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Managing the Expanded Safety Net

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PRESIDENT SENIOR VICE PRESIDENT

In this essay, we first briefly explain why the government's response to the 2007–08 financial turmoil, although justified, expanded the safety net and exacerbated the existing too big to fail (TBTF) problem. A larger TBTF problem is costly, having the capability to sow the seeds of future financial crises, which means we should begin now to develop a new approach to manage TBTF.

We believe recommendations we had already crafted to address TBTF would effectively address the safety net expansion and position policymakers to respond more effectively to "the next Bear Stearns." We describe the recommendations briefly and explain their relevance in today's environment in the second half of the essay. Because our approach and recommendations are spelled out in our 2004 book, *Too Big To Fail: The Hazards of Bank Bailouts*, we conclude with excerpts from it summarizing our arguments in a bit more detail.

A Wider Safety Net, A Larger TBTF Problem

The Federal Reserve's expansion of the safety net was not subtle or implied. The Federal Reserve took on risk normally borne by private parties when it supported JPMorgan Chase's purchase of Bear Stearns. The Federal Reserve also opened the discount window to select investment banks (i.e., primary dealers).

One could describe the former action as one-time and the latter program as temporary. But such a characterization obscures the message these actions send. Through these efforts, the Federal Reserve sought to limit the collateral damage or spillovers caused by the failure of a large financial firm. And these spillovers can take many forms. In a simple example, the failure of a large financial

*The authors thank David Fettig, Art Rolnick, Phil Strahan, Dick Todd, David Torregrossa, and Niel Willardson for their comments.

firm means that other large financial firms might not have loans paid back or otherwise receive funds owed to them by the failing entity. In another case, the failure of a large financial firm could prevent it from providing critical services to financial market participants such as clearing and settlement of financial transactions. In both examples, the shock to financial firms could impair their normal operations, which could injure their customers and the rest of the economy. If the threat of such spillovers presented itself again, and spillovers frequently define a financial crisis, many large-firm creditors would anticipate another extraordinary action or resurrection of a special lending program.

To be sure, Bear Stearns' equity holders—including many employees of the firm—took significant financial losses. This was an appropriate outcome. And doesn't this action sufficiently curtail expectations of government support in the future and thus fix whatever problem such expectations create? The short answer is no. The long answer requires a brief summary of why we care about safety net expansion and TBTF in the first place.

The bigger the government safety net, the more the government shifts risk from creditors of financial firms to taxpayers. With less to lose, creditors have less incentive to monitor financial firms and to discipline risk-taking. Consider an extreme but simple case where nominally uninsured depositors at the largest U.S. commercial banks come to expect complete government support if their bank fails. These depositors have essentially no reason to pull their funds even if these banks take on so much risk that they doom themselves to failure.

Now, this dulling of the depositors' senses has the welcome effect in our example of stopping runs on the largest banks. Such runs can spread into panics and significant economic downturns. The prevention of such ill effects, as noted, motivated the Federal Reserve's safety net expansion and is the reason government support during a crisis should never be categorically ruled out.

But the same stickiness of deposits has a major downside, which is the point of our example. The large bank that fleeing depositors would otherwise close remains open to continue or increase its risky bets. If it does not get lucky, the bank's losses actually grow. In this way, the safety net encourages risk-taking that exposes society to increasing losses, with their associated instability.

Of equal concern, TBTF wastes society's resources. Financial firms allocate capital, and when they work well, they ensure that high-return projects are funded. But excessive government support warps that allocation process, sending too much money to higher-risk projects.

We focused deliberately on depositors in our example; we could have mentioned other short- or long-term holders of interest-bearing investments, insured or uninsured. For it is the reduced vigilance of depositors and other debt holders—lulled by implied government support—that leads large financial institutions to take on too much risk and underlies TBTF. Policymakers face a TBTF problem even if equity holders fully expect to suffer large losses upon failure of the firm in question.

And policymakers faced a TBTF problem even before recent safety net expansions; the

[1] See Stern and Feldman (2004). Mishkin (2006) provides a detailed summary and critique of our book. Analysis published after the book including, but not limited to, Morgan and Stiroh (2005), Rime (2005), and Deng et al. (2007) continues to find evidence of a TBTF problem. For Moody's related assessment of the likelihood that select large banks in the United States would receive government support, see American Banker (2007). Acharya and Yorulmazer (2007) discuss a phenomenon somewhat similar to TBTF.

