Gary H. Stern, Ron J. Feldman, Too Big To Fail: The Hazards of Bank Bailouts, Brookings Institution Press, Washington, DC, 2004, 230 + xiii pp., index, US$ 32.95, ISBN 0-8157-8152-0 .

Moral hazard is one of the most basic concepts in economics: If someone pays you for your accidents, you will expend less effort trying to avoid them. Insurance companies understand this perfectly well. That's why most insurance contracts include customer deductibles and limited coverage. This seems straightforward enough. Why is it, then, that policymakers appear to have missed this important lesson?

In *Too Big To Fail*, Bank of Minneapolis Fed President Gary Stern and Vice President Ron Feldman examine this question in the context of government policy towards bank failures. Written for policymakers, this short book lucidly explains the moral hazard problem that plagues large financial institutions policymakers deem "too big to fail" (TBTF).

Why might some banks receive this privileged status? If a bank has many customers or plays a large role in the nation's financial system—for instance, by processing many of the nation's payments or security transactions—its failure may threaten the solvency of other institutions financially connected to it and to each other. By creating a domino effect, the failure of a TBTF bank threatens to cripple the national economy. For instance, if a major bank fails, and other banks rely upon this bank and its creditors to fulfill their obligations to function, then these banks too, and potentially those institutions they are financially connected to, may collapse as well. If the spillover effects generated via this process are large enough, the failure of a big bank could trigger an economy-wide recession.

To prevent such catastrophe, the government explicitly or implicitly deploys what Stern and Feldman call "TBTF protection." Under this policy, government protects uninsured creditors at big banks from the losses they stand to suffer if bank failure occurs. One well-known manifestation of this policy is federal deposit insurance, which guarantees the deposits of bank creditors up to a certain amount in the event of bank failure. The authors point out that this is far from the only method government uses to protect uninsured creditors, "nor" is there even "any tractable method for, determining the types of TBTF protection that governments have supplied to date" (p. 17).

Protecting uninsured creditors this way is thought to mitigate the potentially disastrous effects of big bank collapse by stopping the spread of failure before it ever begins. An unintended byproduct of TBTF policy, however, is the creation a moral hazard problem. On the one hand, creditors of big banks who expect government to protect their loans have little incentive to monitor bank behavior or to select relationships with banks that are prudent in their decisions. On the other hand, realizing that they face reduced monitoring from creditors and knowing that the government will bail them out if they fail, big banks take on excessively risky projects and generally act less responsibly than they would if they had to shoulder the full burden of their behavior. The result is misallocated resources and more of the behavior that leads to bank failures in the first place. The more extensive the protection that government offers to uninsured creditors, the more massive the moral hazard problem it creates.

According to Stern and Feldman, policymakers understand the long-run negative consequences of the moral hazard problem TBTF policy creates but face the commitment problem of remaining true to declarations that they will not bail out big failed banks in the short run. Faced with a big bank failure now, policymakers cannot resist the temptation to break their former promises to the contrary. In short, anti-bailout declarations by those in authority are time inconsistent.

The first half of the book is devoted to explaining the nature and extent of the moral hazard problem created by this time inconsistency to an audience of non-economists. The economist reader is therefore unlikely to learn anything new from this section, though it will be useful for students of economics and those who are not familiar with the idea of moral hazard. Additionally, in Chapters 4 and 6 the authors provide some basic but interesting data regarding the magnitude of the TBTF problem in light of current creditors' expectations that the government will bail out their financial institution if it becomes insolvent.

In the concluding chapter of Part One, Stern and Feldman consider three reasons that policymakers may pursue TBTF policy. Two reasons they discuss—a desire to affect the allocation of credit and personal benefit—are dismissed as of only minor importance. Instead they favor the third—a desire to prevent the economy-wide consequences of big bank failure, as the real motivation for most bank bailouts.

Some readers will find the authors' claim that what might be generally called "public choice" motivations are secondary to public-spirited ones less than convincing. As they readily admit, their "ultimate justification for this relative weighting is 'gut and experience' rather than empirical evidence" (p. 59). This is fair enough. After all, as long-time Fed employees, Stern and Feldman's "gut and experience" on matters such as these is likely to be more refined than the reader's.

