Not Too Big to Fail. Too Expensive to Exist

Indirect pressure from regulators has been one factor behind a breakup for some financial firms

MetLife said the risk of increased capital requirements contributed to its decision to divest much of its life-insurance business. ENLARGE

MetLife said the risk of increased capital requirements contributed to its decision to divest much of its life-insurance business. PHOTO: MARK LENNIHAN/ASSOCIATED PRESS

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Updated Jan. 13, 2016 7:54 p.m. ET

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Forget too-big-to-fail.

The operative question for the country's largest financial firms is increasingly whether the government has made it too expensive to be big.

On Tuesday, insurer MetLife Inc. became the second major firm in the past 10 months to decide that the demands of being "systemically important" in the eyes of regulators may outweigh the benefits of continuing to operate at its current size. General Electric Co. made the same choice in April for its giant finance arm, GE Capital.

The moves show that while the U.S. government hasn't heeded populist calls to "break up" the nation's largest financial firms, those demands are at times being answered through indirect pressure from regulators.

Next up could be MetLife rivals Prudential Financial Inc. and American International Group Inc., analysts say. The latter is facing a challenge from investors, including Carl Icahn, who argue in part that the firm is "too big to succeed" given the regulatory requirements it now must meet that restrain profits.

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The very largest U.S. banks, some of whom report earnings this week, are also facing increasing questions about whether they can remain profitable at their current size. In recent years, the Federal Reserve and other overseers have made it clear that being big will come with costs: Large

U.S. banks have added $641 billion of capital since 2009 to meet tougher regulatory rules, according to the Fed.

Those requirements make it tougher for firms to produce outsize returns.

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In the banking sector, where policy makers have focused the toughest rules on roughly 30 banks with $50 billion or more in assets, smaller banks with between $5 billion and $50 billion in assets are about 10% more profitable than banks that are above that level, according to an analysis by Keefe, Bruyette & Woods. The shares of those midsize banks accordingly trade at a higher valuation than lenders with $50 billion or more in assets, according to the analysis.

"It's like saying if you have a super fast race car…we'll make sure you only go 70 miles per hour," says Art Wilmarth, a law professor at George Washington University who specializes in banking regulation.

Another major test looms in the coming weeks when regulators have to decide whether 12 top banks have credible plans describing how they could fail without a bailout—dubbed "living wills"—or whether to begin pressing those firms to simplify or shrink.

Policy makers say they aren't explicitly telling firms to break up, but they also make clear they wouldn't be unhappy with that outcome.

Fed governor Daniel Tarullo, the central bank's regulatory czar, has said the goal is essentially to provide any firm that could bring down the financial system with a choice. Firms can shed businesses that the Fed considers risky or maintain the associated high capital levels, he has said.

Firms that fund themselves with more capital, as opposed to debt, can better weather unexpected losses. But they also can look less profitable because profits are measured against capital provided by investors.

In the intensifying presidential campaign, politicians from the left and right have been attacking large Wall Street firms. And liberals such as Vermont Sen. Bernie Sanders, a contender for the Democratic nomination, regularly call for "breaking up" the largest banks.

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Most officials, even under Democratic President Barack Obama, won't openly say they want to go that far. Still, developments like the MetLife announcement amount to expected, if not explicitly intended, consequences of tighter financial oversight that began with the 2010 Dodd-Frank financial overhaul law.

"People are pretty happy with a large firm that we think is systemically important deciding to split itself into groups that aren't," said Andrew Metrick, a Yale University finance professor who previously worked on the Dodd-Frank law while a staffer at Obama's Council of Economic Advisers.

To be sure, MetLife said the risk of increased capital requirements "contributed to our decision," suggesting other factors were at play as well. While its plan would hive off some businesses that regulators had flagged as risky, such as certain guaranteed annuities, that business was also facing profitability pressures amid low interest rates. The Fed also hasn't yet specified what the rules of the road would be for MetLife or other insurance firms.

Privately, some government officials are questioning whether MetLife's decision was entirely regulatory-driven as opposed to driven by market considerations.

On the banking side, those at the very top of the size spectrum have faced the most stringent rules, and have made a mantra of saying they want to be smaller and simpler.

Citigroup Inc., for example, has shrunk total assets by 17% since the end of 2007, to $1.81 trillion from $2.18 trillion. It has jettisoned units considered risky or tangential—such as a Japanese company that runs call centers, or the subprime lender OneMain Financial—but it has also gotten rid of units that some investors would have preferred they keep, like the wealth management firm Smith Barney.

J.P. Morgan, the country's biggest bank by assets with about $2.4 trillion, spent much of last year defending its size, especially after a Goldman Sachs Group Inc. analyst argued breaking up the firm would unlock value in the share price. Fed Chairwoman Janet Yellen said in February that causing firms to think about their size is "exactly what we want to see happen" as a result of higher capital rules.

J.P. Morgan has since become leaner and reduced its regulatory capital requirements by moving certain deposits off its books and continuing to slim down its overall assets.

The firm's chief executive, James Dimon, has also said repeatedly that the bank's size is a massive competitive advantage.

"The synergies are huge, both expense and revenue," he said on a conference call last year.

—Rachel Louise Ensign contributed to this article.