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TBTF problem we described in 2004 has grown since then.[1] Some very large banks and financial firms (e.g., Countrywide Financial) faced significant pressure during the 2007–08 market disturbance. Reporting on these cases, sometimes months before the run on Bear Stearns, had at times explicitly raised the specter of government support. The initial rescue in 2007 and later nationalization of Northern Rock in 2008 by the British government may have contributed to the speculation. Nationalization occurred in a country viewed, like the United States, as having a low propensity to support uninsured creditors and involved a financial institution that supervisors did not apparently treat as if it posed significant systemic risk.

Our concern about the preexisting TBTF problem led us to suggest policy reforms, as detailed in our book. We now turn to summarizing our approach, explaining why it applies to the current situation and why it is preferable to other options.

Managing the Safety Net, Addressing the TBTF Problem

While safety net expansion has increased TBTF concerns, the essence of the problem and underlying cause of TBTF have not changed since 2004: Policymakers support large-bank creditors to contain or eliminate spillover effects, but the support creates an incentive for too much risk-taking in the future. Our approach is straightforward. If spillovers lead to government support, then policymakers who want to reduce creditors' expectations of such support should enact reforms that make spillovers less threatening. Reforms that fail to address this fundamental issue will not change policymaker behavior and will not

convince creditors that they face real risk of loss. We provide more details on this approach in excerpted summaries from our book following this section.

So what should policymakers do to address concerns over spillovers? We recommend a three-pronged approach (again, a few more details follow in the excerpts with many more details in the book itself). Policymakers should

- reduce their uncertainty about the potential magnitude and cost of spillovers through tools like failure simulation. This "disaster" preparation could either directly lead to more informed actions that reduce spillovers or provide sufficient information to policymakers such that they can reduce support for creditors more confidently. Recent progress in addressing potential sources of instability also fall under this approach. For example, the Federal Reserve Bank of New York played an important role in an effort to improve the processing and settlement of certain derivative transactions while the Federal Deposit Insurance Corporation is taking steps to facilitate large-bank resolution absent extraordinary government support.[2]

- augment policies that manage the losses one firm's failure imposes on its counterparties. Policymakers would be more willing to let large firms fail if they thought the fallout would be constrained. Closing firms while they still have some capital left is one example of this approach (although we recommend modifications to the current "prompt closure" regime).

- enhance payments system reforms that limit the exposure that payment processing creates for financial firms. The goal of these reforms is to limit the chance that through the payments system, one firm's failure puts the solvency of other firms in doubt.

For each of the three strategies, we recommend that policymakers broadly communicate the actions they've taken to reduce expectations of bailouts. We detail the form and benefits of potential communication elsewhere, but the basic point is simple.[3] Creditors will not realize that the spillover threats have declined and will not change behavior unless informed through effective communication.

Put together, this approach offers at least the potential for a positive cycle. Policymakers limit the need for government support by managing underlying sources of instability. Reduced expectations of government support lead to less risk-taking and greater stability.

Our approach contrasts with some other alternatives policymakers might adopt. Some observers suggest that policymakers try to manage the expanded safety net, for example, by extending rules that procedurally make it more difficult for policymakers to support creditors. For example, the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) requires on-the-record support from a variety of policymakers before the FDIC can provide extraordinary support to bank creditors (FDICIA subjected such extraordinary support to other reviews and reforms as well). Policymakers might apply these strictures before providing support to creditors of any financial firm.

While we do not oppose expanding the types of firms covered under the FDICIA regime, we doubt the changes would materially reduce the support provided to large-firm creditors. Why? These procedural changes do not reduce the underlying rea-

[2] These two examples are discussed in Stern and Feldman (2006).
[3] See Stern (2007) and Stern and Feldman (2005a, b).

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son policymakers provided support in the first place. Consider that the intervention with Bear Stearns involved the type of on-the-record voting and consultations across agencies that FDICIA would mandate.

Pledges of "no bailouts" from policymakers or general prohibitions against bailouts are even less credible unless accompanied by action. And such prohibitions and related jawboning are unwise. Policymakers will face circumstances where, even accounting for distortions to future behavior, the provision of government support has benefits exceeding costs.

