London Whale is the cost of too big to fail

Financial Times
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March 24, 2013

The report by the US Senate staff on JPMorgan Chase's "London Whale" trades, delivered last Friday, excoriates the bank for failing to make the full extent of the problem known to regulators and the public. But a focus on who knew what when can result in missing the big point: the cost of our too-big-to-fail banks is even heftier than is widely appreciated.

The conventional wisdom in many circles is that the losses caused by the trades are regrettable but we can all move on. After all, JPMorgan's equity cushion can readily absorb it. Private shareholders and managers have paid the price – shareholders lost $6bn and several senior managers have black marks against their names. The episode is embarrassing but the bank can earn more than $20bn a year. "A tempest in a teapot," said Jamie Dimon, its chief executive, last year.

But before the London Whale sinks from view, consider what would befall a conventional industrial company that suffered such a horrendous, expensive managerial lapse. If JPMorgan were in the business of making things, it would have already attracted significant corporate governance activity. The loss might be the trigger for a takeover and break-up effort.

It is certainly believed by many on Wall Street and in Washington that banking behemoths such as JPMorgan that deal in complex financial products have become too big to manage effectively. On a conventional analysis, if this were true, breaking them up would unlock shareholder value. The thinking goes that if synergies in the big financials are few and managerial degradation common, shareholders would, in time, have incentives to make that happen. Corporate governance activists have already circled around JPMorgan and other behemoths, thus far to little effect.

A closer look tells us why they cannot yet succeed in forcing big finance to spin off units to be better run, nimbler, more competitive and more effective in the manner of the big 1980s and 1990s industrial takeovers and conglomerate restructurings. Consider the incentives for restructuring too-big-to-fail financial firms. Suppose active shareholders were to decide that, say, a large bank would be better run if its biggest units were spun off into smaller ones. An active investor – in the mould of Carl Icahn or T. Boone Pickens – might eye up the companies and naively agitate for a break-up. "A company this big and complex can't be managed well, no matter how good the chief executive is," they might say. "It is worth twice as much broken up." But once they began working through the maths of a restructuring, they would find that shareholder values would not shift upwards in the way they might have predicted.

If the banking conglomerates were carved up into their constituent parts, the individual units would have a much higher cost of capital. Today, when financial conglomerates such as JPMorgan borrow to finance themselves, their creditors know the government will probably pay them back in full even if the bank fails because the systemic economic costs of their failing to do so is too large. Creditors therefore charge the conglomerate less. So the firm's cost of capital becomes cheaper.

The dollar estimates of the too-big-to-fail subsidy to the largest banks range into very high numbers. One significant study, by economists associated with the IMF, suggested that banks could borrow 0.8 percentage points more cheaply because of their unshuttable status. The numbers may sound small but this subsidy can readily amount to half of the big banks' profits. Moody's, the credit rating agency, estimates Citigroup would be near junk bond status in credit quality if it were not for the fact that the state is assumed to back it. It is only because lenders lower their interest rate to too-big-to-fail companies such as Citi that its debt is anywhere near investment grade.

So that's the choice for the shareholder: they can own a degraded, too-big-to-fail behemoth, but one with a hefty, not fully visible too-big-to-fail subsidy. Or they can have one that is well run, allocates capital effectively and does well by its customers, but does not enjoy the subsidy that creates much of the present shareholder value.

Seen this way, it is no accident that we have not seen break-up takeovers of too-big-to-fail financial institutions, even in the 1980s and 1990s takeover heyday. And we still do not see much restructuring, even when there are billion-dollar managerial lapses. Too-big-to-fail problems are thus even more costly than they have seemed to be so far.

We pay once as taxpayers, visibly and big when taxpayers' billions bail out the biggest financial firms. And, long before then, we all pay continuously as financial consumers because the too-big-to-fail subsidy means that big financial conglomerates can be profitable for shareholders, even while being poorly run. As the London Whale has graphically shown, too-big-to-fail status insulates the financial sector from normal corporate and stock market constraints and discipline.