The Wrong Way To Break Up Banks

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June 1, 2011
Disclaimer

• My Views

• Not Those of the Federal Reserve Bank of Minneapolis or the Federal Reserve System
Main Points

• Many Popular Rationales For Activity And Size Restrictions ("Restrictions") Do Not Address The Problem

• Many Forms Of Restriction Implementation Will Not Fix The Problem

• Recovery/Resolution Planning May Help Fix The Problem
The Problem

• Creditors of SIFIs *Expect* Protection

• Governments *Expect* To Protect SIFI Creditors

• Creditor *Expectations* of Protection Encourage Excessive SIFI Risk Taking
Why Would Restrictions Change Expectations?

• Restrictions Reduce Political Influence
  – Reduce Government Incentives to Provide Support

• Restrictions Reduce Risk of Failure and Bailouts By Carving Out NonCore Activities
  – Return to “Traditional Banking”

• Restrictions Reduce Diseconomies of Scale That Make SIFIs Risky
Are Small Firms Less Influential?

Financial Contributions, 1989 to 2010

- Nat'l Association of Realtors
- American Bankers Association
- Goldman Sachs
- Credit Union National Association
- Citi
- JPMC

Financial Contributions (in Millions) from 1989 to 2010
Do Restriction Carve Outs Reduce Risk?

• Post Carve Out Banking Is Risky
  – Continental Illinois Test

• Key Features Of US Crisis Would Seem To Hold In Traditional System
  – Losses on Investment Securities
  – Assumption of Aggregate Risk
Restriction Carve Outs Reduce Bailout Incentives?

• Traditional Banking $\rightarrow$ Spillovers $\rightarrow$ Bailouts
  
  – Continental Illinois
  
  • Direct Cross Institution Exposure
  
  • Runs/Panics

• “Border Problem”
Size and Regulatory Reform in Finance: Important but Difficult Questions

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September 2010

Scale Economies in Banking—Related Articles:

- Scale Economies in Banking and Financial Regulatory Reform
- Scale Economies Are a Distraction
- Full PDF of all Scale Economies in Banking articles [PDF, 662k]
Diseconomies?

- Prior Literature Tells Little About Economies of Scale at Current Institutions
- Some Existing Literature Finds Scale At Current Levels
- More Scale = More TBTF
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How Implement Restrictions?

• Carve Out Activity In Legislation

• Set Cap, Allow Firm To Implement

• Government Directed Dismemberment
Will These Implementation Methods Fix The Problem?

• Carve Out Activity In Legislation
  — Not Firm Specific, Private Information
  — Not Well Suited For “Repeat Game”

• Set Cap, Allow Firm To Implement
  — Clones
  — Incentives For Firms To Create TBTF Firms

• Government Directed Dismemberment
  — Would It Go Far Enough?
  — The Case of Continental Illinois
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Why Recovery and Resolution

• Rationale Addresses Problem
  – Policymakers Fear Spillovers, R/R Plans Address Spillovers

• Implementation Addresses Problem
  – Private Information
  – Respond To SIFI Response
  – Link To Resolution