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Banks 'Too Big to Fail' Have Grown Even Bigger

Behemoths Born of the Bailout Reduce Consumer Choice, Tempt Corporate Moral Hazard

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When the credit crisis struck last year, federal regulators pumped tens of billions of dollars into the nation's leading financial institutions because the banks were so big that officials feared their failure would ruin the entire financial system.

Today, the biggest of those banks are even bigger.

The crisis may be turning out very well for many of the behemoths that dominate U.S. finance. A series of federally arranged mergers safely landed troubled banks on the decks of more stable firms. And it allowed the survivors to emerge from the turmoil with strengthened market positions, giving them even greater control over consumer lending and more potential to profit.

J.P. Morgan Chase, an amalgam of some of Wall Street's most storied institutions, now holds more than $1 of every $10 on deposit in this country. So does Bank of America, scarred by its acquisition of Merrill Lynch and partly government-owned as a result of the crisis, as does Wells Fargo, the biggest West Coast bank. Those three banks, plus government-rescued and -owned Citigroup, now issue one of every two mortgages and about two of every three credit cards, federal data show.

A year after the near-collapse of the financial system last September, the federal response has redefined how Americans get mortgages, student loans and other kinds of credit and has made a national spectacle of executive pay. But no consequence of the crisis alarms top regulators more than having banks that were already too big to fail grow even larger and more interconnected.

"It is at the top of the list of things that need to be fixed," said Sheila C. Bair, chairman of the Federal Deposit Insurance Corp. "It fed the crisis, and it has gotten worse because of the crisis."

Regulators' concerns are twofold: that consumers will wind up with fewer choices for services and that big banks will assume they always have the government's backing if things go wrong. That presumed guarantee means large companies could return to the risky behavior that led to the crisis if they figure federal officials will clean up their mess.

This problem, known as "moral hazard," is partly why government officials are keeping a tight rein on bailed-out banks -- monitoring executive pay, reviewing sales of major divisions -- and it is driving the Obama administration's efforts to create a new regulatory system to prevent another crisis. That plan would impose higher capital standards on large institutions and empower the government to take over a wide range of troubled financial firms to wind down their businesses in an orderly way.

"The dominant public policy imperative motivating reform is to address the moral hazard risk created by what we did, what we had to do in the crisis to save the economy," Treasury Secretary Timothy F. Geithner said in an interview.

The worry for consumers is that the bailouts skewed the financial industry in favor of the big and powerful. Fresh data from the FDIC show that big banks have the ability to borrow more cheaply than their peers because creditors assume these large companies are not at risk of failing. That imbalance could eventually squeeze out smaller competitors. Already, consumers are seeing fewer choices and higher prices for financial services, some senior government officials warn.

Those mergers were largely the government's making. Regulators pushed failing mortgage lenders and Wall Street firms into the arms of even bigger banks and handed out billions of dollars to ensure that the deals would go through. They say they reluctantly arranged the marriages. Their aim was to dull the shock caused by collapses and prevent confidence in the U.S. financial system from crumbling.

Officials waived long-standing regulations to make the deals work. J.P. Morgan Chase, Bank of America and Wells Fargo were each allowed to hold more than 10 percent of the nation's deposits despite a rule barring such a practice. In several metropolitan regions, these banks were permitted to take market share beyond what the Department of Justice's antitrust guidelines typically allow, Federal Reserve documents show.

"There's been a significant consolidation among the big banks, and it's kind of hollowing out the banking system," said Mark Zandi, chief economist of Moody's Economy.com. "You'll be left with very large institutions and small ones that fill in the cracks. But it'll be difficult for the mid-tier institutions to thrive."

"The oligopoly has tightened," he added.

Consumer Choice

Federal officials and advocacy groups are just beginning to study the impact of the crisis on consumers, but there is some evidence that the mergers are creating new challenges for ordinary Americans.

In the last quarter, the top four banks raised fees related to deposits by an average of 8 percent, according to research from the Federal Reserve Bank of Dallas. Striving to stay competitive, smaller banks lowered their fees by an average of 12 percent.

