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End Too-Big-to-Fail

BY ALLAN H. MELTZER

The Obama Treasury Department is stuck in the same place as the Bush Treasury. It cannot find a way to value the many mortgages that banks and financial institutions hold. The result is delay and lengthening the financial crisis.

The solution stares at them, but they are either unwilling to see it or to do it. It requires an end to the mistaken policy of "too big to fail." Like past administrations, they forget that they are supposed to protect us, the depositors and taxpayers, not the bankers and financial executives.

The market values much of the mortgage debt at a price that would bankrupt most of the holders. Selling large holdings or getting the market to buy mortgages could only occur at a lower price or large subsidy. Secretary Geithner cannot get buyers to pay more without giving them big incentives at taxpayer cost. That was the problem that his predecessor eventually learned. It is a mystery why sophisticated market people have difficulty accepting that obvious fact.

If a bank is too big to fail, it is too big.

There is an easier way. The market values large banks every day. That value includes a market estimate of the value of the distressed mortgages that the banks hold. If the bank is insolvent or likely to become insolvent, the market price reflects that assessment. In the current environment, the market may be more doubtful about future prospects than Treasury officials want to believe, but the only way they can escape the market's estimate is by sacrificing the taxpayers.

The better way is for the Treasury to announce that banks that must raise more capital will get assistance. If a bank decides to raise $20 billion, the Treasury should offer to lend half at concessional rates to any bank that raises the other half in the market. If the bank cannot raise its half, the Treasury should apply FDICIA, the Federal Deposit Insurance Corporation Improvement Act. That act, passed in 1991, gave the regulators authority for early intervention. They can take over a bank that has deficient capital while it still has positive capital value. The motivation was to keep the Federal Reserve from supporting failing banks while their losses rose, then shifting the loss to deposit insurance. Currently, the threat of activating FDICIA for use against large banks will give the bankers substantial incentive to find its share of funds in the market. And using FDICIA would end "too big to fail."

Failure does not mean that the bank closes. The bank would continue to operate just as Fannie Mae does. Management would be replaced and stockholders would lose, but taxpayers would be protected. The latter is what regulators are charged with doing. They are there to protect us, not to protect bankers who made big mistakes. Unfortunately, neither the Bush nor the Obama administration can remember that their first responsibility is to the citizens, not to the bankers.

The public would gain also from renewed confidence in the part that remained after a bank failed. The Treasury or Federal Deposit Insurance Corporation would sell the bank or merge it at the earliest opportunity. Some would be sold in pieces to prevent creating even larger banks. "Too big to fail" allowed banks to become too big and too willing to take on risk.

No one should be surprised that decades of "too big to fail" encouraged the belief that regulators would rescue imprudent lenders. Bankers and others talked openly about a "Greenspan put"—a bailout by the Federal Reserve if failure threatened. The Federal Reserve may not have intended the "put," but it did not allow large banks to fail. And the current Fed and Treasury have greatly enlarged the safety net for bankers at taxpayers' cost.

For some bankers, taking on excessive risk appeared to be a one-way gamble. Either the bank profited and the bonuses increased, or the public took the loss. No surprise then that leverage rose and risk soared. Not all banks accepted excessive risk, and not all have failed. Under this proposal, some will raise capital and get subsidized capital from the Treasury and the taxpayers. That's a price we pay to end the financial mess. But it is a smaller price than continuing "too big to fail" and the current mess.

If a bank is too big to fail, it is too big. ◆

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