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“TOO BIG TO FAIL”—SHOULD BREAKING UP LARGE FINANCIAL INSTITUTIONS BE AN ANSWER?

*U.S. AND EUROPEAN APPROACHES*¹

*Edward Greene*² and *Katia Kirova*³

On Wednesday, November 18, 2009, the United States House of Representatives Committee on Financial Services (House Financial Services Committee) passed an amendment (the Amendment) sponsored by Representative Paul Kanjorski (D-Pa.) to the financial stability bill, the Financial Stability Improvement Act of 2009, which is a part of a comprehensive set of reforms rolled into an omnibus bill, The Wall Street Reform and Consumer Protection Act of 2009 (the Bill),⁴ passed by the House Financial Services Committee on December 2, 2009. The Bill will be considered on the House of Representatives floor in December 2009. It incorporates nine major pieces of legislation, including the creation of an inter-agency council, the Financial Services Oversight Council (the Council) that will identify and regulate financial firms that pose systemic risk.

The Amendment, unveiled by Kanjorski, Chairman of the House Financial Services Capital Markets Subcommittee, gives regulators preemptive authority to break up the fifty largest financial institutions by total assets in the United States if their “size . . . [,] scope, nature, scale, concentration, interconnectedness, or mix of activities directly or indirectly conducted by a financial holding company subject to stricter standards poses a grave threat to the financial stability or economy of the United States.”⁵ This preemptive authority would be given to the Council, which would be empowered to force a financial institution to undertake one or more of the following “mitigatory actions”: modifying the prudential standards previously set by the Board of Governors of the Federal Reserve System; “terminating [one] or more activities”; imposing conditions on the existing activities; “limiting the ability to merge with, acquire, consolidate with, or otherwise become affiliated with another company”; “restricting the ability to offer a financial product or products”; and, “in the event the Council deems [the aforementioned actions] inadequate as a means to address the identified risks, *selling, divesting, or otherwise*

¹ This article is current as of December 7, 2009.

² Edward F. Greene is a partner in the New York office of Cleary Gottlieb Steen & Hamilton LLP. Mr. Greene served as General Counsel of the Securities and Exchange Commission from 1981 to 1982 and Director of the Division of Corporation Finance from 1979 to 1981. From 2004 to 2008, he served as General Counsel of Citigroup’s Institutional Clients Group. He originally joined the firm in 1982 and returned in 2009.

³ Katia Kirova is currently studying at Columbia University School of Law. She has practiced Corporate and Securities Law in New York City and in Paris and has experience in cross-border transactions.

⁴ The Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (2009), available at http://www.house.gov/apps/list/press/financialsvcs_dem/hr4173.pdf.

⁵ *Id.* § 1105(a).

*transferring business units, branches, assets, or off-balance sheet items to unaffiliated companies.”*⁶

Large financial institutions in the United States that would likely be swept up by this legislation are concerned. The implications of the Amendment could harm their international competitiveness. While the Amendment requires the Council to consider the “need to maintain . . . international competitiveness” and the extent to which other countries are implementing similar rules,⁷ these provisions are too vague and do not present, in our opinion, an efficient and timely restraint on possible action.

A few days before the vote on the Amendment, Jamie Dimon, Chairman and Chief Executive Officer of JPMorgan Chase & Co., published an article in *The Washington Post* entitled “No More ‘Too Big to Fail,’”⁸ warning against a populist impulse to break up large, healthy financial institutions.

On November 16, 2009, members of the Financial Services Forum, an industry group consisting of chief executives of some of the world’s largest financial institutions, including Goldman Sachs and JPMorgan Chase & Co., urged Congress not to pursue “big bank break-up legislation.”⁹

Both Republicans and Democrats are reluctant to give the Council such an accumulation of power and are concerned about a potential unfair taking of private property, in spite of the “due process” clause inserted in the Amendment.¹⁰

We will examine briefly the situation in Europe, since Europe has quickly and dramatically embraced a breaking up authority (Part I), before coming back to the situation in the United States and assessing the U.S. approach (Part II). Finally, we will discuss the general questions that arise with respect to such a preemptive authority (Part III).

I. BREAKING UP LARGE FINANCIAL INSTITUTIONS IN EUROPE

The European Commission is linking the break-up authority of large financial institutions with Competition Law. The assumption seems to be that the European banking sector is concentrated, not competitive, and the result has been several financial institutions that may be too big to fail. Thus, breaking them up addresses both problems. Neelie Kroes, the Commissioner for Competition, mentioned in a press release dated November 13, 2009, that “[t]he European Commission is not destroying banks, it is simply helping this troubled sector to remain competitive whilst dealing with the current crisis.”¹¹ The first major step for the Commissioner for Competition was to break up ING Group NV in October 2009.

⁶ *Id.* § 1105(d)(1) (emphasis added).

⁷ *Id.* § 1105(d)(2).

⁸ Jamie Dimon, *No More “Too Big to Fail,”* WASH. POST, Nov. 13, 2009.

⁹ Kevin Drawbaugh, *Banks Sense Danger, Warn Congress on Breakup Power*, REUTERS, Nov. 16, 2009, <http://www.reuters.com/article/idUSTRE5AG0EQ20091117>.

¹⁰ The Wall Street Reform and Consumer Protection Act of 2009, § 1105(e).

¹¹ Latest News from Neelie Kroes, “The Banks Need to Change,” Nov. 13, 2009, <http://blogs.ec.europa.eu/neelie-kroes/the-banks-need-to-change/>.

At the same time, the European Commission had been pressing the United Kingdom to downsize its largest banks. As a result, the British Government had to force the Royal Bank of Scotland, Lloyds Banking Group, and Northern Rock to sell off parts of their businesses. The consequences included, of course, the shrinking of their workforces.

