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The Myth of Too Big to Fail, Imad A. Moosa (Palgrave Macmillan Studies in Banking and Financial Institutions, UK), 2010; pp XV+223, £65.

In the aftermath of recent financial crisis, the *too-big-to-fail* (TBTF) issue is at the forefront of the debate on financial regulatory reform as witnessed in most of the developed economies like the United States, United Kingdom, and Switzerland. In much of Europe and especially at the European Union level and in Asia-Pacific region, however, the TBTF problem sparsely present in substantial financial policy debates. This looks paradoxical at the first glance, but this very fact also makes it more intractable. Furthermore, the discussion on possible remedies is not a simple one, and many gaps remain in our analytical understanding. Moreover, given the potential risks to systemic stability, there is a case for policy action even in the absence of analytical certainty. There are different dimensions to the problem, each of which is associated with different policy options, including absolute bank size, market concentration, conglomeration, internationalisation, and complexity. However, these difficulties should not be taken as an excuse to avoid an in-depth debate. There is no book in recent times with a sweep as comprehensive and vast, insights as rich and thoughtful, and production as prolific and well done as the *Myth of Too Big to Fail* by Imad A. Moosa, an academician, an economist and a financial journalist as well.

The book is divided into ten chapters and highly critical of the TBTF doctrine and related issues such as *laissez faire* finance, the trend towards massive deregulation, and status of the financial sector in the world-wide economy. It is critical of not only the practice, but also the ideas that drive the practice – some of which are the products of academic work. Most of the discussion in this book pertains to developments in the United States, where the deposit insurance was invented and the term TBTF was coined. The author has mentioned that, it is a normative issue that you can't be neutral about and any discussion is bound to be highly opinionated. This book has been written to explain, by using economic analysis as well as empirical and historical evidence, the popular outrage about TBTF and taxpayers-funded bailouts of failing financial institutions. There was no ideological drive or a hidden agenda than to say frankly – *the too big to fail doctrine is a myth that must go like the dinosaurs, and quickly*.

TBTF and Global Financial Crisis

The dramatic federal response to the current financial crisis has created a new reality in which virtually all systemically significant financial institutions now enjoy an implicit guarantee from the government that they will continue to exist (so also continue to exert moral hazard) long after the immediate crisis passes. The crisis has made it clear that the TBTF doctrine amounts to rescue banks from their own mistakes by using taxpayer's money. The TBTF problem has gained importance in March 2008 with the controversial rescue of 'Bear Stearns', when the US Federal Reserve backed J P Morgan Chase's purchase of that ailing investment bank, and then again symmetrically in September 2008 when the US authorities' decision to let 'Lehman Brothers' fail ushered in a sequence of major market disruptions. On October 10, 2008, a few weeks after the Lehman collapse, the finance ministers and central bank governors of G-7 countries met in Washington, and 'agreed to take decisive action and use all available tools to support systemically important financial institutions and prevent their failure'. The United States and European Union have different starting points for the TBTF debate, in part for reasons linked to their respective histories including the experience of the recent crisis.

The United States has a long tradition of suspicion and concern about large banks, which goes as far back as the controversy between Alexander Hamilton and Thomas Jefferson about the establishment of the First Bank of the United States in 1791. For a long time, the growth of a 'national' financial system was kept in check by initiatives to restrain banking. During the Great Depression of 1930s, the Glass-Steagall Act of 1933 forced a strict separation of investment banking activities from depository banks, leading to the breakup of major institutions. The banking crisis of the 1980s provided a rehearsal for some of the current arguments about the TBTF problem. The crisis surrounding Long-Term Capital Management (LTCM), a hedge fund that suffered heavy losses and liquidity tensions as a result of the Asian and Russian financial crises in 1997-98 and had to be bailed out by major banks under the auspices of the Federal Reserve Bank of New York in September 1998, illustrated a new dimension of the TBTF problem, sometimes referred to as 'too interconnected to fail'. LTCM with assets in excess of $100 billion was not huge, but it was felt that its bankruptcy would cause a chain of reaction throughout the financial system that could have catastrophic consequences.

TBTF Debate

In a report to G-20 Finance Ministers and Governors, the IMF, BIS, and FSB define systemic risk as ‘a disruption to financial services that: (1) caused by impairment to all parts of the financial system, and (2) has the potential to have serious negative consequences for the real economy. Systemically Important Financial Institutions (SIFIs), whether they are banks or non-banks can then be seen as institutions whose impending failure, inability to operate, and disorderly winding up could produce such systemic effects. The key criteria most often listed for identifying such SIFIs include size, concentration, interconnectedness, performance of systemically important functions, and complexity. Many analysts also include leverage and liquidity as tools to define SIFIs, although these can also be regarded as characteristics of vulnerability that apply to all financial institutions. The book has also recognised that TBTF also has a time-dependent or context-dependent dimension, that is, thresholds for TBTF can be much lower if impending failure occurs at a time.

The IMF explores four approaches for measuring interconnectedness: (1) network simulation that draw on BIS data on cross-border interbank exposures and that tracks the reverberation of a credit event or liquidity squeeze *via* direct linkages in the interbank market; (2) a default intensity model that uses data from Moody’s Default Risk Service and that measures the probability of failures of a large fraction of financial institutions due to both direct and indirect linkages; (3) a co-risk model that utilizes five-year credit default swap (CDS) spreads of financial institutions and that assesses systemic linkages among financial institutions under extreme duress; and (4) a stress-dependence matrix that incorporates individual CDS and probability of default data, along with stock prices, to examine pairs of institutions’ probabilities of distress.

