An idea whose time has come?

The merits of breaking up JP Morgan were widely discussed in early January, marking the topic's shift to the mainstream of public discourse. David Rowe **asks whether it is time to demerge the systemically important banks**

In March 2009, I wrote a column entitled *Systemic risk capital* (*www.risk.net/1497567*), where I pointed out that portfolio diversification tends to improve in the early stages of bank growth and that larger institutions can benefit from some operational economies of scale. I argued, however, that the marginal benefits from these sources tend to decline significantly beyond a certain size.

Furthermore, continued growth introduces diseconomies of scale, for example making it much more difficult to maintain a single customer view across proliferating business lines, geographical locations and fragmented computer systems. In addition, the important element of personal intuition becomes harder to maintain as the chain of command lengthens and top management loses direct contact with many parts of the organisation.

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I argued that these issues could perfectly well be left to market forces until such institutions reach a size where they pose a systemic risk to the larger economy if they fail. Unfortunately, events demonstrated that this critical point had been well and truly passed by 2008.

I also argued that more intrusive regulation could never prevent all future bank failures, and that the only way to solve the too-big-to-(be allowed)-to fail problem was to break up the systemically important institutions. My preferred method for doing so was, and remains, imposing onerous systemic risk capital requirements that rise non-linearly with size relative to the economy. Ideally, this would force voluntary demergers to bring each of the resulting institutions below the systemically important threshold. Such an approach, I asserted, was bound to yield a more effective result than a government-directed restructuring.

During the nearly six years since that column, I have frequently said regulators were focused far too much on reducing the probability of a bank failure and far too little on reducing the severity of such a failure. In light of reactions to the latest round of additional capital charges proposed by the US Federal Reserve last December, I may have to soften my judgement.

A much discussed analysis published by Richard Ramsden and his colleagues at Goldman Sachs in early January argued that breaking up JP Morgan into four parts – creating a retail consumer bank, a wholesale commercial bank, an investment bank and an asset management company – would result in increased shareholder value.

The central contention was that the resulting reduction in the cost of required capital, compared with maintaining the status quo, would compensate for any loss of revenue from eliminating cross-selling synergies. The analysis claims most of the existing synergies actually arise within each of the four proposed demerged businesses and would hence be preserved in such an arrangement.

As always, such analysis is fraught with uncertainty surrounding judgements about the valuation of such amorphous concepts as synergies. It also takes no great imagination to see the potential conflict involved in an analyst at a mega-bank arguing the merits of breaking up one of its biggest competitors. Stephen Gandel at *Fortune* came to a similar conclusion about Goldman Sachs.

Matt Levine at Bloomberg wrote one of the most insightful reactions to the Goldman analysis.[1] He pointed out that the report's presumed decline in regulatory capital charges is almost perfectly offset by its estimate of revenue loss from reduced synergies. As he says, a zero impact on net income is "not really a rousing value add".

In fact, the much touted increase in shareholder value comes from a presumed higher valuation, or lower rate of discount, applied to the net income of the components than is true for the integrated firm. Levine points to some theoretical reasons for the so-called conglomerate discount, including "excess complexity, reduced management focus… [and] an option on a basket is worth less than a basket of options". He tends to downplay the validity of the view that "the combined business is too hard for investors to understand".

I tend to find this last view rather more plausible. A business that regulators, with access to highly privileged information, finds hard to understand and supervise must be more opaque to the market than its simpler pure-play components, and the associated uncertainty is a valid reason for a higher earnings discount rate.

Arguments over the details of this analysis will continue. Of more importance is that discussions about breaking up a major systemically important financial institution are no longer the purview of heterodox analysts and fringe politicians – the idea clearly has entered the mainstream thought process.

In addition to the quote from Victor Hugo from which the title is taken, he also said: "One withstands the invasion of armies; one does not withstand the invasion of ideas." So far, senior bank managers have withstood the onslaught of the regulatory army. It remains to be seen if they can withstand an idea whose time may have come. **R**

[1] *Levine, M,* Goldman Thinks JPMorgan Is Too Big But Not Too Big to Fail, *Bloomberg View, January 5, 2015. See: http://www.bloombergview.com/articles/2015-01-05/goldman-thinks-jpmorgan-is-too-big-but-not-too-big-to-fail)*