Too Big To Fail? A Brief Guide for the Perplexed

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Abstract: This note reviews various approaches to the "Too Big To Fail Problem."

When it comes to banking, "Too Big to Fail" (TBTF) is widely thought to be "Too Complicated to Summarize." At some level this has to be true, but, like so many other problems in political economy, the basics are not that difficult. This review tries to represent different points of view in a form proponents would recognize, even if they would not agree with the critical remarks on them.

Firstly, a few words about the nature of the problem, which shares many of the ambiguities that marked arguments about "trusts" a century ago.

The decision by U.S. authorities to allow Lehman Brothers to go bankrupt in September, 2008 triggered a worldwide financial collapse.[1] It also touched off a global outcry at U.S. regulators. In response, the G20 resolved to permit no more failures of financial institutions that were large enough or, perhaps "complex" enough, to threaten the system as a whole.[2] In effect, this policy effectively pulled large financial institutions out of the "free market" system altogether and brought the long simmering problem of "moral hazard" to a boil: Since they know that authorities will not allow them to fail, TBTF institutions can go on taking risks that their rivals dare not. When they finally crash, the public has to pick up the pieces, and the gigantic bills, just as it is doing now with TARP, the FDIC, the PPIP, and (through Treasury guarantees and liabilities) whatever finally goes wrong with all the Federal Reserve's special facilities and emergency purchases.

This predicament has alarmed legions of critics, who put forward a variety of schemes to deal with it.

All such schemes, though, suffer from a major drawback: A globalized financial system is, alas, very different from a Walt Disney world in which a happy ending is guaranteed. Nowadays, failure of a major bank in another country – say, one of the big Swiss banks or the Deutsche Bank – would almost certainly also take down major U.S. financial institutions. Because even a perfectly regulated national banking system is not immune to a transnational "Lehman in reverse," the TBTF problem is insoluble in one country. Some kind of international agreement has to be confected. Though U.S. authorities often like to pretend that their hands are tied by other regulators, in fact the U.S. holds a trump card in

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[1] Why they did this has been much debated. See Thomas Ferguson and Robert Johnson, "Too Big to Bail: The 'Paulson Put,' Presidential Politics, and the Global Financial Meltdown, Part 2: Fatal Reversal – Single Payer and Back," *International Journal of Political Economy*, Vol. 38, No. 2, (Summer) 2009, pp. 5-45. This essay also critically analyzes subsequent claims by John Taylor and others that not the Lehman collapse, but the decision by Treasury and the Federal Reserve to go to Congress caused the financial melt down.

[2] Allusions by bank regulators to "complexity" are typically a coded way of referring to the vast, indeed, tumescent, market for "derivatives"; in particular, credit default swaps. Proposals for light regulation of derivatives, especially "over the counter" derivatives, are essentially schemes to enhance big bank profitability. See Robert Johnson's testimony to Congressman Barney Frank's Financial Services Committee, United States House of Representatives, Hearing on Reform of the Over-The-Counter Derivative Markets: Limiting Risk and Ensuring Fairness (October 7, 2009).

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this situation: It can ban the banks of any country that does not regulate its banks seriously from doing business here.

The potential for importing trouble is magnified by what might be termed the "Iceland Problem" or the "Swiss Dilemma," or perhaps even the "UK Conundrum." Small countries with big banking systems relative to their GDP may wake up one morning to discover that their giant institutions are "too big to bail." That is, that small countries just lack the resources to make up losses on insured deposits, guarantee bank debts, or recapitalize truly gigantic failed banks. Recognition of this interdependence appears to have led the U.S. Federal Reserve to assist major foreign banking systems via swap arrangements in the current crisis. In the future, it may induce more and more large banks to relocate operations to countries big enough to bail them out, which can only accentuate problems of TBTF.

Proposed Remedies

If we set this nest of problems aside, then the main proposals for dealing with TBTF institutions boil down to these.

1. Narrow banking. The core idea of narrow banking is to separate the payments system from the rest of the financial system and then protect the former by a Maginot Line of laws and regulations. The usual proposals limit the taking of government insured deposits to narrow banks, and then permit these only to invest in ultra-safe assets such as government bonds. Narrow banks, of course, yield pencil-thin rewards to their customers. The idea is that if patrons want higher returns, then they should head to another institution – a brokerage house, an investment bank, a money market fund, or whatever – that does not take insured deposits. In theory, this step comes with the Dantesque admonition that all hope of rescue abandon ye who enter here, when the casino goes down.

