

Some Comments on *Too Big to Fail: The Hazards of Bank Bailouts*

by Gary Stern and Ron Feldman

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March 31, 2009



In *TBTF*, Stern and Feldman address

- Why TBTF is a serious problem
- Costs of TBTF
- Why TBTF exists
- How to limit TBTF

On one level, it can be read today in regret, all about the poignancy of the path not taken and the waste of an avoidable accident.

I prefer to read it in anger, as a call for action and will interpret its main messages in the light of our current situation.

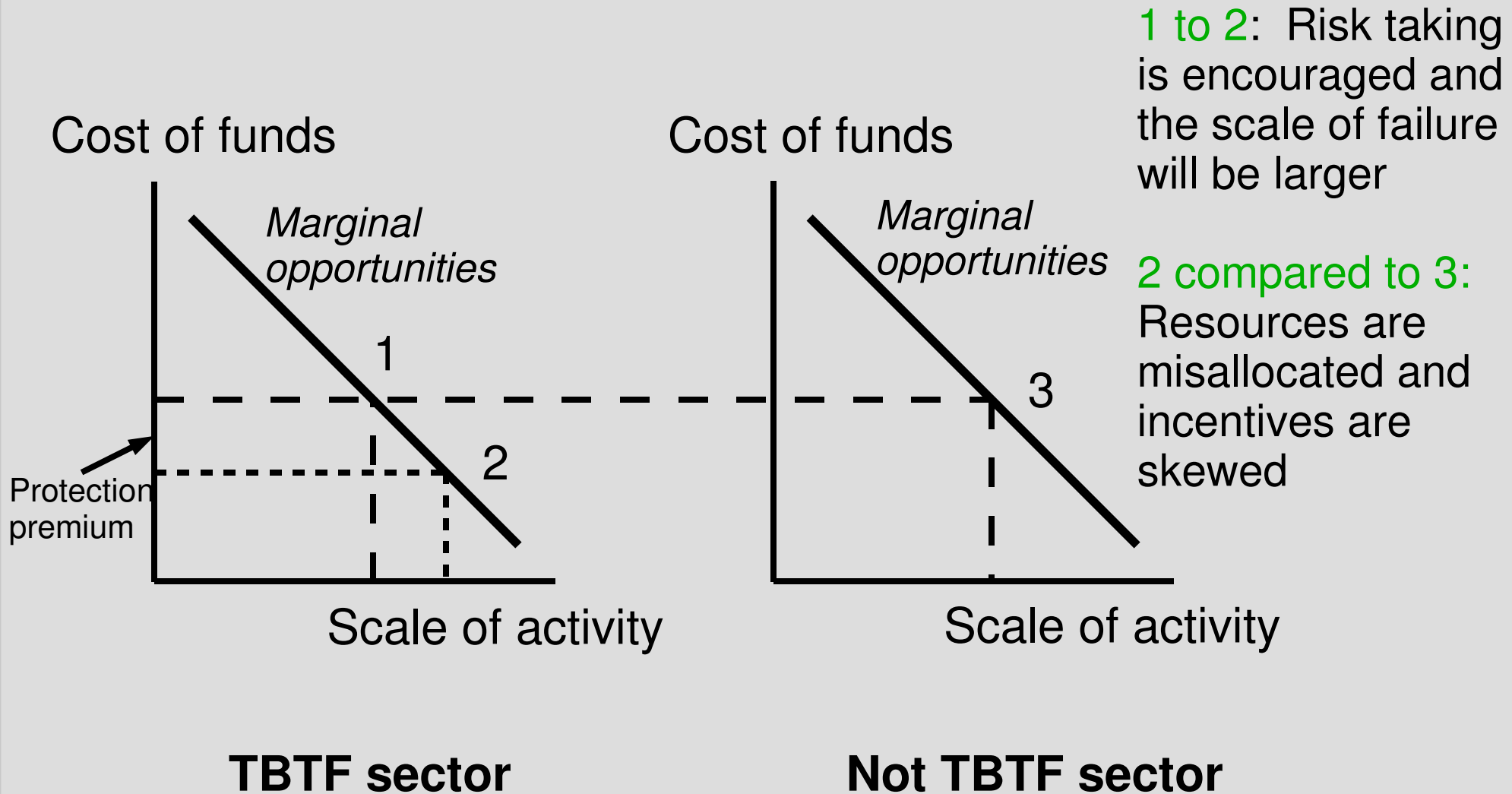
There is one object of irony, although unfair, too big to pass: The balance sheet of the Federal Reserve Bank of Minneapolis
Billions of dollar, March 25, 2009

