

Financial Concentration

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**Wall Street Watch
Working Paper No. 3**

August 2009

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The rate of growth of large U.S. financial institutions accelerated in the 1960s as they expanded their international reach and their share of financial activity at home. Concern about the trend toward financial concentration grew as well and intensified in the mid-1980s as the potential failure of one large U.S. bank, Continental Illinois, threatened to cause ripple effects throughout the system. The Federal Reserve justified its loans and other support for this big bank holding company by arguing that its collapse could weaken other financial institutions that held loans to and accounts with Continental Illinois. Regulators also worried that closing the bank would strain the resources of the Federal Deposit Insurance Corporation (FDIC) if it were required to cover the deposits of the bank's non-financial customers.

"Too big to fail" (TBTF) became a common term of reference for the dilemma posed by the expansion of big banks in the 1980s, but many analysts saw a broader trend extending to other sectors as well. While most of the focus was on banks, their analyses called attention to the number of institutions that accounted for more than half of the resources of any given financial sector. By that measure, the level of concentration was already unacceptably high in the mid-1980s: Less than 1 percent of the total number of banks, securities firms and life insurers accounted for half of the total resources of those sectors. Property casualty insurers and thrifts were only slightly less concentrated with 2 percent of the former and 4 percent of the latter accounting for half of their sectors' resources.¹

Despite widespread recognition that some institutions were "too big to fail," the trend toward concentration increased over the next two decades and intensified as "supervisory mergers" and "purchase and assumption transactions" became the preferred method of handling failing depository institutions. The following overview of the major financial sectors provides information on the level of institutional concentration 25 years ago and some indication of developments since that time.

Institutional Concentration

Banks: In 1984, the top 10 banks accounted for 26 percent of the total assets of the sector, with 50 percent held by 64 banks and the remaining 50 percent spread out among the remaining 11,387 smaller institutions. The Federal Reserve Board reports that about 11,500 mergers took place from 1980 through 2005, averaging 440 a year and reducing the total number of banks to 7,500.² By mid-2008, five banks had become the dominant institutions in the market in terms of total assets and as holders of 97 percent of the total amount of notional derivatives such as interest and exchange rate swaps, collateral debt obligations (CDOs) and collateral default swaps (CDSs).³

Securities Firms: The most concentrated financial sector, mergers have also consistently reduced the number of firms in the securities industry. At year-end 1984, the top 10 firms — 0.12 percent of the 7,800 firms registered — accounted for 41 percent of the sector's capital, 47 percent of total revenue and 55 percent of underwriting profits.

¹ Jane D'Arista, *The Evolution of U.S. Finance, Vol. II: Restructuring Institutions and Markets*. Armonk, NY, M.E. Sharpe, Inc., 1994.

² Loretta J. Mester. "Some Thoughts on the Evolution of the Banking System and the Process of Financial Intermediation," *Economic Review*, First and Second Quarters, 2007. Federal Reserve Bank of Atlanta.

³ Comptroller of the Currency (OCC). *Quarterly Report on Bank Trading and Derivatives Activities*. Second Quarter, 2008.

Of the top 10, all but three (Merrill Lynch, Lehman Brothers and Goldman Sachs) had been acquired by or merged with other institutions by the beginning of 2008. By the end of that year, these three and other large firms had been acquired by or had become bank holding companies or, in the case of Lehman Brothers and Bear Stearns, had failed.

Institutional Investors: Money management has become the dominant activity in U.S. financial markets and almost all sectors are participants in managing investments. While life and property-casualty insurers invest premiums as providers of insurance, the management of the assets of pension funds is distributed among life insurers, banks, securities firms and mutual funds. Nevertheless, asset management is concentrated among a relatively small number of firms given the size of the assets involved. For example, in 1984, 37 institutional investors managed half of the \$1.2 trillion of assets of beneficiaries while 64 banks accounted for half of the \$1.4 trillion of banking assets. By year-end 2007, institutional investors held \$25.3 trillion, or 43.7 percent of total financial assets, compared to \$13.7 trillion, or 23.7 percent, held by banks.⁴ Evidence of asset concentrations in the holdings of these investors is as much a matter of concern as the relatively small number of institutions in which these holdings are concentrated.