Comment. Narrow banking does not deal with the international problems discussed above. It also bypasses the simple fact that financial collapses threaten far more than the payments system. The truly heavy cost of failing to rescue giant institutions is the risk of chain bankruptcy and steep drops in national income. And, alas, bankruptcies of many institutions besides banks can threaten big drops in GDP. Neither Bear Stearns nor Lehman Brothers, for example, took insured deposits or even qualified as banks. Both were investment banks, which would not be covered under any version of narrow banking.[3] In addition, it may well be true that in a deep recession failure by an industrial firm the size of General Motors could provoke a catastrophe. GM is not even a financial institution, though GMAC is.[4] Another difficulty stems from the effect narrow banking would likely have on the incomes of ordinary Americans. They may well find themselves locked into very low rates of return on their savings. This prospect may not bother people who believe that the rate of interest balances savings and invest-

[3] The pivotal roles these investment houses played in the disasters of 2008 makes it hard to credit claims that simply reviving Glass-Steagall – that is, separating investment from commercial banking – would solve the TBTF problem. Similar considerations probably also apply to suggestions that limitations on proprietary trading by banks would either. Whether the proprietary trading division of a bank loses its own or depositors' money is, in the end, irrelevant, if the loss is big enough to threaten the institution.

[4] Both GM and GMAC, of course, were recently bailed out; the latter after transforming itself overnight into a bank in December, 2008.

ments and thus would adjust to some ideal rate; but if you believe in a Keynesian liquidity preference theory of interest, then you should worry about the effects very low rates of interest set by authorities might have on the customers of narrow banks. Anyone who doubts this possibility should consider how, right now, federal regulators are turning a blind eye to the fees and other penalties banks are levying on their customers, as they attempt to recapitalize themselves and return to profitability, while also handing out money to banks at virtually zero rates of interest.

2. Break them up. Apply either anti-trust or special regulation, so that no institution is TBTF.

Comment. If you could do it, the strategy would be a grand one. Not surprisingly, of course, the trend of "reform" proposals everywhere runs in radically different directions, since financiers uniformly detest the notion. Waiving this point, there are perhaps a few possible doubts about the wisdom of the course, though its merits for solving the TBTF problem are apparent. In the spirit of John Kenneth Galbraith's old remark that foreign students of American business often want to see precisely the same firms that anti-trust authorities in the U.S. Department of Justice watch (in the pre-Reagan era), breaking up large banks might lead to a relatively high cost financial system. It might sacrifice economies of scale, especially of large databases, though the issues of scale economies and minimum efficient size in finance are fraught with controversy. A more interesting caveat is that perhaps the Federal Reserve's recent experience running special facilities making markets in commercial paper and other assets indicates that all those bonuses and other ballooning emoluments are quite unnecessary: at least part of the financial system might perhaps be run more cheaply as a kind of public utility, with the pass through to consumers of lower costs guaranteed by stiff regulation.

3. A new "resolution" or "insolvency" regime. Not surprisingly, TBTF institutions prefer to be regulated instead of broken up. Indeed, historically, the TBTF doctrine appears to have been promoted by New York banks, the New York Fed, and the FDIC precisely to cement in the public mind the idea that big banks are a special breed apart that could not be allowed to go bankrupt like other businesses.[5]

The sticking points, of course, are the terms of any such regime.

The Obama administration and big banks have promoted the idea that current law ties the hands of regulators to move aggressively against reckless giants, because so many banks are now organized inside bank holding companies and existing laws generally do not cover the latter. This is disingenuous. Bank holding companies have been going broke since the Franklin National Bank in 1974 and a reasonable body of case law has developed. Since 1991, the FDIC also has broad powers to mandate "prompt corrective action" which any holding company that owned the bank in question would ignore at its peril. But financiers look coldly on the idea of waiting in line with other creditors. Thus they have already pushed Congress into enacting legislation that allows owners of derivatives and repurchase agreements ("repos") to go to the head of the line for swift settlement. Some are now pushing the idea of special bankruptcy courts, even specialized international courts that would resolve bankruptcies of TBTF institutions.

