

PARADISE LOST: ADDRESSING TOO BIG TO FAIL

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Sometimes it helps to contemplate economic predicaments by seeking wisdom from definitively noneconomic sources. Consider this passage from Book III (lines 98–102) of Milton’s *Paradise Lost*, where God answers the question of why He created men and angels who could rebel against Him. Of man, He responds:

I made him just and right,
Sufficient to have stood, though free to fall.
Such I created all th’ ethereal Powers
And Spirits, both them who stood and them who failed;
Freely they stood who stood, and fell who fell.

As is clear from this most celebrated work of literature, the issue of whether entities—be they mortal or divine—should be allowed to fail is one of the oldest philosophical quandaries. It has been debated for eons on a much higher plane than economics or finance. And yet Milton is germane to the vexing issue of institutions considered “too big to fail.” There is no way we can reasonably expect to restore global financial stability without addressing that issue.

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Unintended Consequences

Only a short while ago, we were teetering on the brink of global financial collapse. Essentially, what occurred was a crisis of unintended consequences: Misperceptions of risk and misplaced incentives led to misguided actions. The crisis metastasized in large financial institutions and spread through the entire body of the financial system. Both on and off balance sheets, banks levered up to cancerous levels and funneled funds into assets of questionable quality.

These bad bets were made worse by their scale and the rapidity with which they spread. It was not enough that one or two large institutions erroneously thought that real estate prices would rise forever—nearly all of the biggest banks did. It was not enough that one or two large institutions thought they could contract with third parties they presumed would immunize them against failure—nearly all did. And it was not enough that one or two regulators turned a blind eye to the systemic risk posed by this behavior—nearly all did, including the Federal Reserve.

This is not something new. Readers of history might recall Charles Mackay's 1841 *Memoirs of Extraordinary Popular Delusions*, in which he wrote: "Every age has its peculiar folly—some scheme . . . or phantasy into which it plunges, spurred on by the love of gain, the necessity of excitement, or the mere force of imitation" (Mackay 1841: vol. 2, p. 1), to which he caustically added, "Men . . . think in herds; it will be seen that they go mad in herds" (Mackay 1841: vol. 1, p. 3).

Or they might note this from Walter Bagehot's essay on Edward Gibbon in the *National Review* in 1856: "[A]t particular times . . . people have a great deal of . . . money. . . . [They] seek for some one to devour it, and there is [a] 'plethora'—it finds some one, and there is 'speculation'—it is devoured, and there is 'panic'" (Bagehot 1856: 2).

Or Dickens's bon mot, where he defined insurance as: "[a] person who can't pay, gets another person who can't pay, to guarantee that he can pay" (Dickens 1895: 259).

How different things might have been if financial actors had kept the most human instincts of "love of gain" and "necessity of excitement" from leading them to become accomplices to herd-like imitation and uninsurable speculation. This behavior begat a panic where, but for the intervention of the Federal Reserve and other central

banks, the entire payments system froze and brought the world economy within a hair's breadth of depression.

Having staved off the inevitable consequence of the pathology I have just summarized, it is high time to treat the most malignant of its perpetrators—financial institutions thought to be too big to fail—as we refashion, modernize, and provide needed improvements to the regulatory system.

The Need for an Overhaul

Dan Tarullo (2009) from the Federal Reserve Board recently put it this way:

The regulatory system did not come close to adequately accounting for the impact of trading, securitization, and some other capital market activities on both traditional banking and systemic risk. . . . The need for a thorough overhaul of the financial regulatory system is thus borne out not only by our frighteningly close brush with financial collapse . . . but also by the degree to which too-big-to-fail perceptions and capital-market sources of systemic risk had been permitted—if not encouraged—by regulatory developments in the preceding decades.

From the perspective of monetary policy, I view of paramount interest an overhaul of a system that has come to coddle such “too-big-to-fail perceptions and capital-market sources of systemic risk.” My colleague Harvey Rosenblum and I explained why in the opinion section of the *Wall Street Journal* on September 28, 2009, in an essay titled “The Blob That Ate Monetary Policy.”

We noted that the very existence of the Blob of banks considered as too big to fail blocks, or seriously undermines, the mechanisms through which monetary policy influences the economy.

Distorting the Monetary Transmission Process

When the Fed encounters rising unemployment and slowing growth, it purchases short-term Treasury bonds, thus lowering interest rates and inducing banks to lend more and borrowers to spend more. The banking system, and the capital markets that respond to these same signals, are critical to transmitting Fed policy actions into changes in economic activity.

