

## **Have Banks Become Too Big to Regulate?**

By

Roy C. Smith and Ingo Walter  
Stern School of Business

New York University

After the stock market crash of 1929, the resulting downturn in the economy and then the catastrophic failure of led to pass the Banking Act of 1933, a revolutionary step in the field of financial regulation that, from then on, treated banks differently from other private corporations. They were special, because they held the savings and working capital of most of the country, essential resources that could not again be subjected to the sort of market failure that was sustained in the 1930s. Banks must be kept safe.

After 1933, the federal government (through the enhanced Federal Reserve System, the Comptroller of the Currency and the Federal Deposit Insurance Corporation) regulated not only short-term interest rates, but capital adequacy, deposit taking locations, and permitted corporate activities of banks (including mergers with other banks or with non-banks) under comprehensive regulations that restricted which lines of business they could engage in. The simple idea was that if banks were to be guaranteed by the taxpayer –and had

access to relatively cheap capital because of it -- the government was entitled to regulate the insurance risks that it assumed.

### **Banks Become Growth Stocks**

The guarantee of access to cheap capital, however, created a moral hazard that banks, in the 1960s and 1970s, were unable to resist. The top managers of banks saw rising stock markets reward companies that could grow at 15% or so a year with high price-earnings ratios. Led by Walter Wriston, who was appointed CEO of First National City Bank in 1967, banks began to claim to be growth companies too, so their p-e ratios could rise above the 5-6 that markets had assigned them in the early 1960s because of their slow-growth, regulated-public-utility nature. Wriston claimed in 1970 that a well managed bank (or later a bank holding company) could maintain a 15% annual growth rate indefinitely by concentrating on productivity and regulatory challenge at home, and exploiting the many opportunities in the great unregulated space available to them outside the United States. By early 1973, Wriston had caused his bank's stock to achieve a p-e ratio of 25, and most of the money center banks in the United States, and many abroad, too noticed. This was essentially a five-fold increase in the market capitalization of the company, because it adopted a high-growth strategy. A result was a broad competition among banks to demonstrate growth of assets and earnings, and secure the approval of stock market investors. The competition was facilitated by the ease of access to both bank assets and deposit funding in the unregulated and rapidly expanding

Eurocurrency market. It continued through the difficult decade of the 1970s, when oil price rises, inflation and many other economic troubles put great strains on the world economic system.

The first large bank to fail as a result of too many bad assets accumulated during this time was Continental Illinois, which was taken over by the FDIC in 1984. This event was the first in a two-decade long series of major bank restructurings that began in America, moved next to Europe and then to Japan and other countries in Asia. Fearful of a collapse of the world financial system as a result of overaggressive competitive lending practices, the central banks of twelve leading countries agreed in 1988 to a risk-adjusted bank capital adequacy system (Basel I) to be implemented in 1992. But the installation of the new system would be too late to save the signatory countries from their own banking crises. All of these were expensive, long drawn out, and brought serious difficulties to their domestic economies and structural change to the financial services industry, forcing massive shifts of business into capital markets. To a large degree the banking crises were caused by reckless competition among the banks (to make large loans to wholesale customers) and by failure to manage the market risk of their asset and liability exposures.

In the US, the crisis included a collapse of the savings and loan industry, which was decimated by its unique exposure to market risk a great cost to the American taxpayer, but the carnage was also considerable among large money center commercial banks. Fifty years had passed since the last banking crisis and authorities were rusty and ill prepared when the current one occurred, but

they did their best they could and by the early 1990s American banks, chastised and humbled, merged and reorganized and under new management, were recovering. They had suffered great shareholder losses, restrictions on activities and growth and seen banking regulations tighten around them. In the early 1990s, American banks went back to the basics of doing what they did best, with all but a few of the largest deciding to forego the riskier wholesale business to concentrate on profitable consumer services and regional transactions involving smaller businesses. The banks rebuilt their balance sheets, raised capital, exited unprofitable businesses and invested large amounts in new technologies. The stock prices began to rise again.

