Too Big to Fail: Too Big to Solve?

Michael Mussa traces the history of US bank deregulation since the 1930s and assesses the prospects for reviving the Glass-Steagall Act and other curbs on the banking sector.

Steve Weisman: The banking and financial system of the United States seems certain to undergo major changes as a result of the current crisis and downturn. This is Steve Weisman at the Peterson Institute for International Economics with Michael Mussa, senior fellow at the Institute to discuss what changes are in store. Mike, thanks for joining us.

Michael Mussa: My pleasure once again.

Steve Weisman: Since the Great Depression, the banking system in the United States has gone through many changes. It now seems some of them are possibly going to be rolled back. Give use a succinct chronology of the major changes that have affected the US banking system.

Michael Mussa: Actually, the banking and financial system has been in flux since the founding of the republic. So, there've been many, many changes over the years.

Steve Weisman: Should we go back to Andrew Jackson?

Michael Mussa: No, no. I think we can skip some of that or summarize it very briefly. We had a little more than 30 years of remarkable stability in institutional arrangements, after the passage of major legislation in the 1930s, which included the so called the Glass-Steagall Act, the Federal Deposit Insurance [legislation], some revision of the Federal Reserve Act, and so forth, which left us with a segmented and repressed financial system. Commercial banks were not permitted to pay interest on demand deposits, the activities of banks and other financial firms were restricted to particular areas of business, [and they] were not allowed to compete with each other or across different classes of institutions. Those restrictions were gradually removed from the late 1960s through the 1990s, ultimately with the formal repeal of the last vestiges of Glass-Steagall in 1999.

Steve Weisman: Now, when you say the system was repressed in the early decades, you're not speaking in Freudian terms?

Michael Mussa: No, no. A repressed financial system is something that the economists talk about, where you got a lot of restrictions on what different financial institutions can do. As I say, financial institutions were limited to banking within a single state for example. You couldn't accept deposits out of state. You needed a license and the availablity of licenses [was] restricted. Banks could not compete with investment banks in terms of underwriting and marketing publicly traded securities. They couldn't compete with insurance companies and [there were] just a wide variety of restrictions on the activities of financial institutions.

Steve Weisman: And the implication of saying that that was a state of being repressed is that the vitality, the potential for competition, the potential for profits, and certainly for offering consumers more variety of products was held back. Following the 1960s and 1970s we had this era of liberalization. Is it fair to say that that liberalization was good for consumers as well as the institutions themselves?

Michael Mussa: It certainly improved efficiency and consumer service—service to businesses from financial institutions—in a number of important areas. The reforms were put in, in part, because of the perception in the 1930s that a more liberal, open financial system had been in an important way responsible for the financial turbulance that contributed to the Great Depression. So, this was an effort to suppress at least an important cause of financial sector instability by putting in all of these restrictions. And I think one would have to say that it was to a considerable degree successful in achieving that result—but not without cost.

Steve Weisman: Some of those restrictions are now being reconsidered. Let's take Paul Volcker's proposal to restore, in some measure, the Glass-Steagall restrictions. How would that be implemented? Is it realistic?

Michael Mussa: There [are] a lot of questions about exactly what the proposal is. That relates, I think importantly, to the question of whether it's really feasible or not. What we had coming out of the 1930s in terms of a quite comprehensive restriction on the activities of commercial banks related to investment banking and the other way around, as the investment banks were not permitted to get into commercial banking. That was pretty well enforced for about 30 years.

What's being talked about now is a much narrower type of restriction applied to leading financial institutions. So they could be involved in the main aspects of commercial banking—including a lot of financial business, which was not traditionally in the area of commercial banks—but not specifically in what's called proprietary trading or in sponsoring hedge funds. They would be restricted in a relatively narrow way with respect to a small range of activities that are carried out by investment banking–type firms. But the thing is drawing the distinction between what is proprietary trading for your own account and what is trading that you're carrying out for the benefit of customers or in order to hedge positions risks that are created because you are trading on behalf of customers. That's a very difficult distinction to make and enforce.

Steve Weisman: I often hear the expression that banks should have "skin in the game." Doesn't that mean that they should be able to do both, proprietary trading and trading for their customers?

Michael Mussa: I should note that I used to testify on these issues, now 25 years ago, and I was one of the last defenders of the Glass-Steagall restrictions.

Steve Weisman: Remind us what position you held.

Michael Mussa: I was a consultant and expert witness for the Securities Industries Association, which was basically the broker dealers as opposed to the commercial banks. And understandably, there were these restrictions and then each guy wanted to keep the others out of his own line of business. Of course now they're all in it together.

Steve Weisman: Just because it was in their interest didn't mean you didn't believe this to be a good idea.

Michael Mussa: I thought that there were two important reasons to protect some of Glass-Steagall: One was the question of the financial instability that can result when you've got too much flexibility and freedom in the financial sector. We've observed that not only in the United States but worldwide that virtually every major financial liberalization is followed by an important financial crisis. And that's been true in the history of the United States going back to the Revolutionary War. So, that was one issue. The other issue is that banks have special privileges and protections [that] were created over the years, inculding in the 1930s. And allowing them to compete on the basis of those special privileges in other lines of business tends to be not efficient.

Steve Weisman: The most famous privilege I suppose is the insurance on their deposits?

