

**David Warsh, *Economic Principals*, April 25, 2010**

What should be done about the banks? With a Senate bill headed for a test vote on a procedural matter Monday, a long-simmering debate may finally be coming to a head.

Break up the biggest American banks, which have mushroomed in recent years? Or leave them as they are and write some new rules for them?

Not since the antiwar movement of the mid-1960s has so great a chasm loomed between expert opinion and popular sentiment – or at least that’s my hunch. (There’s a fair amount of evidence of this in various polls.) Back then it took six years and two presidential elections to end the war in Vietnam.

Today the situation is thundery. True, nobody is marching on the Pentagon. There is, however, a sense that the contemplated change is not enough.

When President Obama went to New York on Thursday, it was to set his seal on the compromise with Wall Street that his administration has negotiated behind the scenes: a consumer protection agency for finance, a clearing house for derivatives, comprehensive authority for the government to assess systemic risk, higher capital requirements for banks, among other provisions. There were no more “fat cat bankers” in Obama’s speech. On Thursday it was the “titans of industry” who sat in the first few rows whom he asked to pitch in.

National Economic Council director Lawrence Summers [went on television](#) after the president spoke to defend what he called “the most important expansion [of authority] since the invention of deposit insurance in the 1930s.”

Jeffrey Brown, of “PBS NewsHour,” at one point asked Summers, “Why not just limit the size of banks?”

Summers replied: “Most observers... who study this believe that to try to break banks up into a lot of little pieces would hurt our ability to serve large companies and hurt the competitiveness of the United States. But that’s not the important issue. They believe that it would actually make us less stable, because the individual banks would be less diversified and, therefore, at greater risk of failing, because they wouldn’t have profits in one area to turn to when a different area got in trouble. And most observers believe that dealing with the simultaneous failure of many -- many small institutions would actually generate more need for bailouts and reliance on taxpayers than the current economic environment.”

Leaving aside, for now, the question of the identity of those observers and the nature of their evidence, there have been many on the other side of the issue, in varying degrees of opposition. Among them:

- Former chairmen of the Federal Reserve Board Paul Volcker has advocated something in the spirit of the Glass-Steagall Act, which in 1933 mandated the separation of commerce and banking and split the banking industry into two parts: commercial banks and investment banks (Wall Street, for short), each regulated quite differently. Volcker would permit banks today to underwrite corporate securities, but wants to limit sharply their activities in the capital markets: hedge funds, equity funds, commodity trading, derivatives trading – the so-called “Volcker Rule.”
- Former Federal Reserve chairman Alan Greenspan went even further last autumn, invoking the aggressive trust-busting of the Progressive Era of the early twentieth century. “So, I mean, radical things,” he told a questioner who asked what might be done. “Break them up, you know. In 1911, we broke up Standard Oil. So what happened? The individual parts became more valuable than the whole. Maybe that’s what we need.”
- Five Treasury Secretaries wrote the *Wall Street Journal* in February to endorse the “Volcker Rule,” if its execution can be clearly stated. W. Michael Blumenthal, Nicholas Brady, Paul O’Neill, George Shultz and John Snow wrote that “banks benefitting from public support by means of access to the Federal Reserve and Federal Deposit Insurance Corporation insurance should not engage in essentially speculative activity unrelated to bank services.” Conspicuous by his absence: Robert Rubin, who served as Treasury Secretary for several years during the Clinton administration before taking a top job with Citicorp, one of those banks that would be severely affected if the rule were implemented.
- Mary Schapiro, chairwoman of the Securities and Exchange Commission, may not be formally involved in framing banking regulation. But she turned a powerful searchlight on Wall Street practice last week when the SEC charged Goldman Sachs with civil fraud for having assembled a suite of securities more or less designed (by one of its customers) to fail, then selling them without sufficient explanation to other customers, who subsequently lost nearly \$1 billion to the designer. Legal circles buzzed last week with talk about the difficulty of proving the materiality of the omission under rule 10 (b)5. That brought to mind the story of the woman who complained to [Ettore Bugatti](#) that [his expensive cars](#) were wonderful, that she owned two of them, but that the brakes didn’t work as well as they might. The Italian count was testy: “Lady, any idiot can make a car go slow. It takes genius to make a car go fast!”
- Simon Johnson, of the Massachusetts Institute of Technology’s Sloan School of Management, and co-author James Kwak, resemble a two-man non-stop Internet teach-in. A former chief economist of the International Monetary Fund – and therefore experienced in dealing with nations dominated by financial oligarchies – Johnson got started two years ago with a famous article in *The Atlantic*, “[The Quiet Coup](#)” The article morphed into a highly-popular blog, [Baseline Scenario](#), and the blog into a new best-selling book, [13 Bankers: The Wall Street Takeover](#)

[and the Next Financial Meltdown](#), forcefully elaborating on the authors' conviction that only a large-scale break-up can curb a financial sector grown beyond all reasonable bounds.

Voices, however responsive a chord they strike among the public, don't make things happen by themselves. Recently a focal point has emerged. Last week Senators Sherrod Brown (D-Ohio) and Ted Kaufman" (D-Delaware) introduced a bill – the Safe Banking Act, they call it -- that would compel the break-up of many of the largest banks by mandating limits on their total assets and establishing strict caps on their lending activities. Brown and Kaufman plan to offer their bill as an alternative to the Senate Finance Committee bill, designed by chairman Christopher Dodd (D-Conn.) and endorsed by the administration. It isn't likely to make it to the floor. It will, however, engender more discussion of whether the Dodd bill goes far enough.

What could change? Any number of things. Paul Krugman, of *The New York Times*, America's most widely followed economic populist, could change his mind and back some form of decentralization as a remedy instead of [tougher and more hierarchic regulation](#). "It's not at all clear that the size of individual banks makes much difference to this argument [that banking is inherently unstable]," he says. But the relevant argument here has to do with regulatory capture – the wealth and power of the banking lobby – and with governmental rapture, which is just as bad. Set factions to oppose factions, as both *The Federalist Papers* and the Sherman Act say.

Industrial corporations could cast their lot with advocates of the Volcker Rule, instead of continuing to give their proxy to the powerful Chamber of Commerce lobbying campaign against reform generally.

A Ross Perot-like figure could emerge from the Republican party, advocating traditional regulation with a government safety net for commercial banking, in order to free the capital markets from the kind of intense regulation for which they are headed otherwise. The editorial page of *The Wall Street Journal* mused on such a possibility last week: "Mr.Kaufman [the Delaware Senator] wants to break up the biggest banks, which may well be preferable to making them wards of the Treasury."

What's really needed is a workable plan to implement the Volcker Rule to recreate more-or-less separate but related industries with different appetites for risk. Let's give this desideratum a name – let's call it "partition." Until then, however widely desired it may be, partition – operationalizing the Volcker Rule – will have to wait.