### **Failure Leads to Deregulation**

But, they complained, to recover fully, the banks needed to be free of interstate banking restrictions and of (what they claimed to be the out-of-date) limitations on them imposed by the 1933 Glass-Steagall law (separating banking and investment banking). They pointed to European universal banks, then thought of as among the most powerful and competitive in the world. These banks were claimed to be models for the reconstituted American banks, though in just a few years these banks also succumbed to the same problems that had taken American banks down earlier. The American banks claimed that now that their balance sheets were regulated by Basel I, other constraints on them were no longer necessary, and indeed were anti-competitive. They asked for changes in the regulations which would constitute the removal of most of the restrictions

that had constrained them for the prior fifty years. These regulatory changes, after years of debate and lobbying, were allowed, and by 1999 the banks were largely free of restraints over what they could do and where they could do it.

In Europe, the coming together of the European Union after the Single Market Act in 1987 (also to be implemented in 1992) led to a directive re-regulating the banking industry in the interest of encouraging competition and free markets for banking services. The directive effectively enlarged a bank's area of operation to include all of the EU, and loosened the regulatory controls under which banks had to conduct their business.

These changing regulatory conditions encouraged banks to consolidate through mergers into large regional and national institutions operating in all parts of the country and around the world, and leading to competition in all sorts of different financial services businesses. Indeed, the intensity of mergers within the financial services industry during the 1990s was greater in both the US and in Europe than for any other industry.

### **Banking Today**

By 2004, the financial service industry had become integrated by the joining together of commercial banking, investment banking, investment management, and insurance, into a few large multi-line holding companies. These businesses contained both retail and wholesale services, but only one group (Citigroup) offered all of these services globally. Others provided several of them, if not all, but only the largest firms sought to be leaders in all of the

principal markets they operated in. The wholesale finance business was now anchored in global capital markets (which now account for about four-fifths of all wholesale finance) and was dominated by fewer than ten firms (Table 1), about half of which are universal banks. The retail banking business had evolved into national (but not yet global) markets and was dominated by fewer than a dozen firms with large branch networks, superior technology and marketing skills. All of these firms, wholesale and retail, had recognized the importance of investment management of mutual and pension funds and wealthy private banking services and had aggressively branched out into them. All of the largest fifteen financial service firms ranked by market capitalization (Table 2) have significant activities in the US, Europe and Asia, most of this lateral expansion was acquired recently in merger markets.

All of these firms, since Walter Wriston introduced the idea, still strive to be seen by investors as growth companies and to receive the commensurate benefits of relatively high p-e ratios supporting their stock prices. Accordingly they must set corporate strategy objectives that are primarily directed at achieving a sustainable high rate of profit growth. Those that fail to do so are in danger of being taken over by others. To grow at such a high rate, i.e., at two or three times the nominal growth rate of the national GPD, requires some combination of internally improved productivity, increased market shares and by external acquisitions. Almost all of the major banks have attempted all three, however most of the visible growth has come from acquisitions. As these banks get larger, however, the availability of suitable acquisitions to assist the quest for

growth diminishes, and more has to be left to internal development. For Citigroup to grow at 15%, for example, requires the creation every year of additional market capitalization equal to roughly the value of a firm such as Goldman Sachs.

A continuous acquisition strategy imposes great strains on the ability of a bank to manage integration of corporate cultures, marketing and compensation policies, and compliance and control systems. Many banks, which made several large acquisitions in just a few years, have stumbled over these tasks. Perhaps more significant is the continuing exposure to increasing agency costs, moral hazard and business risk to which banks must expose their stockholders in order to achieve the returns they have committed themselves to producing. These risks have shown up recently in aggressive tied-lending practices and inappropriate relationships with corporate clients (such as Enron, WorldCom and Parmalat), and abusive treatment of fiduciary relationships (Wall Street research, IPOs, mutual fund trading). Citigroup additionally was rebuked by Japanese regulators for its conduct in the private client business, and forced to apologize for its excessively aggressive trading activities in the European government bond market. Altogether the top few banks have already suffered losses, fines and class action settlements related to such activities in the tens of billions of dollars, and many outstanding matters remain pending.

