BOOK REVIEW

Market Discipline

TOO BIG TO FAIL: THE HAZARDS OF BANK BAILOUTS
BY GARY H. STERN AND RON J. FELDMAN
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REVIEWED BY
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A few months ago, as I was researching the size distribution of U.S. commercial banks, I ran across *Too Big To Fail* in our Bank's library. The book, written by Gary Stern and Ron Feldman of the Federal Reserve Bank of Minneapolis, addresses one of the more important issues facing policymakers today: how to deal with large corporations that have been deemed so important to the U.S. economy that the government doesn't dare let one go bankrupt.

The term "too big to fail," hereafter referred to as TBTF, has been around since at least the mid-1970s. But it didn't enter common parlance until 1984, when Congress held hearings on the financial problems of Continental Illinois Bank. The banking sector, of course, is vital to the American economy — and fears that the collapse of one institution would lead to the fall of others has inspired much TBTF policy. Indeed, because of past bailouts, many investors now believe that large banks are subject to implicit government protection. Such protection may produce short-run stability, but the moral-hazard problems that arise from TBTF policies can produce major net costs. "While the fiscal flows of the savings and loan bailout in the United States equaled $150 billion, lost output from the savings and loan crisis — largely attributed to moral hazard and poor resource allocation — was on the order of $500 billion," Stern and Feldman write.

In essence, TBTF banks become 100 percent insured by the government, warping price mechanisms within financial markets. The higher premium that otherwise would be demanded by risk-averse depositors is depressed by implicit government insurance, and TBTF banks enjoy a government subsidy for their risk-taking. Market discipline evades the TBTF bank, leading to suboptimal performance. Independent of failure, there is an inefficient use of capital — and when you add a bank bailout to the mix, the costs can skyrocket.

In today's world of increasing bank consolidations there is some urgency for formulating good policy. Stern and Feldman are cognizant of the serious obstacle posed by systemic risk in correcting the present distorted incentive structure. Accordingly, they couple ways to preempt contagion and limit creditor losses with a credible commitment to let big banks fail.

Preempting Contagion

In Chapter 5, titled "Why Protect TBTF Creditors?", Stern and Feldman present potentially surprising arguments about bank runs. Historically, they claim, many bank failures have not produced the widespread ripple effects one might have expected. "Brief, rapid disruptions weed out poorly run or weak competitors and discipline banks as to future exposures. Banking panics are simply a form of the invisible hand," Stern and Feldman write. Still, they acknowledge that many people will not be convinced that intervention may be unnecessary. So in Chapter 10, titled "Reducing Policymakers' Uncertainty," they introduce targeted reforms aimed at lessening the chances — and costs — of contagion.

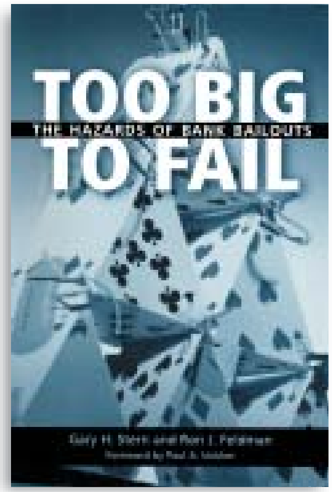
One of these potential reforms is scenario planning. By simulating bank failures, bank supervisors can examine the implications of cross-firm exposure for creditor solvency. Then they can test a wide range of resolution options, and pick the one that minimizes coverage provided to uninsured creditors without creating excessive financial instability.

"Almost as important as the planning itself is the disclosure of scenario planning to bank creditors," write Stern and Feldman. The mere fact that such planning is taking place would inform creditors that the wisdom of TBTF policies is being questioned and that alternatives are being considered. This would likely make those creditors more vigilant in monitoring banks' activities.

What's more, the suggestion for greater transparency in scenario planning "reflects lessons we take away from the experience of monetary policy," Stern and Feldman write. "During the period in which the U.S. central bank established and maintained greater credibility with regard to price stability, it also made its analysis and objectives more transparent. The greater transparency may have helped the Federal Reserve to establish its credibility. In a similar vein, going public with steps that make coverage of the uninsured less likely could establish credibility in reducing TBTF coverage."

