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We Can't Break Up the Giant Banks, Can We? Yes We Can!

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Top economists and financial experts believe that the economy cannot recover unless the big, insolvent banks are broken up in an orderly fashion.
In response, defenders of the too-big-to-fails make one or more of the following arguments:

> (1) The government does not have the authority to break up the big boys
> (2) To break up the banks, the government would have to nationalize them, which would be socialism
> (3) The giant banks have now recovered and are no longer insolvent, so it would be counter-productive to break them up
> (4) We need the giant banks to restore credit to the economy

None of these arguments are persuasive.

The Government Does Have Authority to Break Up the Big Boys

One of the world's leading economic historians – Niall Ferguson – argues in a current article in Newsweek:

> [Geithner is proposing that] there should be a new "resolution authority" for the swift closing down of big banks that fail. But such an authority already exists and was used when Continental Illinois failed in 1984.

Indeed, even the FDIC mentions Continental Illinois in the same breadth as "too big to fail" banks.

And William K. Black – the senior regulator during the S&L crisis, and an Associate Professor of both Economics and Law at the University of Missouri – says that the Prompt Corrective Action Law (PCA), 12 U.S.C. § 1831o, not only authorizes the government to seize insolvent banks, it mandates it, and that the Bush and Obama administrations broke the law by refusing to close insolvent banks.

Others argue that the PCA does not apply to bank holding companies, and so the government really does not have the power to break up the big boys (see this, for example; but compare this).

Whether or not the financial giants can be broken up using the PCA, no one can doubt that the government could find a way to break them up if it wanted.

FDR seized gold during the Great Depression under the Trading With The Enemies Act.

Geithner and Bernanke have been using one loophole and "creative" legal interpretation after another to rationalize their various multi-trillion dollar programs in the face of opposition from the public and Congress (see this, for example).

So don't give me any of this "our hands are tied" malarkey. The Obama administration could break the "too bigs" up in a heartbeat if it wanted to, and then justify it after the fact using PCA or another legal argument.

Temporarily Nationalizing a Bank is Not Socialism

Many argue that it would be wrong for the government to break up the banks, because we would have to take over the banks in order to break them up.

That may be true. But government regulators in the U.S., Sweden and other countries which have broken up insolvent banks say that the government only has to take over banks for around 6 months before breaking them up.

In contrast, the Bush and Obama administrations' actions mean that the government is becoming the majority shareholder in the financial giants more or less permanently. That is – truly – socialism.

Breaking them up and selling off the parts to the highest bidder efficiently and in an orderly fashion would get us back to a semblance of free market capitalism much quicker.

The Giant Banks Have Not Recovered

The giant banks have still not put the toxic assets hidden in their SIVs back on their books.

The tsunamis of commercial real estate, Alt-A, option arm and other loan defaults have not yet hit.

The overhang of derivatives is still looming out there, and still dwarfs the size of the rest of the global economy. Credit default swaps still have not been tamed (see this).

Indeed, Nobel prize winning economist Joseph Stiglitz said today:

> The U.S. has failed to fix the underlying problems of its banking system after the credit crunch and the collapse of Lehman Brothers Holdings Inc.
>
> "In the U.S. and many other countries, the too-big-to-fail banks have become even bigger," Stiglitz said in an interview today in Paris. "The problems are worse than they were in 2007 before the crisis."
>
> Stiglitz's views echo those of former Federal Reserve Chairman Paul Volcker, who has advised President Barack Obama's administration to curtail the size of banks, and Bank of Israel Governor Stanley Fischer, who suggested last month that governments may want to discourage financial institutions from growing "excessively."

While the big boys have certainly reported some impressive profits in the last couple of months, some or all of those profits may have been due to "creative accounting", such as Goldman "skipping" December 2008, suspension of mark-to-market (which may or may not be a good thing), and assistance from the government.

Some very smart people say that the big banks – even after many billions in bailouts and other government help – have still not repaired their balance sheets. Reggie Middleton, Mish, Zero Hedge and others have looked at the balance sheets of the big boys much more recently than I have, and have more details than I do.

But the bottom line is this: If the banks are no longer insolvent, they should prove it. If they can't prove they are solvent, they should be broken up.

