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## Breaking up big banks

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### ABSTRACT

This paper discusses the proposals to limit the size of the banks, also known as tackling the banks' incentives to become "too big to fail". I examine how regulations to curb bank size may affect banks' operating costs. I analyze the relationship between the size of U.S. bank holding companies (BHCs) and their operating costs from 2001:Q2 to 2014:Q1. I find that rules to limit the size of banks could significantly reduce economies of scale. In particular, if large and cost-efficient banks become split into smaller parts, data processing, legal fees, audit and consulting expenses, expenses on premises are likely to increase.

The second part of the paper deals with the phenomenon known as "too big to jail" and examines banks' settlements. I compile a novel dataset on 341 litigation charges and settlements and find evidence that larger banks and banks with a higher credit risk, but not necessarily more systemically risky banks, face litigation charges more frequently. I do however observe that penalties had little effect on BHCs' profitability, and that some of the largest banks continuously faced litigation charges which may imply that benefits from wrongdoing outweighed the costs or that many large banks relied on the fact they will be considered immune from prosecution due to their sheer size and their influence on the economy.

### 1. Introduction

The evolution of U.S. financial legislation reflects a long-running public debate about the appropriate size and scope of banking firms. As noted in [Barth et al. \(2012\)](#), financial institutions have been continuously growing in size. The assets of the top 50 companies in 2011 were roughly equal to total U.S. GDP, which represents about a four-fold increase in four decades. In the fourth quarter of 2011, the combined assets of the five biggest companies totalled about 60 percent of U.S. GDP. By contrast, in 1970 the corresponding figure was only 10 percent. For the top ten companies, the figures increased from 14 percent to 75 percent.<sup>1</sup>

The striking growth in size and importance of BHCs subsidiaries dates back almost entirely to the period after the passage of the Gramm–Leach–Bliley Act 1999, allowing the banks to engage in a broad range of financial activities in various states, including securities underwriting and dealing, insurance underwriting, and merchant banking activities, all of which led to intensified competition in the banking industry. Banks have also faced increased competition in wholesale markets, due to increasingly deeper and more efficient financial markets (e.g., high-yield commercial debt, CP, equity finance) which have provided banks' business customers with alternatives to traditional bank loans.

Well-managed banks responded to these competitive pressures by becoming more cost efficient and more revenue-efficient, which aligns well with the classic economic theory that suggests that when banks grow in size, there might be a significant number of benefits accompanying such expansion, for example, increasing economies of scale and an increase in the banks' bargaining power. This includes offering customers a wider range of new nontraditional fee-based products, selling increased amounts of existing fee-

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<sup>1</sup> A historic perspective on "too big to fail" is provided in [Barth et al. \(2012\)](#).

based products, pricing fee-based products more efficiently, improving the quality of fee-based products and services and minimizing costs by reducing the number of employees and introducing new technologies.

There has been a secular trend in recent decades toward enlarging and contracting the allowable scope of BHC activities. In general, it seems that contraction in banking activities usually follows major crises, and expansion is favored in boom years. It is axiomatic to assert that the past couple of years after August 2007 were not the finest or easiest to the banks. For example, since the recent financial crisis there have been several proposals to impose caps on bank size and limit the scope of banking activities, such as the “Volcker rule” provisions of the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank Act) in the U.S. prohibiting BHCs from engaging in proprietary trading and limiting their investments in hedge funds, private equity and related vehicles. In particular, the recent financial crisis has brought forward concerns about banks that regulators deem “too big to fail” in the sense that their failure would pose serious systemic risks, which has prompted calls for regulatory limits on bank size (Reich and Robert, 2008; O’Driscoll, 2009).

Recent petitions to break up “too-big-to fail” banks and pass new laws similar to the last century’s Glass-Steagall Act have come in various shapes and flavors.<sup>2</sup> For example, Johnson and Kwak (2010: 214) argue that “no financial institution [s]hould be allowed to control or have an ownership interest in assets worth more than a fixed percentage of U.S. GDP” (they propose a 4 percent ownership ratio). Others suggest various alternatives including levies or progressively higher capital requirements on large banking firms to encourage them to shed assets. Big banks oppose efforts to break them up, reasoning that their larger size makes them more efficient. Also, the treatment of large banks as “too big to fail” could generate scale economies by lowering the risk premiums demanded by creditors of large banks, thereby giving them a funding advantage over smaller banks.

