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Special report: International banking

The problems of size

Survival of the fattest

What, if anything, can be done about banks that are too big to fail?

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SUPERVISORS THE WORLD over are trying to work out ways of dealing with banks that are too big to fail. The most obvious solution is to chop them up into manageable bits so none is too big or interconnected to be allowed to go. But it is far from perfect. For a start, carving up big banks that operate internationally does not necessarily reduce their risk—on the contrary, their geographical spread may have made them safer. And Spain's troubled savings banks show that when many small banks stumble they can cause as much trouble as one big one. The risks on their books are often concentrated.

However, reducing big banks to manageable proportions could be a question not just of size but also of the scope of activities. In the run-up to the crisis and right through it most big banks converged on some variant of universal banking, combining both retail and investment business. If anything, the shotgun marriages that took place at the height of the crisis accelerated this trend, joining many of America's investment banks with their commercial rivals. This was done for good reasons. Universal banks generally have more stable earnings and lower borrowing costs than specialists in one or the other area of business.

Looking at costs can, however, be deceptive. One reason why universal banks are able to borrow more cheaply than standalone investment banks is cross-subsidisation, which raises two worries. The first is that they are able to channel cheap deposits from their retail businesses into their investment banks. Normally regulators are not concerned with the pricing of internal transfers, but for banks the cost of borrowing is inextricably tied to the riskiness of the loan. If one part of a bank is getting money more cheaply from another part of the business than it would from the money markets, the chances are that the risks involved are not being properly priced.

The second worry about low borrowing costs is that universal banks are less likely to be allowed to fail than pure investment banks. Their lower borrowing costs probably stem partly from an implicit government guarantee. A study by Oliver Wyman found that if British banks were forced to split up their businesses and fund each one as a separate subsidiary, their borrowing costs would rise substantially. Part of that increase would be due to the loss of genuine benefits from risk diversification. The other half, however, would represent the loss of a hidden public subsidy, says a person familiar with the study.

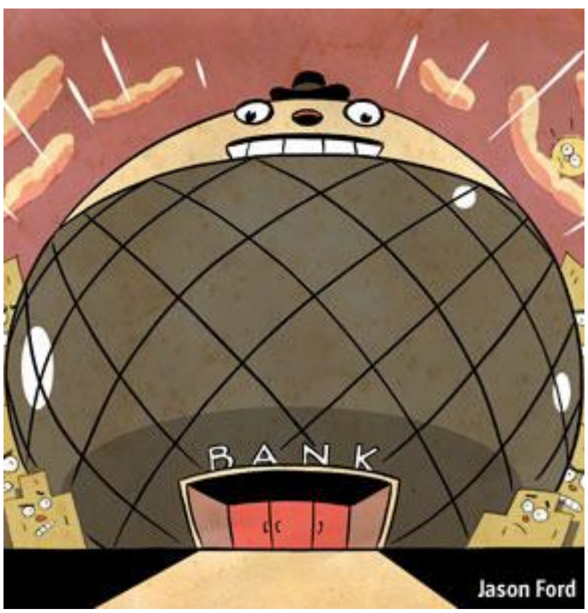
A more rough-and-ready calculation of the public subsidy British banks enjoy, based on the difference between the credit ratings of big and small ones, by Andrew Haldane at the Bank of

England, comes up with a much larger sum. Ending these cross-subsidies might make some forms of investment banking more expensive for companies. On the other hand, it should make retail banking cheaper and savers should get slightly higher rates. So cost alone is not necessarily a convincing argument in favour of universal banks.

A better argument is that they offer clients something that others cannot. As companies expand abroad, they want big banks to help them manage their finances across the world. “To the extent that globalisation is alive and well, you will have global banks,” says Vikram Pandit, the chief executive of Citigroup. He has a point. Companies that are able to sweep up cash from disparate subsidiaries every night can significantly cut their use of debt, says Hugo van Wijk of Vallstein, a firm that advises companies on cutting their banking costs. That is important to bank customers, and regulators probably should not tamper with it. But it is a relatively small part of what many global banks do and could well be left alone even if banks had to make other changes to their business.