Observers also suggest that enhanced supervision, or regulations like those found in Basel II, might curtail the risk-taking of financial firms. While supervision and regulation have an important role to play, these tools may not adequately curtail the risk-taking encouraged by TBTF. Supervisors with discretion, for example, cannot easily limit firm risk-taking before the damage is done. Minimum capital rules also seem one step too slow; that is, regulators cannot readily institute capital rules that link minimum capital levels to current bank risk-taking.

None of this is to suggest that our recommendations are beyond reproach. Some of the specific recommendations we made in 2004 deserve a second look given the events of 2007 and 2008. For example, we suggested that policymakers consider implementing a form of "coinsurance" for uninsured creditors, whereby such creditors must take some loss if their financial firm becomes insolvent. While our proposal differs from the use of coinsurance for insured depositors in England, some observers attribute part of the Northern Rock crisis to this feature, suggesting it deserves reconsideration.

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Our recommendations have received more general critiques as well. Some critics focus on the inability of our recommendations, or any recommendations for that matter, to anticipate the source of the next major disruption. These observers argue that the idiosyncratic nature of each financial disruption means that policymakers can, at best, fight the last war and cannot take steps that limit future spillovers. Who could have foreseen, critics might ask, that losses originating in subprime mortgages would ultimately lead to a freeze in the secured funding markets on which Bear Stearns and others relied?

The manner in which Bear Stearns imploded certainly caught most observers and market participants by surprise. But it was no surprise that a failure of one of the largest U.S. investment banks posed spillover risks or raised TBTF concerns. Indeed, Paul Volcker, in the foreword to our book, raised a similar point.

> The implications of [the TBTF book] … go beyond the world of commercial banking. Witness the officially encouraged (if not officially financed) rescue a few years ago of Long-Term Capital Management, a large but unregulated, secretive, speculative hedge fund. The fact is the relative importance of commercial banks in the United States has been diminishing steadily. Consequently, the lessons and approaches reviewed in *Too Big To Fail* have wider application.[4]

[4] See Stern and Feldman (2004, ix).

[5] Without implying agreement between our proposal and more recent alternatives, other parties have also suggested that policymakers respond to safety net expansion by focusing on broad stability-related issues. For one example, see Nason (2008).

Moreover, we do not need to forecast the event that brings down systemically important firms to make progress against TBTF. Instead, we need to consider the spillovers that failure might cause. Would that failure, for example, eliminate the availability of important clearing and settlement services? If so, what can we do today to facilitate continued provision of those services? Would that failure impose large losses on other firms potentially seen as TBTF? If so, what actions today would help policymakers quickly quantify potential exposures and assess counterparties' management of that risk? Of course, this approach is sure to miss some potential spillovers or risks. While not perfect, this approach is superior to efforts that do not focus on spillover potential or which react to instability once a firm fails.[5]

In conclusion, we think the recommendations we made several years ago have stood the test of time. They offer a structure and specific steps that policymakers can take to better manage the safety net and the TBTF problem. Due to its recent expansion, such safety net management should, in our view, take a considerably higher priority with policymakers than it has in the past. R

