*, and not just specific classes of financial institutions—there *is* another, very basic, economic question: Why are banks big?

To that question, there seems to be an answer: We have big banks because there are efficiencies associated with getting bigger—economies of scale. David Wheelock and Paul Wilson, of the Federal Reserve Bank of St. Louis and Clemson University, respectively, sum up what they and other economists know about economies of scale in banking:

> …our findings are consistent with other recent studies that find evidence of significant scale economies for large bank holding companies, as well as with the view that industry consolidation has been driven, at least in part, by scale economies. Further, our results have implications for policies intended to limit the size of banks to ensure competitive markets, to reduce the number of banks deemed "too-big-to-fail," or for other purposes. Although there may be benefits to imposing limits on the size of banks, our research points out potential costs of such intervention.

Writing at the *National Review Online*, the Cato Institute's Arnold Kling acknowledges the efficiency angle, and then dismisses it:

> There's a long debate to be had about the maximum size to which a bank should be allowed to grow, and about how to go about breaking up banks that become too large. But I want to focus instead on the general objections to large banks.
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> The question can be examined from three perspectives. First, how much economic efficiency would be sacrificed by limiting the size of financial institutions? Second, how would such a policy affect systemic risk? Third, what would be the political economy of limiting banks' size?
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> It is the political economy that most concerns me…
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> If we had a free market in banking, very large banks would constitute evidence that there are commensurate economies of scale in the industry. But the reality is that our present large financial institutions *probably* owe their scale more to government policy than to economic advantages associated with their vast size.

I added the emphasis to the "probably" qualifier.

The Wheelock-Wilson evidence does not disprove the Kling assertion, as the estimates of scale economies are obtained using banks' cost structures, which certainly are impacted by the nature of government policy. But if economies of scale are in some way intrinsic to at least some aspects of banking—and not just political economy artifacts—the costs of placing restrictions on bank size could introduce risks that go beyond reducing the efficiency of the targeted financial institutions. If some banks are large for good economic reasons, the forces that move them to become big would likely emerge with force in the shadow banking system, exacerbating the very problem noted by Krugman.

I think it bears noting that the argument for something like constraining the size of particular banks implicitly assumes that it is not possible, for reasons that are either technical or political, to actually let failing large institutions fail. Maybe it is so, as Robert Reich asserts in a Huffington Post item today. And maybe it is in fact the case that big is not beautiful when it comes to financial institutions. But in evaluating the benefits of busting up the big guys, we shouldn't lose sight of the possibility that this is also a strategy that could carry very real costs.

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