The Increase in Financial Concentration: Causes and Concerns

Central to the concern about bank concentration is this sector's role in the payments system. The FDIC was created in 1933 to restore confidence in banks and promote economic growth by protecting depositors and ensuring the efficient circulation of the nation's money supply. The remarkable success of this agency in restoring and maintaining confidence was, however, undermined in 1980 by the removal of interest rate ceilings. As the level of rates they had to pay to attract deposits soared above returns on outstanding loans, bank and thrift failures escalated, and the decade became disastrous for the deposit insurance funds. From 1980 through 1992, more than 4,500 federally insured depository institutions failed with assets of more than \$630 billion and at a cost of about \$150 billion to the insurance funds and taxpayers.⁵ Although the federally assisted mergers and acquisitions that were part of the strategy for managing the crisis sharply reduced the number of institutions, the crisis itself and its cost undoubtedly relaxed concerns about the rising level of concentration

At the same time, other developments contributed to undermining existing restrictions on bank size. The major legal restrictions were the 1927 McFadden Act that gave states the right to prohibit out-of-state banks from opening branches in their states and regulations imposed by the Federal Reserve that limited a member bank's share of total deposits in a given metropolitan area. The intent was to provide multiple sources of bank credit to prevent the concentration of financial resources, promote competition and ensure access for borrowers.

But these restrictions became meaningless in the 1970s as banks set up credit card operations and loan production offices nationwide and gathered a larger share of non-deposit liabilities in money markets at home and abroad. The irrelevance of the prohibition on interstate branching was pointed out repeatedly using the example of the

⁴ Federal Reserve Board. *Flow of Funds Accounts of the United States*. Various issues.

⁵ James R. Barth and R. Dan Brumbaugh, Jr. "The Changing World of Banking: Setting the Regulatory Agenda." Unpublished paper prepared for the Conference on Financial Prosperity in the 21st Century, Jerome Levy Economics Institute, Bard College, Annandale-on-Hudson, NY, March 1993.

New York banks that could set up branches in every continent across the globe but not in New Jersey. The pressure from banks to end the restrictions was rewarded in 1992 when 34 states changed their laws to allow nationwide banking. The remaining states followed shortly thereafter.

Beginning with the Bank Holding Company Act Amendments of 1970, the expansion of banks into other financial activities also contributed to concentration in the sector. Being able to engage in non-traditional businesses at home and abroad gave larger institutions an advantage in terms of growth that their smaller competitors did not have. For example, smaller banks could not raise the capital to set up leasing, factoring or mortgage banking affiliates, or establish foreign branches or compete in attracting foreign borrowers. In addition, the largest banks were already engaged in a variety of other activities including securities underwriting and trading in their overseas offices before passage of the Gramm, Leach, Bliley Act in 1999.

Meanwhile the Basel capital adequacy standards adopted in 1988 reflected a shift in regulatory views on the appropriate means for curbing bank concentration. It was assumed that market forces would effectively curb the growth of banks and bank credit by providing capital to sound institutions and withholding it from the less sound. In effect, the issue of restraining bank concentration was turned over to the market.

Not everyone agreed. Like former FDIC Chairman William Isaac, some argued that stronger antitrust laws should be applied to banks to ensure that there were plenty of alternative means of gaining access to bank credit.⁶ But the Treasury and other regulators favored consolidation of the more than 12,000 banks operating in the United States in the early 1980s to encourage efficiency and economies of scale. It was not that the “too big to fail” problem was ignored. It was, in fact, accommodated in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) by authorizing federal regulators to rescue large banks and cover their uninsured deposits if their failure would create serious risk to the U.S. banking system.

Concentration and Interdependence

As the current crisis erupted, concern focused not only on the size of individual institutions but on the close connections between them. It became apparent that buying and selling financial insurance to other financial institutions had become a major share of the business of the top firms in the banking, investment banking and insurance sectors. As the web of counterparty relationships developed with the spread of derivatives, banks were no longer the only institutions that posed a threat to the system.

Moreover, these large, diversified institutions became more interdependent as they raised more of their funding by borrowing from one another. The amount of borrowing by the financial sector rose sharply over the decade from 1997 to 2007, pushing the level of its outstanding debt from 64 percent to 114 percent of GDP.⁷ Much of that increase reflects leverage — that is, borrowing (under repurchase agreements) using assets reported on their books as collateral to obtain cash to buy additional assets that could be held off-balance-sheet. Institutional size mattered because the margin of return over the cost of borrowing was so small that profitability depended on the size of the position and thus on the ability to attract the amount of funds needed to finance a

⁶ Ronald Brownstein, “A Wall of Money.” *National Journal*, July 30, 1983.

