The Importance of Big Banks to U.S. Economy*

Jim Sivon

August, 2013

[*Remarks of Jim Sivon to students participating in the Duke University Summer Institute on July 24*]

In the U.S., a big bank has come to mean a bank with more than $50 billion in assets. This is an outgrowth of the Dodd-Frank Act, which subjected all banks with more than $50 billion in assets to heightened supervision and regulation by the Federal Reserve Board.

Currently, there are 36 banks that fall into this category. These 36 banks may be grouped into certain categories. The very largest, JP Morgan Chase, BofA, Citi and Wells, have over a trillion dollars in assets and are engaged in a broad range of activities.

Just below these banks in asset size are Goldman Sachs and Morgan Stanley, which specialize in capital markets activities. Then there are three large banks, Bank of New York Mellon, State Street, and Northern Trust, which specialize in asset management. The remainder of the banks in this size category, a group that includes U.S. Bank, PNC, Capital One and BB&T, focus on retail and commercial banking services.

Some of the growth in bank assets in the U.S. is a reflection of the overall growth in economic activity. The Clearing House Association reports that U.S. bank assets have grown 261 percent in the past 20 years, while the S&P 500 average has grown 297 percent and U.S. exports have increased by 293 percent.

Much of the growth in bank assets among the largest banks also is due to consolidation within the banking industry. Between 1984 and 2011, the

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number of commercial banks has dropped by over half, from some 14,000 banks to just over 6,000 banks.

U.S. Banks Compared to Foreign Banks

While these banks, especially the top four, are large in asset size, they are not unusual when you look at banks in other countries.

Based upon December 2011 data, the U.S. had only three banks in the top 20 of the world's largest banks, JP Morgan at number 9, BofA at number 10 and Citi at number 14. China has four banks in the top 20; the UK, France and Japan each have three banks in the top 20.

U.S. banking assets also are a smaller percentage of the overall economy than the banking assets in other developed countries. The Clearing House Association has published data which shows that in the U.S., total banking system assets were 117 percent of the nation's GDP in 2011. In comparison, French banks constituted over 420 percent of that country's GDP; in the UK, banking assets were over 370 percent of the nation's GDP, and in Germany, banking assets constituted over 330 percent of the country's GDP.

Economic Benefits of Large Banks

As a general matter, banks perform four basic functions in the economy. They provide retail banking services to individual customers; commercial loans and lines of credit to businesses; payment and clearing services; and they engage in capital markets activities. Big banks are active in each of these areas and have a demonstrable and positive impact on the economy in each area.

Cost Savings — In some areas, large banks can offer cost savings for consumers. Certain products and services are technology intensive, and large banks have an ability to offer these products and services at a lower unit cost to consumers than smaller banks. These products and services include credit and debit cards, wire transfers, and on-line payments.

A number of studies say that the economies of scale diminish after banks reach $300 to $500 million — well below the $50 billion threshold we are

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now using for what constitutes a large bank. However, there are some more recent studies that have found a potential for scale economies for banks with $1 trillion or more.

Geographic Scope of Services — Large banks can serve customers, both retail and commercial, on a broader geographic basis than small banks. Large banks have more extensive branch and ATM networks to serve customers. They also have foreign offices that can support U.S. firms engaged in business outside the U.S. This is particularly important for large U.S. businesses.

Range of Products and Services — Generally, large banks offer customers a wider range of products and services. Commercial customers, in particular, can receive not only lending products, but cash management support, trade financing, and capital markets products and services. There also is some overlap between geography and product offerings, since a large bank can accommodate large borrowers with diversified needs, both by product and geography.

Innovation — Large banks have an ability to invest more in product development than smaller banks, and this produces product innovations such as check imaging.

Safety and Soundness — Finally, banks that are more diversified in their activities — which is the case with most large banks — generally pose less risk of failure. One of my law partners is a former Chairman of the FDIC and his evaluation of bank failures finds that banks that are less diversified are more prone to failure than banks with a more diversified book of business.

This was borne out during the recent financial crisis in which roughly 450 small banks failed and some 200 small banks have yet to pay back their TARP assistance.

Are These Economic Benefits Offset by Moral Hazards?

Some economists maintain that these economic benefits are offset by a perception that these banks are too big to fail, and this gives them an unfair funding advantage in capital markets and encourages them to take undue risks.

Frankly, the literature on funding is mixed. Some studies find a funding

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advantage, others do not. It depends, in part, on how the analysis is conducted and what factors are considered. Congress has directed the General Accountability Office to study this issue and a report is due out sometime this Fall.

Even if you accept that these institutions enjoy a funding advantage, it may be that markets recognize that large, diversified banks, as a general matter, pose a lower risk of failure than less diversified banks.

That doesn't mean that large banks may not take undue risks. The financial crisis demonstrated poor risk management by many large institutions. At the same time, the crisis demonstrated that banks of all sizes engaged in overly risky activities.

Preventive Medicine

The question for policymakers is how to ensure that there is fair competition among banks, and that the actions of banks do not pose an undue risk for the economy.

The Dodd-Frank Act provided one answer to this question. Congress and the Administration decided that the best approach was enhanced supervision and regulation of the nation's largest banks and non-bank financial companies, and a new procedure for resolving large bank failures.

The enhanced regulation imposed by Dodd-Frank has included stress testing that is linked to capital distributions and higher capital requirements. Regulators also have made it clear that they will not approve significant merger and acquisition activities by larger firms.

The new procedure for resolving large bank failures is still under development by the FDIC, but appears to be focused on a "single point of entry" concept which it intended to place the entire risk of failure on equity holders and long-term creditors of a parent holding company — not taxpayers.

Despite the reforms embodied in the Dodd-Frank Act, there are repeated calls for breaking up the banks or re-imposing the Glass-Steagall Act, which provided for the separation of traditional banking and capital markets activi-

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ties.

Calls to break up the banks fail to acknowledge that Congress already has given federal regulators this power. Since 1978, the Federal Reserve Board has had the express authority to force bank holding companies to divest banking or non-banking subsidiaries upon a finding that continued control of the bank or non-banking subsidiary "is inconsistent with sound banking principles."

This authority, which appears in section 5(e) of the Bank Holding Company Act, was granted to the Board in response to the failures of some mortgage banking and real estate subsidiaries of bank holding companies in the mid-1970s.

More recently, in section 121 of the Dodd-Frank Act, Congress gave the Federal Reserve Board, in conjunction with the Financial Stability Oversight Council, the authority to force the sale of any assets of a large bank holding company or a nonbank financial company supervised by the Board upon a finding that that bank holding company or nonbank financial company "poses a grave threat to the financial stability of the United States." That authority became effective on June 21, 2010, when Dodd-Frank was signed into law.

Proposals to break up the big banks also face some difficult policy questions, not the least of which is what is the appropriate asset size for banks? Moreover, breaking up large banks would reduce the scale benefits currently associated with large banks, especially those related to technology.

Thank you.

Jim Sivon is a partner with the law firm of Barnett Sivon & Natter, P.C.

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