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Bigger isn't better if you're a bank [Edition 2]

David Wighton. **The Times**. London (UK): Apr 9, 2009. pg. 45

Abstract (Summary)
The worry now is that some banks have become too big to bail. Even rescuing Royal Bank of Scotland on its own would have badly stretched Britain's **public finances**. So why not cap the size of banks -- or, at least, as some regulators are suggesting, penalise bigger banks by increasing the proportion of capital they must hold? Unnecessary and damaging, the banks will say. Unnecessary, because improving regulation and banks' own risk management will prevent future disasters. Anyone who believes that is living on another planet. There will be future disasters and at least by restricting bank size we can minimise the risk that they bankrupt their home countries.

Just about the only thing that appears tightly correlated with a bank's size is the size of the chief executive's pay packet.

'Above a certain size, economies of scale appear to tail off '

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Full Text (517 words)

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George Osborne, the Shadow Chancellor, is pushing two ideas for the reform of the banking system. One is bad and won't happen; the other is good(ish) and just might.

The bad one is that retail banks and investment banks should be legally separated, as they were in the United States until the repeal of the Glass-Steagall Act in 1999.

There are just two tiny snags with this notion: it would be almost impossible to implement and would not have prevented the banking crisis, anyway.

The idea has been rubbished by such as figures as Tim Geithner, the US Treasury Secretary, Lord Turner, the head of the Financial Services Authority, and the Prime Minister. But it is fashionable in political circles on both sides of the Atlantic, and Mervyn King, the Governor of the Bank of England, thinks it is at least worth debating.

Mr Osborne's other idea is that, in banking at least, big is bad. Over the past year, we have been reminded that many banks are too big to fail.

The worry now is that some banks have become too big to bail. Even rescuing Royal Bank of Scotland on its own would have badly stretched Britain's public finances. So why not cap the size of banks -- or, at least, as some regulators are suggesting, penalise bigger banks by increasing the proportion of capital they must hold? Unnecessary and damaging, the banks will say. Unnecessary, because improving regulation and banks' own risk management will prevent future disasters. Anyone who believes that is living on another planet. There will be future disasters and at least by restricting bank size we can minimise the risk that they bankrupt their home countries.

Banks will argue that restricting size will not be in customers' interests. It will reduce economies of scale, which can be passed on to customers, and will prevent banks providing a full range of services worldwide. Bankers love to point out that their business is much less consolidated than other global industries, such as carmaking.

The truth is that above a certain size, the economies of scale in banking appear to tail off. Analysts at Citigroup measured the efficiency and profitability of a large group of banks in 2006 and found no link to size at all.

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From the British point of view, however, there is at least one big drawback. If we restrict the size of our banks, they are likely to lose out internationally, unless other countries do the same. And reaching agreement would be tricky. What is too big to bail for Iceland would not be too big to bail for the US.

We might decide that dropping out of the banking premier league would be worth it. But it would be a big price to pay. At least until recently, banking was one of the things we were rather good at.

'Above a certain size, economies of scale appear to tail off '

Credit: David Wighton Business Editor's commentary