Irrespective of the specific yardstick used to identify SIFIs, one non-trivial policy question is the following: if financial institutions deemed systemically significant are subject to a specific regulatory regime, should this list be made public? Some have argued that going public would undesirably confer official TBTF status on such institutions, thus reinforcing moral hazard. However, it appears unlikely that the identity of firms subject to a specific regulatory treatment can in fact be kept private, especially, since such firms would likely be able to challenge their designation as SIFIs. Indeed, such a challenge is part of the Dodd-Frank Act of 2010 in the new US financial reform legislation and similar concerns are likely to arise in other countries. Also, most large and

complex financial institutions already receive a funding discount and credit rating upgrade in the market (relative to smaller financial institutions) that can be at least partly linked to the formers' perceived higher probability of obtaining government support if they get into trouble. Thus, it is not as if the absence of a public SIFI list will eliminate perceptions of unequal bailout treatment. Most importantly, designation as a SIFI is not identical to deeming that institution TBTF; a SIFI can fail if other elements of the regulatory and/or supervisory regime make resolution credible and orderly and do not make liquidation too expensive for the taxpayer. Conversely, the cases of LTCM in 1998 and of Northern Rock in 2007 suggest that even institutions that would have been unlikely to be included in an official list of SIFIs can be considered too important to be allowed to fail.

Prohibiting Bigness

A first set of policy options is to discourage TBTF and to internalise the externalities associated with bigness and complexity through curbs and incentives. The book has identified three main such options: capital and liquidity surcharges; size-related taxes or levies; and competition policy. The Basel Committee on Banking Supervision (BCBS), which prepares capital and liquidity standards, has discussed for some time the idea of imposing higher capital (and also liquidity) requirements on financial institutions deemed systemically important relative to those not so designated. A second approach would be to create disincentives to bigness through tax or tax-like instruments. This would be especially relevant in countries that envisage setting up a new contribution, tax, or levy on financial institutions as a form of compensation for the public support they receive in the event of crises. Yet a third approach in this category is to use competition policy to curb the size of the largest financial firms. In the European Union, the European Commission has extensively used its powers since the beginning of the crisis to keep a check on state rescues and on the size of rescued firms.

A more radical approach than curbing the size of financial institutions is to prohibit, or cap, them from growing beyond a maximum size. The Dodd-Frank Act of 2010 specifies that any insured depository or systemically important non-bank could be prohibited from merging or acquiring substantially all the assets or control of another company if the resulting company's total consolidated liabilities would exceed 10 per cent of the aggregate consolidated liabilities of all financial companies. This liability size-cap would not require

any existing US financial institutions to shrink, though, and does not prohibit their organic growth in the future.

Allowing Banks to Fail

The book has prescribed a set of proposals to address TBTF relates not to the size of institutions, but to the possibility of their failure. If even huge financial conglomerates can fail without creating major market instability, then their bigness becomes less of an inherent problem. The financial crisis, and especially the successive decisions taken by the US authorities on Bear Stearns, Lehman Brothers, and AIG, has illustrated both the difficulties of applying a consistent policy framework to all crisis situations without creating massive moral hazard, and the disadvantages of taking different stances in different cases.

It is difficult to separate the debate about the possibility of financial institution failure from a more general conversation about competition in the financial industry, which is made more complex by its multifaceted links with financial stability. Competition simultaneously imposes discipline on financial firms, and can foster excessive risk taking. A bank failure can increase concentration, or on the contrary, provide opportunities for new entrants, depending on how open and competitive the banking system is in which it takes place. In a system, where all or most of the financial industry is in government hands, an actual bank failure is virtually impossible and a government bailout is almost guaranteed.

The availability of a resolution regime and resolution authority is a necessary condition to envision the orderly resolution of large financial institutions, but it is not sufficient. The resolution authority does not only need the legal powers to intervene, it must also have the operational capability to do so, which can prove to be a significant challenge in itself. The failure of a large financial conglomerate can be a hugely complex affair, especially as corporate structures in the financial sector have become ever more complex, partly as a result of continuous regulatory and tax arbitrage.

Basic Finance without TBTF

There is only one perceived benefit that can be gained from bailing out financial institutions deemed too big to fail: avoiding a systemic collapse. However, corporate failure is an integral part of the so-called ‘creative destruction’, which is a feature of capitalism that the TBTF doctrine is inconsistent with. Avoiding systemic failure is a perceived benefit only because

regulators and managers of failed institutions use the language of fear to warn that failure to bailout the underlying institution will cause misery for millions of people. It is all nonsense because humans are resilient. If people can outlive an earthquake or a tsunami, they can surely survive and flourish in the aftermath of the collapse of a bank, an insurance company or a hedge fund.

Financial institutions, it seems, are too important to be left to financiers, and that is why it is prudent to intensify regulation and reverse deregulation. One way forward is to forget about the international harmonisation and unification of banking regulation and to leave every country to formulate its own regulation. This is what happened after the collapse of the Bretton Woods system of fixed exchange rates when countries were allowed to choose the exchange rate system they deemed appropriate for their economies. After all, the global financial crisis has taught us big lessons on financial regulation. The BIS and Basel Committee could still provide a forum for regulators to consult and exchange views. The book is interesting to read as it prescribes that we must return to and embrace the principle of capitalism that a failing firm must vanish with no life support offered by the government and financed by the tax-payer's money.

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