Limiting Creditor Losses

The most direct way to limit the chance of a bailout is to reduce the expected loss to a creditor. This in turn limits the probability of systemic risk. To accom-



plish this, policymakers must be willing to close weak but solvent banks, Stern and Feldman argue. This is not a new concept. A provision of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) allows policymakers to take "prompt corrective action" (PCA). Stern and Feldman find this reform "attractive on a conceptual basis" but argue that there are flaws in the way PCA is triggered.

They suggest that PCA triggers must meet four conditions. They must be (1) largely outside the manipulation of the bank; (2) reflective of the current risk profile of the institution; (3) feasible to calculate routinely and to observe; and (4) set to close banks likely to fail while allowing those likely to survive to stay open. Also, "although it may appear obvious, to be effective, the early closure regime must take real steps to remove the discretion of supervisors," the authors write. The current PCA triggers do not meet those conditions and thus do too little to limit losses by shutting down insolvent banks, Stern and Feldman argue.

In addition to instituting more robust PCA triggers, Stern and Feldman would like to see a coinsurance system instituted for deposits at large banks that exceed the current FDIC insurance limit of $100,000. The idea is fairly simple. "Under a coinsurance scheme, the insured has to bear some of the loss rather than have the insurer pick up 100 percent of it," the authors argue. "For example, the government could give itself the right to provide coverage to the uninsured under extraordinary circumstances up to a capped amount (say, 75 percent of their funds)."

Stern and Feldman consider some possible objections to coinsurance, but one topic they don't address is the potential problem caused by discount window lending by the Federal Reserve, an issue raised by former Richmond Fed President Al Broaddus at the Chicago Fed's 2000 Annual Conference on Bank Structure and Competition. Coinsurance and other attempts at reintroducing market discipline can be undermined if the Fed makes last-minute loans to failing banks. In effect, the bank passes on the loss to the Fed as uninsured creditors flee.

Also, coinsurance is not costless to provide, since it involves more insurance for large banks than they currently receive. One could envision a number of ways of funding such a system — for instance, charging large banks an additional deposit insurance premium — but the authors have little to say on the issue. Certainly, should these ideas move toward becoming policy, the allocation of the costs of giving explicit special treatment to large banks would need to be considered.

Establishing Credibility

Throughout the book Stern and Feldman make it clear that they regard many of the FDICIA reforms as positive — though insufficient — steps toward limiting the problems associated with TBTF policies. Although FDICIA substantially increased the likelihood that uninsured depositors would suffer losses when their bank fails, it also provided for a "systemic risk" exception. This exception threatens the government's ability to credibly commit to closing troubled banks. Ending that exception and taking a harder line could help establish much-needed credibility. But taking a hard line requires putting your money where your mouth is — or in this case, not putting up any money when a bank goes down.

Getting creditors to believe that regulators will allow unsound banks to fail will not happen overnight. Still, policymakers must find a way to "establish credibility even when they face a history of actions that undermine the goal." (Again, Stern and Feldman point to the experience of Federal Reserve monetary policy during the 1980s and 1990s as an example of an institution earning credibility despite initial skepticism by market participants. During that time, the Fed established its commitment to achieving price stability following a relatively long period of high and variable inflation during the 1970s.) Putting the uninsured on notice by establishing an easily monitored commitment and then sticking to it would help do the trick.

The optimal form of this commitment is not obvious to Stern and Feldman, though they offer some ideas. For instance, they suggest appointing "conservative" bank regulators — "that is, policymakers who have demonstrated a predilection for giving serious consideration to the costs of TBTF bailouts and an ability to reject bailouts where appropriate." This is similar to the appointment of "inflation hawks" within the Federal Reserve System — people who took the issue of price stability seriously and were willing to take necessary, if unpopular, actions to achieve that goal. In short, "personalities matter in establishing credibility," write Stern and Feldman.

The payoff from establishing credibility could be large. A "virtuous circle" might arise in which banks would take on fewer risks, presenting policymakers with fewer opportunities to bail them out. Outside of random shocks, the system converges to a situation where bailouts are no longer expected.

Stern and Feldman have written a book that is informed by the best basic research available but which should also be easily digestible by policymakers and non-economists more generally. Indeed, people particularly rushed for time could profit from reading Chapters 1 and 14, which summarize the book's major points. But hopefully many will take the time to read the entire book — and to take seriously the proposals contained within. The subject may seem dry, but it is important. The problems associated with too big to fail policies are simply too large to ignore. **RF**