These links normally function fairly smoothly. Numerous academic studies have concluded that monetary policy before the financial crisis was working better, faster, and more predictably than it did a few decades ago. Monetary policy's increased effectiveness helped usher in a quarter century of unprecedented macroeconomic stability with infrequent and mild recessions and low inflation. This was perhaps the closest we have come to economic paradise.

Then the Blob gummed up the works. With financial markets in trouble and the economy wobbling, the Fed began lowering its target interest rate two years ago, bringing it close to zero by December 2008. Other central banks followed suit. Based on recent experience, such aggressive policies should have returned our economy to the trajectory of stability and growth more quickly. Unfortunately, the Blob began blocking the channels monetary policy uses to influence the real economy.

As the financial crisis erupted, the largest banks, by capitalization and influence, saw their capital bases erode, and wary financial markets made them pay dearly for new capital to shore up their balance sheets.

In this environment, monetary policy's *interest-rate channel* operated perversely. The real borrowing costs that matter most for the economy's recovery—those paid by businesses and households—rose rather than fell. Those banks with the greatest toxic asset losses were the quickest to freeze or reduce their lending activity. Their borrowers faced higher interest rates and restricted access to funding when these banks raised their margins to ration the limited loans available or to reflect their own higher cost of funds as markets began to recognize the systemic risk posed by banks presumed to be too big to fail.

The *credit channel* also narrowed because undercapitalized banks, especially those writing off or recognizing massive losses, must shrink, not grow, their private sector loans. Too-big-to-fail institutions account for more than half of the U.S. banking sector, and the industry is even more highly concentrated in the European Union. Small banks, most of them well capitalized, simply don't have the capacity to offset shrinking lending activity of the behemoth banks. This problem is exacerbated by the procyclical nature of bank capital regulation, which operates on the implicit assumption that banks get into trouble one, or a couple, at a time. Bank capital regulation provides some microeconomic incentives, but destabilizing

macroeconomic outcomes, when a large number of very large banks are simultaneously in trouble.

The *balance-sheet channel* depends on falling interest rates to push up the value of homes, stocks, bonds, and other assets, creating a positive wealth effect that stimulates spending. When the financial crisis pushed interest rates and spreads perversely high, balance-sheet deleveraging took place instead, with households and businesses cutting their debt at a time when stimulative efforts were needed to prop up the macroeconomy.

Falling interest rates, all else equal, usually nudge down the dollar's value against other currencies, opening an exchange-rate channel for monetary policy that boosts exports and tempers imports. In the financial crisis, the dollar rose for about nine months relative to the euro and pound (but not the yen). This unusual behavior partly reflected higher interest rates and no doubt some "flight to quality" but probably had more to do with the perception that financial conditions at the very largest banks were worse in the United Kingdom and the rest of Europe than in the United States.

Finally, the troubles of mega-financial institutions interfered with the *capital-market channel*. In past crises, large companies had the alternative of issuing bonds when troubled banks raised rates or curtailed lending. In the past decade, however, deregulation allowed mega-banks to become major players in capital markets. The dead weight of their toxic assets diminished the capacity of markets to keep debt and equity capital flowing to businesses and scared investors away.

Obstructions in the monetary policy channels worsened a recession that has proven to be longer and, by many measures, more painful than any post-World War II slump. With its conventional policy tools blocked, the Fed resorted to unprecedented measures, opening new channels to bypass the blocked ones and restore the economy's credit flows.

In summary, the Blob reduced the effectiveness of monetary policy's transmission mechanisms. To be sure, the Fed found ways, under Ben Bernanke's adroit leadership, to bypass those blockages by undertaking unorthodox policies. It would be dishonest of me to say that I have not supported many of the Rube Goldbergian devices we have crafted. But it would be disingenuous of me to deny that these measures carry great and unprecedented risk. They give rise to questions about the Federal Reserve's commitment to its traditional

mandate, to suspicions that we are undertaking fiscal-like initiatives, and to concerns that these initiatives might compromise our independence by putting us on the road to political perdition. At a minimum, they bloat our balance sheet, requiring us to now craft and articulate an exit strategy that might take us even further from our traditional practices.

Dealing with the Too-Big-to-Fail Problem

In my view, the sooner we are able to return to traditional policymaking the better. I do not believe we can do so without treating the basic pathology of too big to fail. So I am a keen student of the various remedies that have been prescribed. They essentially break down into two camps: “learn to live with ‘em” or “get rid of ‘em.”

The “learn to live with ‘em” camp bases its position on a presumption that we derive economic value from large firms, especially in a globalized world where businesses need transnational financial services delivered efficiently. Josef Ackermann, the CEO of Deutsche Bank, speaking in Frankfurt, restated the argument that big banks provide “the necessary means for financing growth and innovation” because they can most efficiently provide loans and services like cash management and foreign-exchange trading for big international companies (Lauder and Dauer 2009).