Assets	23	Liabilities	20
Securities	14	Federal Reserve notes	17
Term auction credit	6	Deposits	3
Central bank swaps	5	Other	0
All other	-2	Capital	0.5

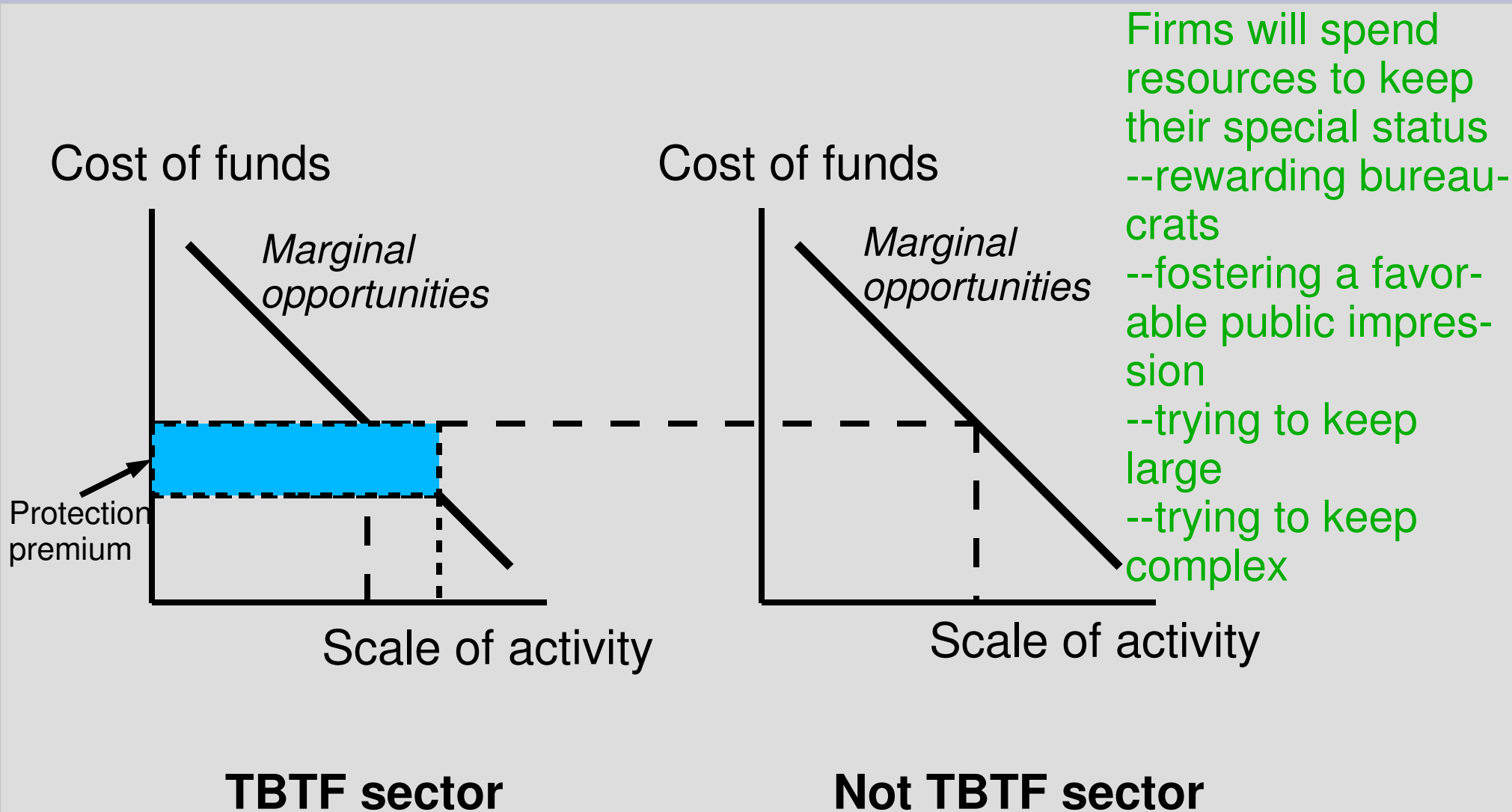
Stern and Feldman establish

- TBTF is a serious problem
 - That has gotten worse
 - Rooted in a lack of credibility
- TBTF is a big umbrella covering banks and non-banks
 - Too big to fail
 - Too complicated to resolve
 - Too interconnected to close
 - In too many House districts to touch

Traditional costs of TBTF



An issue under-explored: Rent seeking



Firms will spend resources to keep their special status

- rewarding bureaucrats
- fostering a favorable public impression
- trying to keep large
- trying to keep complex

Rent-seeking firms

- Will go slow on industry initiatives that limit risk
 - Netting of swaps, central clearing houses
- Will weave systemically important activities into the firm's structure
 - Clearing banks
- Will resist regulation that would make closure easier
 - Uniform insured depositor list

And they will do this as long as a TBTF premium is in play

The private sector can solve complicated joint problems as long as it doesn't threaten the TBTF premium

- CLS Bank provides the largest multi-currency cash settlement system
 - Eliminates settlement risk for over half the world's foreign exchange payment instructions.
- Owned by the foreign exchange community
- CLS delivers greater operational efficiency
 - Settles payment instructions related to trades executed in six traded instruments and in 17 major currencies

Why do policy makers allow TBTF?

- Fear of spillovers
 - The tyranny of event studies
- Self interest of officials
 - Krugman's "capture by Wall Street"
- Disguised subsidy to some forms of credit
 - Housing is preferred beyond all else

Stern and Feldman identify three ways to manage TBTF