We Don't Need the Giant Banks

Fortune pointed out in February that smaller banks are stepping in to fill the lending void left by the giant banks' current hesitancy to make loans. Indeed, the article points out that the only reason that smaller banks haven't been able to expand and thrive is that the too-big-to-fails have decreased competition:

> Growth for the nation's smaller banks represents a reversal of trends from the last twenty years, when the biggest banks got much bigger and many of the smallest players were gobbled up or driven under…
> As big banks struggle to find a way forward and rising loan losses threaten to punish poorly run banks of all sizes, smaller but well capitalized institutions have a long-awaited chance to expand.

BusinessWeek noted in January:

> As big banks struggle, community banks are stepping in to offer loans and lines of credit to small business owners…
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> At a congressional hearing on small business and the economic recovery earlier this month, economist Paul Merski, of the Independent Community Bankers of America, a Washington (D.C.) trade group, told lawmakers that community banks make 20% of all small-business loans, even though they represent only about 12% of all bank assets. Furthermore, he said that about 50% of all small-business loans under $100,000 are made by community banks…
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> Indeed, for the past two years, small-business lending among community banks has grown at a faster rate than from larger institutions, according to Aite Group, a Boston banking consultancy. "Community banks are quickly taking on more market share not only from the top five banks but from some of the regional banks," says Christine Barry, Aite's research director. "They are focusing more attention on small businesses than before. They are seeing revenue opportunities and deploying the right solutions in place to serve these customers."

And Fed Governor Daniel K. Tarullo said in June:

> The importance of traditional financial intermediation services, and hence of

> the smaller banks that typically specialize in providing those services, tends to increase during times of financial stress. Indeed, the crisis has highlighted the important continuing role of community banks…
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> For example, while the number of credit unions has declined by 42 percent since 1989, credit union deposits have more than quadrupled, and credit unions have increased their share of national deposits from 4.7 percent to 8.5 percent. In addition, some credit unions have shifted from the traditional membership based on a common interest to membership that encompasses anyone who lives or works within one or more local banking markets. In the last few years, some credit unions have also moved beyond their traditional focus on consumer services to provide services to small businesses, increasing the extent to which they compete with community banks.

Indeed, some very smart people say that the big banks aren't really focusing as much on the lending business as smaller banks.

Specifically since Glass-Steagall was repealed in 1999, the giant banks have made much of their money in trading assets, securities, derivatives and other speculative bets, the banks' own paper and securities, and in other money-making activities which have nothing to do with traditional depository functions.

Now that the economy has crashed, the big banks are making very few loans to consumers or small businesses because they still have trillions in bad derivatives gambling debts to pay off, and so they are only loaning to the biggest players and those who don't really need credit in the first place. See this and this.

So we don't really need these giant gamblers. We don't really need JP Morgan, Citi, Bank of America, Goldman Sachs or Morgan Stanley. What we need are dedicated lenders.

The Fortune article discussed above points out that the banking giants are not necessarily more efficient than smaller banks:

> The largest banks often don't show the greatest efficiency. This now seems unsurprising given the deep problems that the biggest institutions have faced over the past year.
> "They actually experience diseconomies of scale," Narter wrote of the biggest banks. "There are so many large autonomous divisions of the bank that the complexity of connecting them overwhelms the advantage of size."

And Governor Tarullo points out some of the benefits of small community banks over the giant banks:

> Many community banks have thrived, in large part because their local presence and personal interactions give them an advantage in meeting the financial needs of many households, small businesses, and agricultural firms. Their business model is based on an important economic explanation of the role of financial intermediaries–to develop and apply expertise that allows a lender to make better judgments about the creditworthiness of potential borrowers than could be made by a potential lender with less information about the borrowers.
>
> A small, but growing, body of research suggests that the financial services

> provided by large banks are less-than-perfect substitutes for those provided by community banks.

It is simply not true that we need the mega-banks. In fact, as many top economists and financial analysts have said, the "too big to fails" are actually stifling competition from smaller lenders and credit unions, and dragging the entire economy down into a black hole.

But don't believe me.

The Bank of International Settlements – the "Central Banks' Central Bank" – has slammed too big to fail. As summarized by the Financial Times:

> The report was particularly scathing in its assessment of governments' attempts to clean up their banks. "The reluctance of officials to quickly clean up the banks, many of which are now owned in large part by governments, may well delay recovery," it said, adding that government interventions had ingrained the belief that some banks were too big or too interconnected to fail.
>
> This was dangerous because it reinforced the risks of moral hazard which might lead to an even bigger financial crisis in future.

Given that BIS is the ultimate insider, this is quite a criticism.