Thoughtful proponents of this approach recognize that the benefits of supra-large banks—from formerly traditional banks like Citigroup to newly converted ones like Goldman Sachs—come with risks that must be corralled. According to members of this camp, that corraling may be achieved through a mixture of various tools, including:

- Increased capital requirements;
- Credible loss structures for unsecured creditors as well as shareholders;
- The issuance of debt with contingent conversion to equity requirements—what some have taken to calling “Coco” bonds;
- Policies to conserve capital such as dividend restrictions;
- Compensation regulation; and
- A well-articulated and practicable resolution regime that will facilitate the proper burial for a large failed institution rather than allow for an indefinite stay of execution.

Essentially, the proponents of this approach understand the fallibility of regulatory institutions and the permeability of rules and capital requirements but believe they can be improved upon.

Members of the “get rid of ‘em” school do not believe that there is any other way aside from their own to treat the moral hazard created by a too-big-to-fail culture that inculcates the privatization of gains and the socialization of losses—what some refer to as “heads I win, tails you lose.” They understand the academic and management theories that posit the benefits of size and sophistication, especially in a globally interconnected world. They also accept that banks need to invest their own capital and hedge against investments that flow naturally from their banking business. But they are wary of the distortions they believe derive from having government guarantees of deposits and other underpinnings of public trust underwrite additional risk-taking ventures such as proprietary trading.

In trying to develop my own perspective, I return to Milton’s *Paradise Lost* (Book III, lines 124–28):

I formed them free, and free they must remain,
Till they enthrall themselves: I else must change
Their nature, and revoke the high decree
. . . which ordained
Their freedom, they themselves ordained their fall.

The Fed, like the other regulators and the Congress that will ultimately fashion a new regulatory regime designed to treat too-big-to-fail and other problems, is far from divine. We are a worldly institution created to further the efficiency of mammon’s great agent of capitalism, what I consider to be the most effective vehicle for economic progress. I am a disciple of Schumpeterian creative destruction. I accept that, painful as it might be, destruction of errant or inefficient economic agents must occur for progress to take place in a capitalist society—that without failure there can be no good. Therefore, in the words of Milton, I would say that regulation should be designed to enable financial institutions to be “sufficient to have stood, though free to fall.”

Overall, I would recommend that the treatment for too big to fail be crafted with the late Irving Kristol in mind. Kristol was no Milton. Nor was he an economist. But he was nonetheless a wise man whose writings in *The Public Interest* had an early influence on my

approach to problem solving. In writing his eulogy this past September in the *New York Times*, David Brooks (2009) summarized him this way: “Kristol grew up in a working-class neighborhood . . . and seems to have absorbed the elemental Jewish commandment: Don’t be a schmuck. Don’t fall for fantastical notions that have nothing to do with the way people really are.”

It is a fantastical notion to ignore the dynamic that leads business and financial organizations to want to grow to become the biggest and the most profitable. It is a fantastical notion to assume that smart bankers will not take advantage of government guarantees to customers or creditors of one part of their business to incur risk and higher returns in another part, as long as they are allowed to do so. It is a fantastical notion to expect that the law of unintended consequences can be repealed and that mortals, be they bankers or regulators, will not henceforth miscalculate risk or take misguided actions. It is a fantastical notion to expect that having once pulled poorly run, systemically threatened firms out of the fire, government won’t do it again, no matter how many times and how loudly it says it won’t.

Conclusion

To craft a smart solution to this vexing problem of banks considered too big to fail requires that we deal with the way people and businesses really are. To me this means finding ways *not* to live with ‘em and getting on with developing the least disruptive way to have them divest those parts of the “franchise,” such as proprietary trading, that place the deposit and lending function at risk and otherwise present conflicts of interest.

But we can’t stop there. Our supervisory structure must ensure that these institutions do not have the opportunity, or the incentive, to grow to too-big-to-fail status again. Activities that present risks to taxpayers must be contained using at least some of the tools proposed by the “learn to live with ‘em” camp—increased capital requirements, “living wills,” “Coco” bonds and the like. We would also be well served to roll back various pieces of the government’s safety net, forcing creditors of risky, nonbank behavior to bear the full cost of their actions. These higher requirements could act as a tax or disincentive to bigness and, if structured properly, could provide a useful

brake on the dynamic that leads to reckless growth and unmanageable complexity.

I know this conclusion will hardly endear me to the handful of large institutions that are commonly viewed as too big to fail. But I think it best to take a lesson from *Paradise Lost* and “revoke the high decree . . . which ordained their freedom”—for, after all, “they themselves ordained their fall.”

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