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CAPITAL

Three Theories on Solving the 'Too Big to Fail' Problem

THE BIGGEST financial crisis in 70 years has bequeathed a to-do list of overwhelming length for bankers, regulators and politicians. Somewhere near the top is the "too big to fail" (TBTF) problem: The existence of financial institutions so large, so interconnected, so leveraged or so complex that the government dare not let them fail for fear of endangering the whole economy.

By David Wessel

Investors who lend to or trade with these firms, for good reason, believe taxpayers will stand behind the debt of TBTF firms if things go bad. So, these firms can borrow more cheaply than too-small-to-save firms. That taxpayer subsidy—and that's what it is—means these institutions can make riskier bets, collecting rewards if they win and sticking taxpayers with the tab if they don't.

This is an old problem. But the rescues of Bear Stearns and American International Group and the uproar over the Lehman Brothers bankruptcy have expanded it beyond ordinary big banks. The past year has established a pattern: Executives of TBTF firms may be fired and their shareholders squeezed, but bondholders and trading counterparties will be protected. The already big institutions that survived the panic are now even bigger, and the obligations the government implicitly backs has broadened from bank deposits to bonds, derivative deals, even shares of money-market funds.

No one defends this. Promising not to do it again won't work. Everyone knows what the government will do next time. The solutions fall into three strains.

■ The Mervyn King-George Shultz view: Bust them up.

Mr. Shultz, a former Treasury secretary, says that if banks are too big to fail, they are too big. Mr. King, governor of the Bank of England, is sympathetic. Noting with disapproval that the U.K. now has only four big banks, he said recently, "It is in our collective interest to reduce the dependence of so many households and businesses on so few institutions that engage in so many risky activities."

Others counter that size wasn't the only factor this time. Lehman Brothers was hardly the biggest investment bank. Even midsize firms, it appears, can put the system at risk. And breaking up big firms may not be possible or even wise. "Our biggest firms are extremely large in almost every industry," Alan Blinder, a Princeton University economist, said at a Boston Federal Reserve Bank conference last week titled "After the Fall."

"Why should finance be different? [M]odern finance is all about interconnections. Globalization itself involves some minimum scale and scope," he said. Anyhow, he added, the U.S. simply isn't going to create a market in which no financial institution is too big or too interconnected to fail.

■ The Paul Volcker view: Separate trading from deposit-taking and loan-making.

The former Federal Reserve chairman, his views on this subject largely ignored by the Obama administration, tells anyone who will listen: Deposit-taking banks should be tightly supervised and their deposits insured by the government, but they shouldn't be allowed to trade aggressively. "Extensive participation in the impersonal, transaction-oriented capital market does not seem to me an intrinsic part of commercial banking," he has said. Let banks do enough trading to serve their customers, but leave big-money trading to firms outside the government safety net.

Critics say the boundary between those two reasons for trading may prove hard to define. But there's support for a less radical approach that would require financial firms to hold more capital in their trading business than they do now. That would provide a bigger cushion in times of adversity and, perhaps, make trading less profitable and thus less attractive.

■ The Ben Bernanke-Timothy Geithner-Barney Frank view: Stuck with TBTF institutions, the government should make them less prone to failure. To this camp, the King-Shultz and Volcker solutions wouldn't have prevented the recent crisis and amount to trying to roll back the tide.

Without waiting for Congress, Treasury Secretary Geithner and Fed Chairman Bernanke are moving to require banks to hold more capital so they can absorb greater shocks themselves, perhaps requiring TBTF banks to hold proportionately more capital than smaller banks. And they vow more stringent supervision. "We will impose tough rules on our largest, most leveraged, and most interconnected firms," Mr. Geithner has said. "We will require these firms to hold more capital to protect the system in the event of the firm's failure.

Critics deride this as insufficient or more of the same, as intensifying past efforts rather than erecting strong new guard rails of finance. But the view appears to be prevailing.

ON ONE THING, all three agree. The government, no matter what, someday will face the imminent collapse of another big, interconnected firm. So Congress should, as Mr. Frank proposes, give regulators a better way to cope with a big failure than the two bad ones it had in September 2008—bankruptcy (Lehman Brothers) and bailout (AIG). Basically, Messrs. Bernanke and Geithner want Congress to give them a way to take over a TBTF institution and decide, with some rules and discretion, who gets paid off in full and who doesn't.

Oh, and next time, Messrs. Frank, Bernanke and Geithner now agree, taxpayers shouldn't pay the bill. They would have the Treasury, not the Fed, advance money for a rescue, and then assess big financial firms for the costs afterward.

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