- Penalize policy makers
 - FDICIA
- Impose more supervision and regulation
 - Bernanke and Geithner
- Foster market discipline
 - Stern and Feldman

Three more specific proposals

Adam Smith's small is beautiful

- “By dividing the whole circulation into a greater number of parts, the failure of any one company, an accident which, in the course of things, must sometimes happen, becomes of less consequence to the public.”
 - Wealth of Nations, Book II, Chapter 2
- This is not part of the current discourse
 - Not because the evidence of scale economies (other than a TBTF premium) is overwhelming

Bernanke and Geithner's Star Chamber

- Grant the government expanded resolution authority
 - To put a TBTF firm into conservatorship or receivership
 - To administer its effective, orderly reorganization or wind-down
- The Star Chamber was also set up for a noble reason: To try prominent people who would never be convicted in a common court
 - Both attempt to solve a design failure in the core system by adding another level with special powers
 - One ended badly

Ole Kirk Christiansen's modular solution

- The whole of a financial holding company can be made of parts that can be disconnected and reassembled
 - LEGO is formed from the Danish words "LEg GOdt" meaning "play well"
- Any part of the firm that is systemically important can be protected in bankruptcy
 - With haircuts in the event and
 - Infrastructure developed over time to limit the perimeter of systemically important activities
- But the rest can be turned over to the market

Stern and Feldman's *Too Big to Fail: The Hazards of Bank Bailouts*

- Directs attention
 - To the consequences of policy actions
 - To the power of self interest when rents are on the table
- Offers market-based means of amelioration
- Reminds us of the road not taken