⁷ Federal Reserve Board, *Flow of Funds Accounts of the United States*. Various issues.

huge pool of investments. The result of burgeoning leverage was even larger balance-sheet and (especially) off-balance-sheet liabilities that increased the market dominance of these institutions at the same time that it exacerbated their fragility and interdependence.

One of the more distressing legacies of this trend is the concentration of counterparty relationships among a relatively small number of multinational institutions domiciled in the advanced economies. The problem is underscored by revelations that much of the funding given to AIG by the Treasury and the Federal Reserve in 2008 was used to settle derivatives contracts with counterparties at full value, including multi-billion dollar payments to U.S. institutions that had received TARP funds and large foreign banks. Some argue that a better strategy for managing these positions would have been to require firms receiving taxpayer funding to net out derivatives contracts and share the gains and losses. But there is general agreement that a priority for reform is to move derivatives trading to exchanges (where the exchange itself is the counterparty) or to a clearinghouse that can increase the transparency of trading.

Dealing with Institutional Concentration

Proposals offered so far by official entities such as the Financial Stability Forum (FSF),⁸ the European Parliament and the UK's Financial Services Authority (FSA)⁹ do not make recommendations for limits on concentration. The UK FSA report implies that a reformed regulatory environment will likely shrink the size of institutions by reducing their profitability. Certainly limits on leverage would lead to shrinkage even if no other regulatory limits were put in place. But this might not be sufficient to reduce concentration to levels that would shrink the number of institutions that are too big to fail.

The report issued by the Group of Thirty in January 2009 does deal with the issue of institutional concentration. It argues that excessive concentration in national banking systems has implications for effective oversight, management control and competition. It recommends nationwide limits on deposit concentration at a level appropriate to individual countries.¹⁰ But that recommendation is limited to depository institutions. It ignores the role that systemically important institutions in other sectors played in precipitating the crisis and the extent to which government funding has been used to execute a new round of "supervisory mergers" or "purchase and assumption" transactions involving both banks and institutions other than banks.

Moreover, the Group of Thirty's recommendation does not spell out what the appropriate level of concentration might be for a given country. The financial collapse in Iceland may provide a powerful warning for regulators going forward, having added yet another dimension to the concern about the size of institutions. The new measure of TBTF is a financial sector — not just individual institutions — that has expanded to a

⁸ Members of the Financial Stability Forum include representatives of the Ministries of Finance, central banks and financial regulators of 12 economies plus representatives from the International Monetary Fund, World Bank, Bank for International Settlements, Organization for Economic Cooperation and Development and the European Central Bank. The first report of their recommendations was published in 2008.

⁹ See Turner Review, www.fsa.gov.uk.

¹⁰ Group of Thirty, *Financial Reform: A framework for Financial Stability*. Washington, DC: The Group of Thirty, 2009.

size that is many multiples of a nation's GDP.¹¹ A financial system can only grow to that size if it is built on leveraged speculation. Financial institutions cannot survive if their assets are not based on credit that promotes real economic activity. And if the assets of highly leveraged institutions substantially outstrip national output, their collapse will bankrupt the country.

Dealing with Asset Concentrations

Institutional concentration is not the only problem that must be addressed if future financial crises as serious as the present one are to be avoided. As demonstrated in the crises that afflicted Japan and emerging market countries in the 1990s and the U.S. and other advanced economies in the 2000s, asset concentrations also precipitate collapses in financial systems that cause losses to nonfinancial sectors and halt growth.

In the United States, making diversification a necessary component of soundness regulation goes back to the National Bank Act of 1964 and its requirement that loans to a single borrower be limited to no more than 10 percent of bank capital. Requirements for diversification were also embodied in holding limits on investments in stocks of individual corporations by insurance and investment companies. Moreover, margin requirements were imposed as part of New Deal reforms to prevent the excessive use of credit for purchases of stocks that fueled a rapid build-up in stock prices and precipitated the crash of 1929.

Margin requirements limit the amount of credit that can be used to buy stocks and are an effective tool for dealing with asset concentrations because they apply to all investors, financial and non-financial. Former Federal Reserve Board (FRB) Chairman William McChesney Martin raised margin requirements to contain the bull market that developed in the 1960s, and former Fed Chairman Arthur Burns used them again in the 1970s. During the chairmanship of Alan Greenspan, however, the FRB left the requirement at 50 percent. As the boom in technology stocks got underway at the end of the 1990s, many analysts argued that raising the margin requirement would have moderated both the bubble and the bust that followed.

