Minutes of the June 28 2013 Financial Advisory Roundtable (FAR) Meeting


The overall topic for this meeting was the oversight of large, complex financial firms. The meeting commenced with two discussions from roundtable members centered on the questions posed in the meeting agenda (agenda and slides are available online at http://www.newyorkfed.org/aboutthefed/far.html). Each set of remarks was followed by an open discussion. The main topics discussed were as follows:

How big are U.S. bank holding companies (BHCs)? Members presented evidence indicating that U.S. BHCs are among the largest financial institutions globally, though relative to GDP, financial institutions in the U.S. are smaller than in other countries. Some members also noted that insurance companies are less frequently mentioned in discussions of size and complexity, but deserve more attention.

Are BHCs getting bigger? Members noted that increasing BHC size is the result of a considerable wave of consolidation over the last 20-30 years; during this period, BHCs have become more complex as well. One example given was the significant increase in the number of subsidiaries held under a common BHC umbrella.

Why are BHCs getting bigger and more complex? Members noted that factors driving size and complexity are not necessarily the same. While size and complexity are related developments, they do not have identical causes or consequences. Members mentioned several possible drivers of increasing BHC size and complexity. Some cited economies of scope, as exemplified, for instance, by cost savings associated with information sharing, common clients over multiple services, and cross-product offerings. Others argued that growth in complexity was associated with increasing costs of running financial institutions, and that increased scale is needed to absorb these costs. The growth of securitization activity was also mentioned as a reason for the growth in complexity. Members also noted that most types of large organizations, not just banks, have become more complex in recent decades. This likely reflects an ongoing tendency to specialize activities and to establish specific policies and processes to address known problems that have occurred. Moreover, some members noted that an increase in organizational complexity can also be an unintended consequence of enhanced regulation, particularly when regulations differ across jurisdictions or differentiate across types of legal entities.

Some members suggested that customers might prefer to deal with larger firms, generating a self-reinforcing mechanism. Some members argued that BHCs are large because their clients are large. These clients require big and complex services. Several members felt that taxation, accounting and compensation motives, sometimes cited in the discussion of size and complexity, are less important factors. These members noted differences across countries along these dimensions as suggesting that they are less likely to be the cause behind increasing size and complexity, which is a global phenomenon.
Social value of BHCs. There was some degree of consensus among the members that size and complexity are likely driven by a number of factors associated with value enhancement. However, members also noted that private value does not necessarily correspond to social value, and argued that it is important to have a better understanding of the social costs of size and complexity.

Members felt that there are, potentially, large social losses associated with the failures of large, complex financial institutions. Such losses to society are particularly related to the loss in banks’ informational capital accumulated as part of credit creation. Some members argued that therefore, bundling activities may increase private value, but not necessarily social value. This argument suggests a separation in activities at large BHCs. Some members noted that similar arguments would apply to the insurance industry.

Other members had a different perspective, noting that bundling of activities is not necessarily risk increasing. In fact, combining activities within a single firm may lead to lower risk through diversification of income streams, which would imply more stable credit creation activity over time. Some members noted that monolines---certain types of insurance companies that are specialized in a single business line---were under distress during the crisis, suggesting that a simplified business line structure, in and of itself, does not necessarily lead to financial institutions that are more robust to failure.

Is there a TBTF subsidy? Several members thought that evidence suggested a funding advantage for the largest BHCs due to a perception that these firms are “too big to fail” (TBTF). Some members argued that observed funding differences across BHCs of different sizes also reflect other factors. For instance, large banks have more liquid debt markets, which are then reflected in more favorable funding costs at issuance. To some members any funding cost advantage seemed be of small magnitude.

The role of regulation. There was some consensus among the members that bankruptcy may not be a viable option for resolving very large or complex entities. The Lehman Brothers experience was cited as an example where bankruptcy produced systemic externalities. Three issues were highlighted: 1.) Transmission through credit exposure; 2.) Credit risk transfer; 3.) Creditors would have been better off if all entities under the parent had remained viable. Members commented on challenges in resolving large, complex financial institutions. Members pointed to potential difficulties with cross-border positions and the need for coordination across different national regulatory authorities. Some members were concerned that market expectations for the resolution process may be misaligned with regulators’ perspectives. Members noted that financial crisis have large surprise components that are difficult to regulate. Sudden panics and the consequent liquidity needs should be considered when designing regulation. Finally, members emphasized the need to think of prudential regulation: the problems identified during the financial crisis had been built up years earlier. Hence, effective monitoring and regulation should aim at minimizing the need for ex post intervention.