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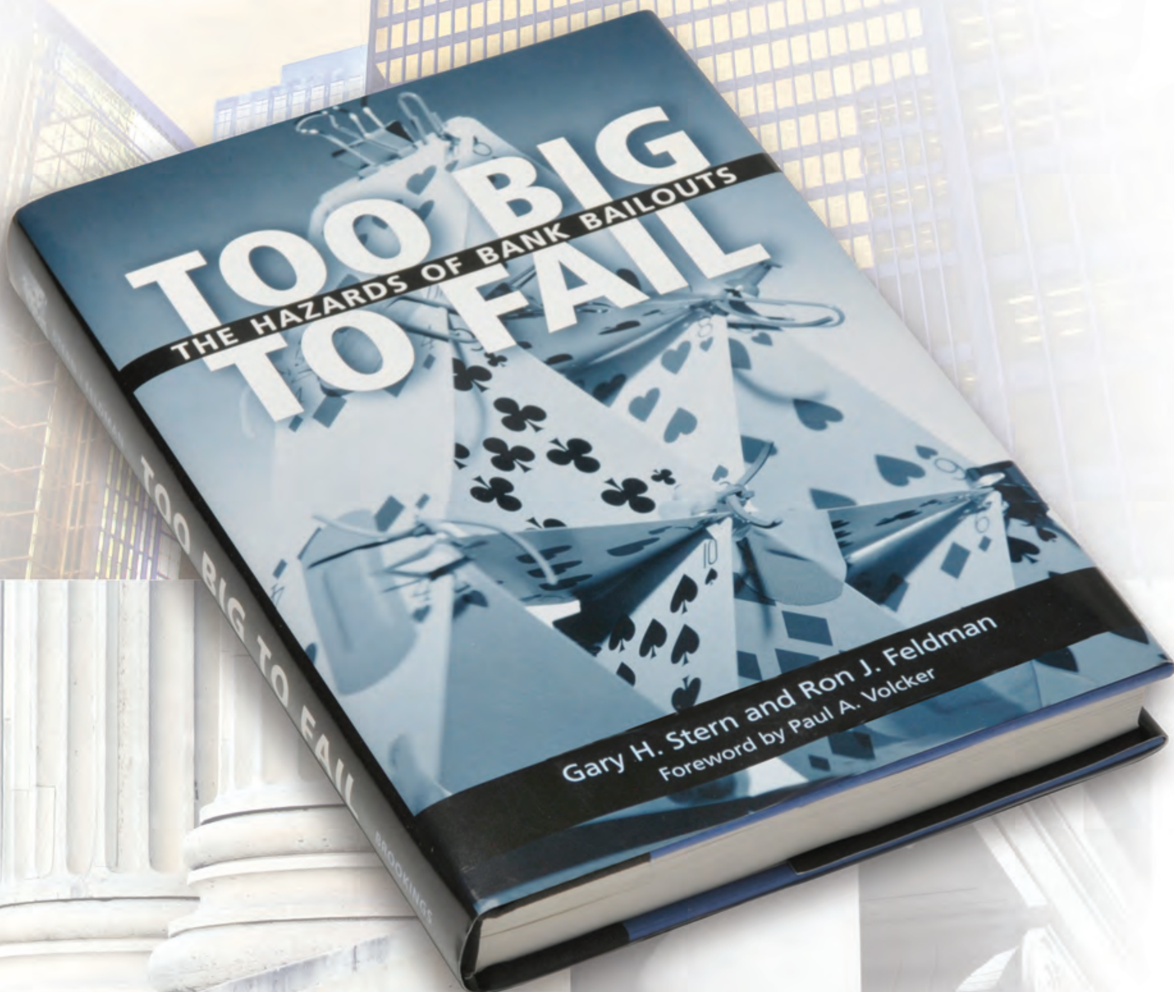
TOO BIG TO FAIL
THE HAZARDS OF BANK BAILOUTS
Gary H. Stern and Ron J. Feldman
Foreword by Paul A. Volcker
TOO BIG TO FAIL
BROOKINGS

Too Big To Fail: The Hazards of Bank Bailouts[*]

Excerpts from the 2004 book by Gary H. Stern and Ron J. Feldman

EDITOR'S NOTE: The preceding essay in this Annual Report explains the authors' policy recommendations in light of the 2007-08 financial turmoil. This excerpt, from the book's introduction, summarizes the authors' main messages and contrasts their approach with some alternatives.

Despite some progress, our central warning is that *not enough has been done to reduce creditors' expectations of TBTF protection*. Many of the existing pledges and policies meant to convince creditors that they will bear market losses when large banks fail are not credible and therefore are ineffective. Blanket pledges not to bail out creditors are not credible because they do not address the factors that motivate policymakers to protect uninsured bank creditors in the first place. The primary reason why policymakers bail out creditors of large banks is to reduce the chance that the failure of a large bank in which creditors take large losses will lead other banks to fail or capital markets to cease working efficiently.

Other factors may also motivate governments to protect uninsured creditors at large banks. Policymakers may provide protection because doing so benefits them personally, by advancing their career, for example. Incompetent central planning may also drive some bailouts. Although these factors receive some of our attention and are addressed by some of our reforms, we think they are less important than the motivation to dampen the effect of a large bank failure on financial stability.