### **New Regulatory Realities**

Many of the most important controls to which banks were subject before 1999 have been repealed. The US government, in the spirit of deregulation and liberal economic thinking, went along with this willingly with broad support from academics and industry leaders. If it could be established that a *laissez-faire* financial system is in the country's best interest, then the issue of controls would be moot. But this point of view has not been established, so an unintended but waning government control of banks was an inadvertent and premature result of the move to deregulate.

Concentration has provided fertile ground for management tolerance of conflicts of interest (between managers, clients and stockholders) and internal compensation incentives (offered to important producers) encouraged some banks to decide some potential conflicts of interest in their own favor. The usual remedy for abuse of such conflicts is a combination of some form of regulatory enforcement action and civil litigation, with a possibility of significant fines or settlement costs, which taken together have the potential to be very costly to the firm, and can affect a stock price decline. Normally, this threat of harm would restrain firms from abusing conflicts of interest. However, some of the financial conglomerates have become so large and diverse that they may be impervious to such financial punishments. Given their essential growth strategies such punishments tend to be regarded simply as a cost of doing business. After all, the sum of all these costs of business related to the unwinding of the bubble period (1995-2000) will never be more than a very small part (less than 2%) of the \$750 billion combined market capitalization of the top ten wholesale banks in

mid 2004 (after their stock prices had already been significantly “adjusted” for their exposures). Not only are these banks “too big to fail,” they have also become too big to reprimand.

This may suggest a serious flaw in the modern financial system. The largest multi-line banks have become harder to control by regulators, despite the fact that the government is effectively guarantying all of their deposits, and the condition is likely to continue because of the demands of the banks’ common business model. Although there are only two or three large multi-line banks in America, there are a few more in Europe, as well as a few large global insurance companies with similar growth-oriented business strategies that are also part of the increasing integrated global financial system. Further, there are two large government sponsored mortgage finance companies in the United States (both currently in trouble with their regulators over suspicious accounting). All of these firms are arguably too-big-to-fail and dependent on capital markets for their own finance, as well as for providing it to clients. The capital markets can be very fickle when disappointed – and rollover of maturing debt and access to simple credit lines, as well as access to equity financing, can disappear instantly when a company is seen to be failing. This was certainly the experience of Continental Illinois and other banks in the 1980s, of Salomon Inc in 1991 (following exposure of its illegal activities in the auction market for US Treasury securities), Long Term Capital Management in 1998, and of Enron in 2001.

Nevertheless, it is difficult to establish that these dozen or so large global financial institutions with high-growth business strategies are likely to fail at once

-- or indeed even to fail at all. The current levels of industry concentration (in terms of restraint of trade) are not yet substantial – even in the most concentrated businesses lines the top firms have less than a 15% market share. And, despite their commitment to high-growth strategies, regulatory scrutiny and market pressures, it is assumed, will prevent them from developing a long-term run of rogue or predatory behavior. This could change in the years ahead, but if the concentration is not large relative to the entire market, can there be a serious systemic risk for which regulators need to show concern?

### **Systemic Risk in a Deregulated Market**

The simplest understanding of systemic risk in financial markets is one in which the failure of a single firm spreads to others sufficiently to injure the entire system. The system of course includes banking and capital markets, and all of their respective sources of liquidity and payment mechanisms, without which much of the world's economic activity would be significantly. Central bankers have historically been the guardians of systemic risk, but increasingly capital market regulators must recognize responsibilities for it too.

The first thought of those confronting an apparent form of systemic risk is to rescue the failing firm with an infusion of capital, normally a function of a lender-of-last resort. This is what the US banking authorities did in the case of Continental Illinois, and to prevent the collapse of savings and loan companies and other banks in the later 1980s. The Federal Reserve also offered liquidity support to the broker-dealer community after the stock market crash of October

1987, and again, acted to prevent a systemic problem at the time of the failure of Long Term Capital Management in 1998. Certainly systemic risk is now widely understood to stretch well beyond runs-on-banks to include anything that might bring the massive global financial system (with nearly \$2 trillion per day turning over in the foreign exchange markets – mostly for financial transactions) to a halt, even if a relatively brief one.