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[5] Interview with former Federal Reserve official; see also Walker Todd and James Thompson, "An Insider's View of the Political Economy of the Too Big to Fail Doctrine," Federal Reserve Bank of Cleveland, Working Paper 9017, December, 1990.

Comment. The comparison to the Elizabethan Court of Star Chamber is hard not to make. Why one part of the community should be afforded special bankruptcy systems is unclear; delay is a problem that bedevils many citizens, not merely banks. Better fix the system.

Questions also abound about how TBTF institutions should be regulated, if their existence is conceded. The Obama administration wants to broaden existing legislation to give regulators the power to order bank holding companies, insurance companies, and other large financial institutions to take "prompt corrective action."

Many analysts worry that the problem of forcing "prompt corrective action" applies as much to regulatory authorities as to banks. Mindful that financial regulation in the American system is at bottom a crisis in political finance, some analysts hold out hope for more specific, mandatory regulatory reviews according to criteria fixed in advance. Common suggestions concern regulations covering capital, leverage, and liquidity. All are at least somewhat problematic. Actually estimating the leverage of financial institutions leads to a maze of accounting problems, so that empirical estimates of leverage by different observers sometime differ sharply, even allowing for differences in national systems of accounting. In addition, any plausible set of capital requirements will almost certainly prove inadequate to really severe shocks. Many have noted, for example, that in the recent crisis, many financial institutions looked well capitalized until virtually the day they crashed. Non-U.S. institutions also commonly regard talk about capital requirements by American authorities as barely disguised schemes to force foreign competitors to make costly adjustments.

The Governor of the Bank of England has suggested forcing banks to make "living wills" that could facilitate settlement of claims in bankruptcy. This would almost certainly end many transfer pricing and other schemes banks use to disguise what they are doing with assets and make them pay higher taxes. Banks, accordingly, are strongly opposed.

Comment. The fundamental problem, perhaps, is the compelling need to take the profit out of going broke if institutions are going to be rescued. That is, one might decide to rescue banks for the sake of protecting national income, but no bankers should ever be rescued. This is a key point that apologists for banks, especially in the US press, like to confuse. In the New Deal, Jesse Jones, head of the Reconstruction Finance Corporation, required letters of resignation from the top three bankers of any institution receiving aid. These were not always accepted, but their mere existence was a potent deterrent to repeat behavior. A contemporary regime along these lines would need to reach considerably further down into the financial institution's hierarchy, modify contracts so that even promised bonuses could not be paid, and make heavy use of clawbacks. A vital aspect of any such regime also has to be legislation that makes it impossible to pay off credit default swaps merely because the government assumed control of a firm.[6] Not only bank stockholders, but bank creditors (that is, bondholders) also have to take a hit. If they do not, then TBTF banks will fund themselves at lower costs than their competitors, eventually driving the latter out of business. It is also idle to pretend that giant institutions will not abuse their oligopolistic positions to gouge depositors, add on fees, and overcharge for debit, bank, and credit cards. Any bank accorded TBTF status will require much more onerous regulation.

[6] This is not an endorsement of credit default swaps, which should be regulated along traditional insurance lines. But that is another note.

Right now authorities are being coy about which institutions they consider TBTF. This must inevitably produce the usual pathologies of Federal Reserve secrecy, leading to insider tipping and, in crises, waves of rumor mongering that could affect individual bank funding costs. In addition, at least one aspect of American finance quite certainly offers economies of scale: political action. Unless their lobbying and political contributions are tightly restricted – or simply banned[7] – as a condition for being TBTF, TBTF institutions as a group are likely to morph into the devouring monsters that partisans of Andrew Jackson used to imagine the Bank of the United States was.

[7] Many analysts believe that the Supreme Court is likely soon to strike down existing laws restricting corporate political contributions. At least in the case of Congress, this would not be completely disastrous: Congress has near-absolute powers to set its own rules. It could ban representatives serving on committees from taking contribtions from interested parties. That would infringe no one's constitutional rights and would not require a constitutional amendment.