Despite the lack of definitive evidence on the moral hazard costs and benefits of increased stability generated by TBTF protection, the empirical and anecdotal data, analysis, and our general impression—imperfect as they are—suggest that TBTF protection imposes net costs. *We also argue that the TBTF problem has grown in severity*. Reasons for this increase include growth in the size of the largest

[*]Excerpts are reprinted, with permission, from *Too Big To Fail: The Hazards of Bank Bailouts*, Gary H. Stern and Ron J. Feldman, Washington D.C.: Brookings Institution Press, 2004.

banks, greater concentration of banking system assets in large banks, the greater complexity of bank operations, and, finally, several trends in policy including a spate of recent bailouts.

Our views are held by some, but other respected analysts come to different conclusions. Some observers believe that the net costs of TBTF protection have been overstated, while others note that some large financial firms have failed without their uninsured creditors being protected from losses. However, even analysts who weigh the costs and benefits differently than we do have reason to support many of our reforms. Some of our recommendations, for example, make policymakers less likely to provide TBTF protection and address moral hazard precisely by reducing the threat of instability. Moreover, our review of cases where bailouts were not forthcoming suggests that policymakers are, in fact, motivated by the factors we cite and that our reforms would push policy in the right direction.

A second camp believes that TBTF protection could impose net costs in theory, but in practice legal regimes in the United States—which other developed countries could adopt—make delivery of TBTF protection so difficult as to virtually eliminate the TBTF problem.

We are sympathetic to the general and as yet untested approach taken by U.S. policymakers and recognize that it may have made a dent in TBTF expectations. In the long run, however, we predict that the system will not significantly reduce the probability that creditors of TBTF banks will receive bailouts. The U.S. approach to too big to fail continues to lack credibility.

Finally, a third camp also recognizes that TBTF protection could impose net costs but believes that there is no realistic solution. This camp argues that policymakers cannot credibly commit to imposing losses on the creditors of TBTF banks. The best governments can do, in their view, is accept the net costs of TBTF, albeit with perhaps more resources devoted to supervision and regulation and with greater ambiguity about precisely which institutions and which creditors could receive ex post TBTF support.

Like the third camp, we believe that policymakers face significant challenges in credibly putting creditors of important banks at risk of loss. A TBTF policy based on assertions of "no bailouts ever" will certainly be breached. Moreover, we doubt that any single policy change will dramatically reduce expected protection. But fundamentally we part company with this third camp. *Policymakers can enact a series of reforms that reduce expectations of bailouts for many creditors at many institutions*. Just as policymakers in many countries established expectations of low inflation when few thought it was possible, so too can they put creditors who now expect protection at greater risk of loss.

The first steps for credibly putting creditors of important financial institutions at risk of loss have little to do with too big to fail per se. Where needed, countries should create or reinforce the rule of law, property rights, and the integrity of public institutions. Incorporating the costs of too big to fail into the policymaking process is another important reform underpinning effective management of TBTF expectations. Appointment of leaders who are loath to, or at least quite cautious about, providing TBTF bailouts is also a conceptually simple but potentially helpful step. Better public accounting for TBTF costs and concern

about the disposition of policymakers could restrain the personal motivations that might encourage TBTF protection.

With the basics in place, policymakers can take on TBTF expectations more credibly by directly addressing their fear of instability. We recommend a number of options in this regard. One class of reforms tries to reduce the likelihood that the failure of one bank will spill over to another or to reduce the uncertainty that policymakers face when confronted with a large failing bank. These reforms include, among other options, simulating large bank failures and supervisory responses to them, addressing the concentration of payment system activity in a few banks, and clarifying the legal and regulatory framework to be applied when a large bank fails.

Other types of reforms include reducing the losses imposed by bank failure in the first place and maintaining reforms that reduce the exposure between banks that is created by payments system activities. These policies can be effective, in our view, in convincing public policymakers that, if they refrain from a bailout, spillover effects will be manageable. Such policies therefore encourage creditors to view themselves at risk of loss and thus improve market discipline of erstwhile TBTF institutions.

We are less positive about other reforms. A series of reforms that effectively punish policymakers who provide bailouts potentially also could address personal motivational factors. However, we are not convinced that these reforms are workable and believe that they give too much credence to personal motivations as a factor to explain bailouts. The establishment of a basic level of supervision and regulation (S&R) of banks should help to restrict risk-taking, although we view S&R as having important limitations.