The current effort by the Basel Committee of central banks to address revised minimum bank capital adequacy regulations attempts to capture systemic risk as practically as possible. It consists of various forms and degrees of credit risk, trading risk and operational risk. The new system which is to go into effect in 2006 will consist of three “pillars” of control – the risk-adjusted capital adequacy test, the inspections and regulatory efforts of banking supervisors, and requirements for disclosure that will permit market analysts to make their own judgments. The system may be as good as it can be, but it is only a limited guaranty that systemic risk is to be regulated effectively. There are some additional risk components that are not addressed:

- The Basel rules do not apply to all of the major market operatives that are not banks such as FNMA, AIG, Merrill Lynch, and large hedge funds. Also certain investments by multi-line banks may be excluded from consolidation, such as hedge funds and mutual funds managed by constituent parts of the group.
- The new Basel rules will depend on cooperation, more than ever, between home country and host country regulators. It may be too much to expect regulators from all the countries in which Citigroup operates, for example, to coordinate their efforts, especially if these need to be expanded to include bond trading activities in the Euromarket and private banking in Japan, both of which offended Citigroup’s regulators in 2004.

- The new Basel rules will allow the major banks to utilize risk measurement programs of their own design, and therefore become somewhat self-regulatory. The programs will determine the capital ratios and other information to be reported to supervisors and to the markets. Given the role in recent years of accounting manipulation in corporate failures or scandals, this provision may contain dangers of its own.
- Neither the Basel rules, nor any other risk scoring measures, can identify the extent to which risk becomes concentrated through a network of inadvertent funding of identical positions, such as those held by hedge funds, proprietary trading desks of banks or securities firms, and mutual funds. These concentrations are largely unknown and only seem to become known when a sudden default or credit downgrading affects all holders simultaneously.
- “Operational risk” is a very broad matter that might cover anything a bank does, and the extent to which different banks apply control standards may vary widely. Certain aggressive actions that are profit driven, but presumed not to be illegal, may result in public scandal when revealed, e.g. The Bankers Trust experience with derivatives in 1995 which led ultimately to the sale of the bank, might be impossible to regulate. Also a covered up fraud, such as occurred recently at Parmalat, might be beyond the reach of regulation. In 1995, the Daiwa Bank’s New York branch was closed by regulators because the bank had misreported its billion dollar losses in the Treasury market. It is also difficult to predict an event like Merrill Lynch’s involvement with Orange County, California in 1996 that led to the firm’s being sued for several billion dollars, an amount which at the time would have affected Merrill’s capital position significantly.

In short, the sources of systemic risk are many, and they are only partly manageable. And even with systemic risk detectors in place, regulators are often slow to spot problems, or to act on them. In the US, this is compounded by the plethora of different financial industry regulators that share responsibility for containing systemic risk.

Of course it takes a major event of failure to generate a truly systemic event, and such is much more likely to be caused by the largest players in the

field. Such large players, presumably, ought to be watched closely, especially knowing that their basic business policies are to attempt a high rate of profit growth and to provide necessary incentives to employees to do so. Such policies, which have tempted bank employees to cut corners in the past, are common in the multi-line banking industry.

### **Too Big to Regulate?**

The largest banks have also grown, through mergers and otherwise, into very large entities (the three largest banks in the US each have approximately \$1 trillion in assets) with very formidable political influence. They have also become so multi-lined as to be subject to large quantities of regulatory reporting, but the regulatory officials themselves are diluted over many different business lines none of which has authority to stray beyond its own. The entities also operate all over the world, through many different layers of subsidiaries, branches, and other investments so that each is subject to a variety of different national regulatory demands. Regulation, in short, has become widely fragmented and dispersed in these large multi-line banks.