Michael Mussa: The insurance on their deposits; their access to the discount window; the tendency of the financial regulators, when the banks get in trouble, to take this as something very serious and to adjust more general policies to make sure that banks don't fail in large numbers. In contrast, say, with the securities industry. When they eliminated fixed-commission trading on the New York Stock Exchange in May of 1975, in the subsequent two years 25 percent of the bokerage houses went under. So there has traditionally not been the same sympathy of protecting the existence of nonbank financial institutions. The Federal authorities drove Drexel Burnham Lambert out of business when Michael Milken was engaged in a variety of a semi-nefarious practices.

Steve Weisman: Mike, can we go back to Glass-Steagall? You seem to be suggesting that it'd be hard to just go back without making some adjustments.

Michael Mussa: I think that going back to Glass-Steagall as such would be practically impossible, in part because of another very powerful force that has transformed finance. That's modern computing and communication technology. That has simply made it possible to do types of financial transactions and operations that were simply not feasible before. For instance, now a ban on interstate banking doesn't really make any sense. I mean, you can control your deposits over your computer and they can exist anywhere in cyberspace. So, going back to that type of system doesn't really make sense technologically. The question is for the core institutions of the financial system, the large investment banks, and the few large commercial banks and a few key other institutions: Is it desirable to restrict the range of their activities in some important way in order to limit the amount of risk they can undertake—relative to the amount of capital they are holding—and thereby protect the public from the disruption that occurs if one of these major institutions is forced to the edge of failure?

Steve Weisman: So is it feasible?

Michael Mussa: I think that it is feasible, yes. One of the problems is that I think it does require a degree of discretion on the part of the regulatory authorities who would say, "No, you can't do that." And I think that was part of the problem. Commercial banks were sponsoring hedge funds. They could do that within their bank holding company structure but if the Federal Reserve had said, "We don't really like your being in that business, we feel it's not consistent with your other responsibilities," they would have been out of it. They sometimes talk about the eyebrows of the central banker, you need to be prepared occasionally to tell people, “No. We think that this is unwise and inconsistent with the needs of the stability of the financial system. So don’t get into this business, or if you’re in it, get out of it.”

Steve Weisman: One of our colleagues here at the Institute Simon Johnson has proposed a cap on the size of a financial institution so that either its assests or its capital, whatever measure, does not exceed a certain percentage of the gross domestic product. Is that, in your judgment, [a] realistic or wise way to approach this?

Michael Mussa: I think I can see some usefulness to that. I mean, we do have a cap in terms of deposits. No bank is supposed to have more than 10 percent of total deposits. Bank of America is somewhat above that now after the merger, and at Wells Fargo, I’m not sure where they are with the Wachovia merger. I don’t see that, though, as likely contributing in an important way to improving financial sector stability. After all, key institutions that got us in trouble this time included Bear Stearns and the Lehman Brothers and AIG. AIG was a very large insurance company but it would not have passed any or been above any sort of boundary level test for its size. [That] doesn’t say that there shouldn’t be such a restriction, but I think the notion that [that] would in an important way reduce the risk of financial instability is a bit overdone. I think you need to be more focused and say, “Well when is it that an institution is engaging [in] activities that are unduly exposing it to—”

Steve Weisman: Or the system.

Michael Mussa: Or the system to risk and I think that higher capital standards are an important part of what needs to be done and the question is: How do you design and enforce those capital standards? And part of the answer is, well, you can’t if the policeman is not interested actually, in exercising [his] police power. So if you allow banks and others to circumvent the capital requirements by putting risk off balance sheet that really should be on balance sheet, then you’re not going to be able to contain the problem. So it’s not just that we need the rules. We need to make sure that the rules are being enforced, which I think was not the case prior to the present crisis. The Federal Reserve in particular, also others, should have been aware of the risks that were building up on the balance sheets of major financial institutions or the degree of interconnectedness of the key institutions with firms like Bear Stearns and so forth. And I think they were insufficiently attentive to those issues. Maybe they need a few more tools to help them out as well. But if the cop is not prepared to do his job, then giving him a more powerful gun doesn’t help very much.

Steve Weisman: But bottom line, Mike, will we come out of this crisis with institutions that are still too big to fail?

Michael Mussa: Oh, undoubtedly. And I think it’s a mistake to believe that that problem can be solved. It can be lessened. But in the face of a major financial crisis, which is what we were observing in the fall of 2008, where—

Steve Weisman: Some of us were more than observing.

Michael Mussa: Yes. We were observing key credit markets freeze up so that even the most credit-worthy borrowers could not obtain credit. Then you want the government to be able to step in and liquify the system because certainly the financial system as a whole, along with the economy as a whole, is too big to be permitted to fail. So when a crisis reaches that stage, then the government needs to step in and there are going to be enterprises of a sufficient scale that having them fail at that point is not desirable. Indeed, the auto companies—I think one can argue that Chrysler, at least, should have been allowed to—but they did go into the bankrupcy court—should have been allowed to go under and be liquidated and perhaps even GM. But not at the end of 2008.

Given the enormous difficulties in the system as a whole and given the importance of those enterprises, you couldn't add that on top of what else was happening. So, even though I wouldn't say Chrysler was too large to fail in a meaningful sense in normal circumstances—in the midst of an intense financial crisis, you guarantee even enterprises that are not that big because you need to protect the stability of the system as a whole. So that will continue to be a feature the authorities will need to remain there as the last resort and in the midst of a general crisis, which hopefully we will not see frequently, there will be institutions where the government will need to step in and say, "No, not now."

Steve Weisman: All right. Mike Mussa, thank you. As always, great to talk to you.