The assessment of the extent of scale economies is important for a full analysis of the costs and benefits of any policy intervention to limit the size of banks. Policymakers should consider the loss of any scale benefits when determining the net benefit of limiting the size of banks. Although bankers often claim that banks can lower costs by expanding in size, many policymakers and academics remain skeptical (e.g. Stern and Feldman, 2009; Greenspan, 2010; Haldane, 2010).

A frequently mentioned rationale for splitting large banks is that larger banks can enjoy cheaper insurance premiums disconnected from their actual risk levels, and implicit government insurance, since government cannot allow huge banks to collapse. This means they can essentially gamble for resurrection and expect to be bailed out if things go wrong. That is, it is possible that operating costs are no lower in big banks, but simply that large banks benefit from implicit guarantees. However, it may be the case BHCs become more efficient as they grow in size and subsequently can reduce their operating costs which will have a positive effect on a wider society and bank fees decrease, consistent with the classic economic theory. In that case, government-mandated size limits are likely to be a deadweight loss and constitute an unnecessary or even unfair form of intervention in financial markets.

In this chapter, I focus primarily on the costs which banks control internally. Thus, as far as banks’ operating costs are concerned, it is true that while banks cannot generally choose what regulations to comply with, as these are most often exogenous, they are free to choose their operating costs. I examine questions such as whether banks obtain more bargaining power as they grow in size and thereby can reduce their operating costs, or whether some costs increase proportionally with size or perhaps some costs grow more rapidly than the growth of banks’ assets. There exists some empirical evidence (e.g. Kozubovska, 2017) that size is positively correlated with opacity, and for that reason many of the banks’ costs might rise (e.g. audit, legal fees, FDIC premiums) as it is more difficult to evaluate banks’ exposure to various risks. On the other hand, postage and IT costs can decrease, as these may constitute monthly fixed costs which when spread over a larger sized entity will increase operating revenue or alternatively decrease efficiency ratios. This is important because banks typically pass on these costs to customers or shareholders.

The recent financial crisis has not been solely an economic phenomenon, but a legal one as well. It has brought to light much of banks’ wrongdoing. A frequently mentioned but perhaps less pronounced feature of big banks is that for a long time they have been shielded from legal responsibility for their misconduct. As noted by some leading U.S. judges, some banks have become “too big to jail” (Rogoff, 2016). Term “too big to jail” was coined to describe the theory that certain financial institutions, even if they engage in criminal misconduct, should be considered immune from prosecution due to their sheer size and their influence on the economy. A mere look at the levels of the recent tsunami of legal settlements shows why politicians have been active as ever in trying to break up big banks and eliminate the incentive for banks to become simultaneously “too big to fail” and “too big to jail”.<sup>3</sup>

Litigation risk has been of paramount importance, especially after the mounting charges and litigation settlements related in particular to market manipulation litigation, U.S. mortgage-related issues, product mis-selling litigation, tax evasion litigation, U.S. embargo issues, misrepresentation litigation, and company-specific issues. The penalties for such behavior are sobering. For example, since 2009 litigation costs have grown four years in a row, and banks on both sides of the Atlantic have paid out a total of \$178 billion in litigation costs; banks’ legal bills have also swelled with them (WSJ, 2014). During the first nine months of 2014, banks in the U.S. and the E.U. paid out \$60 billion to settle legal claims. That was up from \$46 billion in 2013, \$44 billion in 2012 and \$22 billion in 2011, as noted in the recent research by Boston Consulting Group (BCG) and references in FT (2015). Even though U.S. banks have settled the bulk of claims arising from pre-crisis mortgages, BCG predicts that potential litigation risks remain substantial. For example, as of 2014 JPMorgan Chase said that it was involved in legal proceedings on more than 20 fronts, including investigation by the U.S. Department of Justice (DoJ) into whether the bank bought car loans that had been priced according to the race and ethnicity of the borrower.

<sup>2</sup> For example, E. Warren’s calls on Congress to break up the big banks: “U.S. Senator Elizabeth Warren on Wednesday called on lawmakers to break up big banks and change tax rules that benefit Wall Street. She said lawmakers should break big down and limit the U.S. Federal Reserve’s ability to lend in a crisis so that big institutions cannot count on a bailout” (Reuters, April 15, 2015).

<sup>3</sup> Elaborate discussion on litigation issues are provided in ‘Litigation Handbook’ prepared by OCC, available at <http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/pub-ch-m-litigation-and-other-legal-matters.pdf>.

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