But if it is true that policymakers face the commitment problem the authors describe, how are they are able to say TBTF protection stems from concerns for social welfare? It would seem that a primary reason for this commitment problem that policymakers face derives from the shortsightedness bias that, public choice economists warn us, self-interested politicians inevitably adopt. The costs of foregoing creditor protection now—even if healthy from a long-run perspective—are deferred to future policymakers who must deal with the long-run problem that creditor insurance creates. On the other hand, policymakers immediately enjoy the benefits of "saving the economy" in the short run if they choose to bail out a failed bank. In short, the commitment problem Stern and Feldman describe fundamentally results from self-interest on the part of policymakers—a motivation they seem to deny as a central to explaining TBTF protection.

In Part Two, Stern and Feldman turn their attention to evaluating policy changes that have been undertaken to ameliorate the moral hazard problem that TBTF protection creates. More importantly, they also lay out their recommendations for how to improve this situation further. In America, the most significant change undertaken to reduce the moral hazard problem created by TBTF protection was the 1991 Federal Deposit Insurance Corporation Improvement Act (FDICIA). The FDICIA improved the supervision and regulation of banks and formally limited the Federal Reserve's ability to make loans to faltering banks as means of keeping them afloat.

However, as Stern and Feldman effectively argue, in reality the FDICIA did little to change existing policy towards TBTF financial institutions. Most of the "new" measures it introduced to combat the moral hazard problem created by TBTF protection already existed in some form or another. Thus, although the FDICIA may have helped on the margin, there remains room for substantial policy improvement.

Towards this end, the authors offer several policy changes intended to reduce the prevalence of bank bailouts by affecting the root cause they identify as motivating bailouts in the first place—the likelihood of spillover effects. Among other changes, the authors recommend that policymakers use stress testing and contingency planning to identify the likely effects of a major bank's failure on the economy, as a means of reducing the uncertainty of spillovers in this event. Other recommendations include introducing policy that would: provide liquidity more rapidly to creditors when failure occurs, close faltering banks before they can impose larger losses on creditors, require deposit coinsurance, and alter existing payment systems to limit the amount that banks owe each other through the system.

These are just a few of the numerous changes that Stern and Feldman suggest to limit the costs of TBTF protection. Of course, some are more appealing than others. For instance, requiring coinsurance is a fairly straightforward way to minimize the moral hazard problem that protection creates, while a policy expediting liquidity to uninsured creditors seems a bit like ingesting a cup of poison to prevent one from drinking a bottle of it down the road. The authors also fail to address how their solutions overcome the fundamental commitment problem confronted by self-interested policymakers in the first place. Why would policymakers take actions now that they know will reduce their discretion to bail out banks down the road?

One option for limiting the moral hazard problem created by TBTF protection not considered by Stern and Feldman is that of free banking. Under free banking, banks are unregulated, and there is no central bank in charge of issuing currency. In this laissez-faire banking system, banks and money are private and competitive. The work of Lawrence White, among others, suggests that banks in such a system are highly stable and may be less prone to runs that can bring about their failure. Before the advent of central banks, the relatively unregulated banking industries of Scotland, Sweden, and Switzerland provide some historical support for this position as well (see for instance, White, 1999). If banks in the context of such a system are in fact less prone to failure than they are in our current system, it may be worth investigating free banking as a means of limiting the costs of TBTF protection.

Too Big To Fail delivers more to certain readers than others, but contains something of interest for everyone. In the first place, it provides valuable reading for those who have not been exposed to the moral hazard problem that government bailouts of big banks create. Economists will find little new in Part One, but stand to learn more about the policy options for dealing with this problem in Part Two. Finally, policymakers will get the most of out this book, grounding themselves in the problem of TBTF protection made so accessible by Stern and Feldman in the first half of the book, and learning about potential reforms in the second.

References

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Available online 2 October 2004

doi:10.1016/j.jebo.2004.07.002