Indeed, it may be that the role of regulator has been taken up by the markets themselves. The banks are required to disclose a great deal of information about their operations, and they are followed closely by credit and investment analysts, and by many canny investors. These investors know that regulators may be inept, ineffective and politically intimidated – for a while. But when an event occurs that threatens the system, regulators are usually

empowered to do whatever is thought to be necessary at the time to fix things, and that might very well mean the loss of considerable market value. The investors also know that it does not take much for a major company to lose as much as a third of its market capitalization when a surprise and unwelcome announcement is made (observe the experience of Marsh, Inc. the world's largest insurance broker, whose stock dropped 50% after a lawsuit by the New York State Attorney General was announced in October 2004). The investor will know that regulators have a disproportionate influence on banks (more so than most other industries) that can affect a firm's growth strategies. If the bank operates in a way to offer concern to regulators, especially if it appears to regulators to becoming a repeat offender as in the case of Arthur Andersen and Marsh, then it begins to affect investors' perception of risk. If the market marks down the bank's stock sufficiently, the bank should come under pressure (sooner or later) to change course and to adopt a different business model. Such was the experience of the industrial conglomerate companies, formed during the 1960s and 1970s, and then broken up in the 1980s.

This may be the best hope of those who are concerned that these banking behemoths endanger the entire system by their aggressive ways. Financial regulators, especially in the United States, are usually insufficiently powerful politically to move forcefully against large banks that only worry them. It can be done, of course, but generally not without some political price to pay – unless a crisis condition has already been declared. Then things are quite different.

In the 1980s, once a banking crisis was declared, US regulators acted in several ways to tighten their controls. The FDIC (and the other banking regulators) intervened in several cases, taking control of ailing banks or arranging for their sale. At the same time the word went out from the regulators that banks could not expect any expansionary actions to be approved by regulators until their balance sheets were repaired. Further, they would be required to reduce assets, recapitalize and sometimes to make management changes to escape regulatory intervention. The Federal Reserve made directors of bank holding companies sign letters acknowledging their responsibilities to depositors and regulators, as well as to stockholders. In 1989 the Congress passed a broad Financial Institutions Reform, Recovery and Enforcement Act that restructured the government's role and powers in dealing with failed banks, encouraging earlier, rather than later intervention by the banking regulators to put out fires. The FDIC also sued more than 1,000 individual directors of failed S&Ls to recover some of the funds expended by the government to rescue the banks. Regulators, of course, have to feel the time is right for intervention, even mini-intervention such as cautioning specific banks without iron-clad justification.

Bank regulators are also entitled to insist that licensed and insured banks conduct themselves in the markets they serve in a manner than is "fit and proper." That means that they maintain adequate resources to back up what they undertake ("fit") and that they behave in a manner thought to be correct ("proper") for important fiduciary institutions. A general announcement by someone like the Governor of the Federal Reserve System to this effect might begin to influence

both directors of large multi-line banks, and investors in their securities. If the general announcement is not heeded sufficiently, then the governor can no doubt find ways to be more clearly understood by particular banks.

However, when a Federal Reserve governor feels the time is right to make such a reprimand, publicly or privately, the consensus of urgency most likely will have already been established. The powers of the governor are considerable, and the appointment once made by a president difficult to rescind, so such a governor could intervene earlier but the longstanding traditions of the office are for letting the markets do their job and not to do so until the necessity for intervention has become obvious. This arrangement has no doubt prevented many inappropriate interventions in US financial history, though possibly it has also caused American intervention on the whole to be later than it might usefully have been. But before an intervention point is reached, the stock market may begin to question management's strategies for growth and, if these are seen as being sufficiently aggressive as to concern regulators, the market may have already begun to discount them more heavily.

Our review suggests that after a decade of deregulation, consolidation and diversification, the government's role in regulating banks to avoid systemic risk has become ineffective. But, because the small number of universal banks pursuing high growth business strategies, the scale of the risk may not have reached a threshold that is seen to be dangerous to the system as a whole. Though government regulators could begin to restrain banks they think of as overly aggressive or out of control, this may require political courage to do so and

thus not be expected. However, the process of building up such large multi-line banks has also created a substantial risk transfer to investors who now begin to behave as interested parties and scrutinize banks for their possible entanglement in regulatory or legal disputes that signal greater troubles in the future; troubles that would destroy a lot of shareholder value. These investors look forward six months to a year, not backwards as regulators tend to do. Inadvertently, we may have allowed the shift of considerable financial regulatory powers to the stock market. Such a shift has major implications for the paradigm of regulation in general – why have it at all if the stock market can do the job? – and for national regulatory policy in major countries – do we want to leave such important matters to something as unpredictable as the stock market?