"None of us are saying dismember these institutions. But you do want to create a system that allows for others to grow, where no one has an oligopolistic power at the expense of others who might be able to provide financial services to consumers," said Richard Fisher, president of the Federal Reserve Bank of Dallas.

Normally, when faced with price increases, consumers simply switch. But industry officials said that is not so easy when it comes to financial services.

In Santa Cruz, Calif., Wells Fargo, Bank of America and J.P. Morgan Chase hold three-quarters of the deposit market. Each firm was given tens of billions of dollars in bailout funds to help it swallow other banks.

The rest of the market, which consists of a handful of tiny community banks, cannot match the marketing power of the bigger banks. Instead, presidents of the smaller companies said, they must offer more personalized service and adapt to technological changes more quickly to entice customers. Some acknowledged it can be a tough fight.

Wells Fargo is "really, really good at the way they cross-sell and get their tentacles around you," said Richard Hofstetter, president of Lighthouse Bank, whose only branch is in Santa Cruz. "Their customers have multiple areas of their financial life involved with Wells Fargo. If you have a checking account and an ATM and a credit card and a home-equity line and automatic bill payments . . . to change that is a major undertaking."

Wells Fargo, J.P. Morgan and Bank of America declined to comment for this article.

Last October, when the Fed was arranging the merger between Wells Fargo and Wachovia, it identified six other metropolitan regions in which the combined company would either exceed the Justice Department's antitrust guidelines or hold more than a third of an area's deposits. But the central bank thought local competition in each of those places was sufficient to allow the merger to go through, documents show.

Camden Fine, president of the Independent Community Bankers of America, said those comments reveal the government's preferential treatment of big banks. He doubted whether the Fed would approve the merger of community banks if the combined company ended up controlling more a third of the market.

"To favor one class of financial institutions over another class skews the market. You don't have a free market; you have a government-favored market," he said. "We will never have free markets again if you have the government picking winners and losers."

Moral Hazard

Before the crisis, many creditors thought that the big institutions were a relatively safe investment because they were diversified and thus unlikely to fail. If one line of business struggled, each bank had other ventures to keep the franchise afloat. And even if the entire house caught fire, wouldn't the government step in to cover the losses?

With executives comforted by that thinking, risk came unhinged from investment decisions. Wall Street borrowed to make money without having enough in reserves to cover potential losses. The pursuit of profit was put ahead of the regard for safety and soundness.

The federal bailouts only reinforced the thought that government would save big banks, no matter how horrible their decisions.

Today, even with the memory of the crisis fresh in their minds, creditors are granting big institutions more favorable treatment because they know the government is backing them, FDIC officials said.

Large banks with more than $100 billion in assets are borrowing at interest rates 0.34 percentage points lower than the rest of the industry. Back in 2007, that advantage was only 0.08 percentage points, according to the FDIC. Such differences can cause huge variance in borrowing costs given the massive amount of money that flows through banks.

Many of the largest banks reported a surge in profit during the most recent quarter, including J.P. Morgan Chase and Goldman Sachs. They are prospering while many regional and community banks are struggling. Nearly three dozen of the smaller institutions have failed since July 1, including Community Bank of Nevada and Alabama-based Colonial Bank just last week.

If the government continues to back big firms over small, regulators worry that reckless behavior could return to Wall Street.

The administration's regulatory reform plan takes aim at this problem by penalizing banks for being big. It would require large institutions to hold more capital and pay higher regulatory fees, as well as allow the government to liquidate them in an orderly way if they begin to fail. The plan also seeks to bolster nontraditional channels of finance to create competition for large banks. If Congress approves the proposal, Geithner said, it would be clear at launch which financial companies would face these measures.

Economists and officials debate whether these steps would address the too-big-to-fail problem. Some say, for instance, that determining the precise amount of capital big financial companies should hold in their reserves will be difficult.

Geithner acknowledged that difficulty but said the administration would probably lean toward being more strict. Taken together, the combination of reforms would be a powerful counterbalance to big banks, he said.

"Our system is not going to be significantly more concentrated than it is today," Geithner said. "And it's important to remember that even now, our system remains much less concentrated and will continue to provide more choice for consumers and businesses than any other major economy in the world."

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