But margin requirements do not apply to other classes of assets. There are no limits on how much can be borrowed to buy mortgage backed securities (MBSs), for example, or holding limits on the amount that can be held by institutional investors. The absence of these restrictions created the asset concentrations at the heart of the current crisis. Moreover, limits on banks' loans to individual borrowers as a percentage of capital do not apply to all systemically important institutions. And banks, too, have been able to avoid capital restrictions on both individual and aggregate lending as securitization allowed them to originate, distribute and service a rising volume of residential mortgages and consumer loans.

Securitization also facilitated the expansion of unregulated non-depository institutions such as mortgage brokers and finance companies. Like banks, they can originate and distribute a large volume of mortgages without having to raise funds to hold these assets for their own account. And, on the investment side of securitization, the need

¹¹ At the time of the collapse of Iceland's financial sector in the fall of 2008, assets of the three main banks were nearly ten times the nation's GDP. Reflecting Iceland's self-defined role as an international financial center, most of these assets were generated by highly leveraged speculative activity involving both foreign and domestic borrowers and investors. (See Robert Wade, "Iceland as Icarus," *Challenge*, May/June 2009.)

for buyers to take up a rising volume of MBSs and other asset-backed securities¹² encouraged the expansion of unregulated “highly-leveraged” institutions, such as hedge funds and finance companies. As they exploited the competitive advantages of having no limits on borrowing in relation to capital or on holdings of individual classes of securities, their growth also contributed to higher levels of asset concentrations.

An increasing share of total credit used to finance residential mortgages raised the potential for a housing bubble. Part of that bubble was inflated by the growth in sub-prime lending but it was the overall concentration in lending for mortgages that was the driving force in creating the bubble. The rise in housing prices kept pace with the escalation in outstanding mortgage debt and resulted in a run-up in household debt from 66 to 100 percent of GDP over the decade ending in 2007.¹³ The debt burden increased both the strain on families and the fragility of the financial system.

The small business sector is one of the many casualties of the concentration in credit flows to housing. Increases in direct bank lending to small businesses all but collapsed after 2001, but banks restructured credit flows to these borrowers by offering to use their homes as collateral. This channel for lending was more profitable for banks since loans for housing could be securitized and sold rather than held on their balance sheets.¹⁴ For small business owners, there was little choice other than to borrow against the inflated value of their homes. But, as house prices dropped, they lost that source of financing and many are now struggling to save both their businesses and their homes.

Policy Concerns

In the past, structural and regulatory efforts to promote competition within the financial services industry and ensure access to credit stressed the need to prevent the concentration of financial resources. Beginning in the 1970s, changes in financial structure made these restraints obsolete and increases in institutional and asset concentrations helped drive the process of restructuring. Failure to restrict institutional concentration began to impair the market system itself since markets work best when decision making reflects different viewpoints and perspectives. Reducing the number of independent decision makers in the system increased the potential for “one way” markets. The regal position and market power of a few large institutions in each financial sector contributed to the spread of destructive, lemming-like behavior in all sectors. Coping with the consequences of their own excesses has crippled the ability of these institutions to fuel productive growth.

Even without evidence of its damaging effects in the current crisis, failure to curb concentration undermines systemic efficiency in a number of ways. For example, as the number of institutions declines so does the number of alternative sources of capital and credit. The result may be an uneven distribution of credit that rewards some sectors at the expense of others. Rising levels of institutional concentration may make it harder for the financial system to assist the development of small, innovative companies and processes that would mature in time to ease the disruptions caused by declining older firms and methods.

¹² Other asset-backed securities include pools of credit card receivables and car and student loans.

¹³ Federal Reserve Board, *Flow of Funds Accounts of the United States*. Various issues.

¹⁴ Federal Reserve Board, *Flow of Funds Accounts of the United States*. Various issues.

Fewer institutions may also result in increased volatility in secondary markets for traded assets. As the growth of institutional investors' share of securities markets indicates, individual transactions have tended to be larger and have greater impact on markets. The result was a rise in demand for instruments and vehicles to offset wider swings in prices and increased risk even as the number of counterparties for hedging contracts shrank.