The Governor of the Bank of England, Mervyn King, has mentioned that one option to create greater competition may be the separation of activities (similar to the Glass-Steagall Act of 1933 in the United States).¹²

European, and now British, regulators are clearly leaning toward a more competitive banking system with smaller players. Prior to the Amendment, experts were wondering whether the United States would pursue a similar approach.

II. THE U.S. APPROACH

President Obama’s administration pushed Citigroup to sell operations to improve its financial prospects, although the administration has neglected to place similar pressure on healthier institutions. The adoption of the Amendment is similar to the European approach, though it is not predicated on increasing competition.

A provision similar to the Amendment is also included in the Restoring American Financial Stability Act of 2009 (Discussion Draft), proposed on November 10, 2009 by Senator Christopher Dodd (D-Conn.), the Chairman of the Senate Banking Committee.¹³ The Agency for Financial Stability called for by the Discussion Draft would give regulators the authority to break up companies that are deemed to be a threat to the financial stability of the United States. The precise definition of a “threat” has not been provided.

It is important to note the differences between the U.S. market and the European markets. The U.S. banking system is not as concentrated as the European Union’s banking system. Moreover, the fifty largest financial institutions covered by the Amendment obscure the fact that problems can arise amidst mid- or small-size banks.

Such provisions raise questions that are still unanswered today.

III. QUESTIONS WITH RESPECT TO BREAK UP AUTHORITY

Such a preemptive authority in Europe or the United States raises business issues, as described in Jamie Dimon’s article,¹⁴ but it also raises legal issues, *inter alia*:

- *Interference of political authority in the corporate governance of a private company.*
The Council is chaired by the Secretary of the Treasury, funded by departments and

¹² Mervyn King, Gov. of the Bank of England, Speech to Scottish Business Organisations, at 8 (Oct. 20, 2009), available at <http://www.bankofengland.co.uk/publications/speeches/2009/speech406.pdf>.

¹³ Restoring American Financial Stability Act of 2009, S., 111th Cong. § 119 (Discussion Draft, 2009), Sec. 119, http://banking.senate.gov/public/_files/AYO09D44_xml.pdf.

¹⁴ See Dimon, *supra* note 8.

agencies represented by voting members of the Council on an equal basis, and reports to the U.S. Congress.

- *Interference in contractual freedom.* The “mitigatory actions” described in the Amendment could result in drastic and quick change in contractual relationships between the company forced to take such “mitigatory actions” and its co-contractors. This uncertainty would foster a lack of confidence in such large financial institutions, due to the third parties’ anticipation of an adverse change in their contractual relationships. If the market suspects that financial institutions may be approaching a size limit and consequently broken up, counterparties will be concerned about credit exposure and either insist on enhanced collateral or shift their business elsewhere. Uncertainty does not contribute to stability.

In addition, an enormous uncertainty will emerge when it comes to deciding exactly which financial institution can be subject to “mitigatory actions,” because no precise definition of systemic risk exists. The Amendment gives significant discretion to the Council, which would be empowered to make decisions on a case-by-case basis.

Ben Bernanke, Chairman and a member of the Board of Governors of the Federal Reserve System, offered a broad definition of the term “systemic risk” in an October 30, 2009, letter to Senator Bob Corker (R-Tenn.).¹⁵ The definition includes institutions with “unsafe amounts of leveraging by banks, gaps in regulatory oversight and the possibility that the failure of a large interconnected firm could lead to a breakdown in the wider financial system.”¹⁶ An even greater uncertainty exists for multi-national institutions because, in spite of the international policy coordination mentioned in the Amendment, no precise, standardized, and sufficiently narrow definition of systemic risk exists on the international level.

IV. CONCLUSION

The United States has a diversified financial institution structure unlike the United Kingdom. In the United Kingdom, and in Europe in general, competition authority is being used to create smaller financial institutions as a consequence of the cartel legislation. European legislation is not necessarily focusing solely on the size of a financial institution or being driven by the “too big to fail” issue, although that is part of the discussion.

The reforms prescribed by the U.S. Congress would, if enacted, create for the first time systemic risk oversight and procedures for reporting and collecting information, as well as give regulators the ability to review capitalization standards, control activities, and intervene when an institution becomes dangerously undercapitalized. In addition, Congressional proposals would regulate, for the first time ever, the over-the-counter (OTC) derivatives market, through the use of central clearing and trading on an exchange or electronic platform. Moreover, some institutions would be identified as posing systemic risk and would therefore be subject to higher standards to be reviewed and imposed by the regulators. Would not the foregoing proposed reforms be enough? To focus solely on the size of a financial institution and subject the fifty largest institutions to a

¹⁵ See Corey Boles, *Bernanke Offers Broad Definition of Systemic Risk*, WALL ST. J. BLOGS, Nov. 18, 2009, <http://blogs.wsj.com/economics/2009/11/18/bernanke-offers-broad-definition-of-systemic-risk/>.

¹⁶ *Id.*

break-up authority in addition to the aforementioned proposed regulations will create confusion in the market and for the investors. If size becomes the measure, how will the market know what the size limits are? And if there are artificial size limits, well-run institutions may curb activity as they approach the limit, which may not be in the best interest of consumers and large institutional clients. This is a belt and suspenders approach which is not necessary and will only cause confusion. The risk could be controlled by focusing on the activity that triggers that size and, in the event such a risk exists, capital requirements should be sufficient to control it. Artificial size limits may cause migration to foreign markets where such restrictions do not exist.

It is imperative to reform the financial services markets quickly, as the more the markets improve, the more the impetus for reform lessens. However, in this particular instance, it would be prudent not to implement such break-up provisions hastily, as it takes less time to break up than to build a large financial institution.