The really tough decision for regulators is whether the cost of making banks separate out their investment arms is justified by the gains of reduced systemic risk. “I'm against the idea that you solve the problem of a universal bank that is too big to fail by splitting it up,” says one senior regulator. “You just end up with an investment bank and a retail bank that are both too big to fail.”

In Britain an independent commission on banking thought long and hard about separating investment and retail banks. In a report published last month it suggested that banks should have to fence off their retail arms to insulate them from any failure of their investment arms. Both would have to hold thicker capital cushions. Banks would also have to provide a source of ready funds for a bail-out in the shape of convertible or bail-in capital.



Good resolutions

If chopping up big banks into smaller pieces is not necessarily the answer, at least regulators could make it easier to deal with disasters once they have happened. Small-bank resolution regimes on the whole work well (see article). Could they be adapted for use in rescuing very big banks too? Since the collapse of Lehman Brothers threw the world economy into turmoil, much has been done to improve the resolution of domestic banks. (Jamie Dimon, the chief executive of J.P. Morgan, objects to the term: “I wish you'd call it minimally damaging bankruptcy for big dumb companies,” he says.) Yet regulators confess that they would struggle to extend such arrangements to large and complex banks. “We have a very good resolution regime in this country,” says one British official. “But it is a small-bank resolution regime.”

Even America's Federal Deposit Insurance Corporation (FDIC), an agency created to maintain stability and public confidence in the nation's financial system, finds it hard to come to grips with this problem. Sheila Bair, its chairman, insists that she has the legal power and the resources to shut down any financial institution, no matter how big. Yet one person who was involved in winding up IndyMac, a Californian lender with $32 billion in assets that wilted in July 2008, reckons that the agency would probably not be able to cope with dismantling anything bigger than that. The failure a few months later of Washington Mutual, an even larger bank, was also managed by the FDIC but substantial parts of its business were passed virtually intact to J.P. Morgan, which had been trying to buy it for months.

One difficulty in dealing with complex banks is their tendency to spawn hundreds or even thousands of subsidiaries. When a bank fails, each subsidiary has to be dealt with separately, which can introduce a lot of complexities. “First you have to figure out which one of the subsidiaries employs the staff,” says one person who was involved in the bankruptcy of Lehman. “You can find you've got an organisation with a huge balance sheet but no one actually works for it.”

Big international banks are even more difficult to wind up, not least because they are so much more complex than their stay-at-home siblings. A bigger issue, however, is that legal systems and bankruptcy laws have not kept up with the globalisation of finance. Banks are able to whisk money around the world in an instant, and their creditors can withdraw their money in the blink of an eye. This is why bank resolutions must be completed in a single weekend. Yet most bankruptcy laws are geared to the leisurely counting of assets or liabilities in an industrial firm over months, sometimes years. National laws are often incompatible with each other. In Britain, for instance, the courts look at a company's worldwide balance-sheet and apportion what assets they recover to all the creditors of the failed company. By contrast, under American law a failed bank's American depositors are compensated first before any money can be handed out to foreign ones. “Hypothetically it's very simple [to resolve a bank] if you have a hypothetical institution that is established as a single legal entity in one country,” says Simon Gleeson of Clifford Chance, a law firm. “As soon as you get into the real world you see that institutional structures are very difficult to deal with.”

Politics also intervene. If winding up or bailing out a big cross-border bank, whose taxpayers should be called upon to save it if most of its business is abroad? The problem is particularly acute in Europe, where the single market's rules allow banks to do business freely across borders. Even if countries are worried about the health of a foreign bank that is taking deposits from their citizens, they have little power to stop it from doing so.

One answer would be to draw up an international bank-resolution treaty that would set out how countries should deal with the failure of big cross-border banks. The European Commission is making a start by trying to get members at least to write national laws that do not conflict. But even the most ardent supporters of a global treaty concede that it would take decades to achieve. “I think of this as a trade negotiation,” says Mr Kashyap at the University of Chicago. “It's on that sort of scale.”

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