Meanwhile, the implications of institutional concentration for the conduct of monetary policy are almost totally ignored in discussions of these issues. As the market power of individual institutions and the interdependence of institutions and markets increased, the central bank's effectiveness as a stabilizing force diminished. The smaller size of its transactions relative to those of the largest institutions meant that, over time, these institutions became somewhat insulated from Federal Reserve influence by virtue of their own market power. Moreover, as the size of failures and their monetary and social costs rise, the government's ability to protect customers of financial institutions has weakened and the burden forced on taxpayers has ballooned.

Proposals for Reform

Limits on institutional and asset concentrations must be given priority status in reform proposals. At stake is what is termed the "macroprudential" function of financial structure and regulation in performing this sector's key role in promoting growth in a national economy. The breakdown in that role during the current crisis requires that its causes be addressed both to end the crisis and ensure it will not be repeated. The following proposals provide guidelines for reforms that should be considered in meeting that objective.

Unwind recent mergers. One of the important elements in current and past crisis management strategies has been to encourage or permit the take over of fragile institutions or their assets by supposedly stronger acquirers. While this option may be necessary in some cases in the short-term, it is one that intensifies the potential for systemic risk in the future. Many of these mergers should be unwound when the crisis subsides and all institutions be made to conform to new limits on institutional concentration.

Limiting the size of institutions. The Group of Thirty's recommendation to limit the share of deposits held by banks nationwide is a start, but Congress will need to develop new strategies to limit the size of all financial institutions, not just banks, and take into account the size of their operations worldwide. Some of the measures and principles that should be included in these strategies are:

- Limits on the total size of the financial sector in relation to the size of the national economy. While financial institutions that are domiciled in one country may have operations world-wide, it is the central bank in the home country that is responsible for providing liquidity to its financial sector and the taxpayers of that country that must fund the bailouts. The capacity to perform those critical functions is determined by the proportional relationship between the size of the financial sector and the output of the economy in which it is based.
- Limits on the size of individual institutions. One basis for setting the limits must be the size of the financial guaranty programs — FDIC,

Securities Investors Protection Corporation (SIPC) and state programs to protect insurance beneficiaries, for example. TBTF could be defined as any institution whose failure would cause a substantial depletion of the resources of the guaranty programs and thus put taxpayers at risk.

- Reinstating or adopting competition policies that place limits on de novo expansions as well as mergers and acquisitions. The objectives of such policies are to increase the number of decision makers in the system (and thus reduce the potential for bandwagon behavior), provide many alternative means for borrowers to gain access to capital and credit, promote diversity in financial services and ensure that those services meet local needs. Measures of their success would be their ability to prevent a contraction and promote an increase in the number of institutions that account for half the total assets of a given financial sector or, in terms of conglomerates, of the financial sector as a whole.

To meet these objectives, regulatory agencies must be given authority not only to prevent excessive expansion but to break up institutions if they reach a size that exceeds either the policy guidelines or any specific numerical limits that Congress might impose.

Limiting asset and counterparty concentrations. Imposing margin requirements on all financial assets (including derivatives and commodities) bought on credit would be an effective way to stop the development of bubbles in the future. Congress must amend the law to ensure that the Federal Reserve responds to large increases in holdings of any financial asset, including equities, by raising the margin requirement and that it uses margin requirements both to restrict and stimulate credit flows to various sectors of the economy.

Imposing limits on transactions with financial counterparties is needed to address the high level of contagion that characterizes a systemic crisis like the one from which the U.S. and the global economy are still reeling. Limits on loans to and borrowings from individual counterparties should conform to the same restrictions that now apply to banks' loans to individual nonfinancial borrowers in relation to capital. Again, they must apply to all financial institutions and be applicable to their international as well as domestic operations.

Conclusions

The guidelines and proposals outlined above draw on existing restrictions and objectives that have defined competition policy for the financial sector in the past. Most of these restrictions have become obsolete because of the many and profound changes in financial structure. For example, the role of traditional bank lending has declined dramatically as a result of securitization while a rising share of household savings is now invested in mutual and pension funds rather than in bank deposits. Thus banks' share of total holdings of financial assets has dropped from more than half to less than a quarter over the last 30 years even as fee-based services and proprietary trading have propelled growth and concentration among the largest bank holding companies. The amount of credit now generated by nonbank institutions underscores the need to include a wider range of firms and sectors in reform proposals to address the potential for systemic crises

in the future. But, again, addressing that potential must include efforts to stem the tide of concentration. The TBTF problem has not only moved beyond the banking system, it has become much too costly for taxpayers and the U.S. economy.