Some Comments on *Too Big to Fail: The Hazards of Bank Bailouts* by Gary Stern and Ron Feldman

Vincent Reinhart  
*Resident Scholar*  
American Enterprise Institute  

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*

<table>
<thead>
<tr>
<th>Assets</th>
<th>23</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities</td>
<td>14</td>
</tr>
<tr>
<td>Term auction credit</td>
<td>6</td>
</tr>
<tr>
<td>Central bank swaps</td>
<td>5</td>
</tr>
<tr>
<td>All other</td>
<td>-2</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>20</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal Reserve notes</td>
<td>17</td>
</tr>
<tr>
<td>Deposits</td>
<td>3</td>
</tr>
<tr>
<td>Other</td>
<td>0</td>
</tr>
</tbody>
</table>

**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

1 to 2: Risk taking is encouraged and the scale of failure will be larger.

2 compared to 3: Resources are misallocated and incentives are skewed.

TBTF sector
Not TBTF sector
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