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A Better Way to Control the Banks

By THE EDITORIAL BOARD FEB. 26, 2016

Nearly eight years after the financial crisis, behemoth banks still dominate the global economy. They are still immensely complex, highly leveraged and politically powerful. They are still difficult, if not impossible, to manage and supervise. For those reasons, they remain a threat to the economy, and the notion of breaking them up appeals to many voters, policy makers and politicians.

In his campaign for the Democratic presidential nomination, Senator Bernie Sanders has made breaking up the banks a central plank of his economic agenda. The idea has merit. Smaller, more manageable banks would allow for better internal controls over dubious ethical behavior and better regulatory oversight of risky business practices that seem entrenched despite efforts at reform.

But it is also a distraction. It offers a distant and politically uncertain solution to the problem of too-big-to-fail banks that the incremental Dodd-Frank financial reforms of 2010 have already begun to address. In the process, it plays into the hands of Republican critics of Dodd-Frank, who want to repeal the post-crisis reforms and block any further regulation. That's why Hillary Clinton's plan — to defend and build on Dodd-Frank — makes more sense at this time.

What gets lost in the discussion is that Dodd-Frank, properly executed, would help to create the conditions for breaking up large and complex banks. That's because the banks would face rising regulatory costs, which means they might well be worth more to investors if taken apart. Essentially, effective regulation and market forces would work together to make banks smaller and safer.

For example, Dodd-Frank and related regulations require big banks to hold considerably more capital now than they were required to hold before the crisis. The aim is to ensure that banks can absorb any losses they may generate, instead of relying on taxpayers to pick up the bill.

Even so, the capital requirements are not strong enough, in part because they do not require banks to fully account for potential losses from the trading of derivatives, a multitrillion-dollar activity.

Recent data provided by the banks to the Federal Reserve show that capital at big American banks recently averaged a healthy 13 percent of assets. But if derivatives and other holdings were fully included — as is required under international accounting rules but not under American ones — capital would come to a feeble 5.7 percent.

Mrs. Clinton has vowed to fight for higher capital requirements, which can be accomplished without new legislation if regulators willing to impose them are appointed. Of course, that would not be as blunt a way to shrink the banks as simply requiring them to stop their riskiest trading. Still, it would not preclude breaking up the banks at some later date. And it would make the journey from here to there a safer one.

As campaign slogans go, "more capital" does not have the same ring to it as "break up the banks." But both are paths to the same destination. Mr. Sanders has the right goal. Mrs. Clinton has the right means.

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