Finally, policymakers have a host of other available options once they have begun to address too big to fail more effectively. For example, policymakers could make greater use of discipline by creditors at risk of loss. Bank supervisors could rely more heavily on market signals in their assessment of bank risk-taking. Deposit insurers could use similar signals to set their premiums.

EDITOR'S NOTE: This excerpt, from the book's conclusion, recaps the key points from the book and offers some more details about the authors' proposals.

Three Bottom Lines

FIRST, the TBTF problem has not been solved, is getting worse, and leads, on balance, to wasted resources.

SECOND, although expectations of bailouts by uninsured creditors at large banks cannot be eliminated, they can be reduced and better managed through a credible commitment to impose losses. Policymakers can establish credible commitments by addressing and reducing the motivation for bailouts.

THIRD, although other reforms could help to establish a credible commitment, policymakers should give highest priority to reforms limiting the chance that one bank's failure will threaten the solvency of other banks.

We now provide supporting points for these conclusions.

The Problem

—Even though they are not entitled to government protection, uninsured creditors of a large or systemically important bank believe they will be shielded from at least part of the loss in the event of bank failure.

—Anticipation of government protection warps the amount and pricing of funding that creditors provide a TBTF bank, which, in turn, leads banks to take excessive risk and make poor use of financial capital. The costs of poor resource use resulting from TBTF guarantees appear to be quite high. We believe these costs exceed the benefits of TBTF coverage in most cases, but even those who weigh the costs and benefits differently should be able to support many of our reforms.

—Expectations of TBTF coverage have likely grown and become more strongly held because more banks are now "large" and because a smaller group of banks controls a greater share of banking assets and provides key banking services. In addition, banks have become increasingly complex, making it more difficult for policymakers to predict the fallout from bank failure and to refuse to provide subsequent coverage to uninsured creditors.

—Reforms over the last decade aiming to limit TBTF protection, including those adopted in the United States, are unlikely to be effective in the long run (although they have yet to be tested and may have made a dent in TBTF expectations).

Commitment as the Solution

—In order to change the expectations of bailouts, policymakers must convince uninsured creditors that they will bear losses when large banks fail; changes in policy toward the uninsured must involve a credible commitment.

—A credible commitment to impose losses must be built on reforms directly reducing the incentives that lead policymakers to bail out uninsured creditors.

—Reforms that forbid coverage for the uninsured are not credible because they do not address underlying motivations and are easily circumvented.

—Policymakers have considerable experience in establishing credible commitments in the setting of monetary policy. The experience of monetary policy over the last two decades demonstrates the feasibility of reducing long-held expectations, such as those likely held by uninsured creditors of large banks.

Specific Motivations and Reforms

—The most important motivation for bailouts is to prevent the failure of one bank from threatening other banks, the financial sector, and overall economic performance. To reduce that motivation, we recommend that policymakers in developed countries take three general steps: enact policies and procedures that would reduce their uncertainty about the potential for spillovers; implement policies that directly limit creditor losses or allocate losses such that market discipline increases without an excessive increase in instability; and consider or follow up on payment system reforms that reduce the threat of spillovers.

—Reforms that reduce policymaker uncertainty include the following: increase supervisory planning

for, and simulation of, a large bank failure; undertake targeted efforts that reduce the likelihood and cost of failure for banks dominating payment markets; make legal and regulatory adjustments that clarify the treatment of bank creditors at failure; and provide liquidity more rapidly to uninsured creditors.

—Reforms that could address concerns of excessive creditor loss include the following: close institutions before they can impose large losses; require banks in a weak position to increase the financial cushion to absorb losses; impose rules that require creditors to absorb at least some loss when their bank fails (for example, requiring coinsurance); and allow for select coverage of the nominally uninsured while, in general, making it more likely that creditors will suffer losses.

—Although payment system reforms are quite complex in implementation, they are fairly straightforward in concept. One type of reform would eliminate or significantly limit the amount that banks owe each other through the payment system. A second type of reform would establish methods by which a bank owed funds by a failing institution could offset losses (for example, by seizing collateral). R