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'Too Big To Fail' Is Too Foolish To Continue

By: Louise Bennetts – April 26, 2013

Talk about fiddling while Rome burns. For the past few weeks we have been flooded with sound bites from politicians and former regulators arguing that "too big to fail" banks need to be broken up.

The banks are too big and too complex, they argue, and we are one major misstep away from the next economy-wide crisis requiring a massive government bailout.

But while talking heads have been piling on their favorite whipping boys — big banks — the Treasury and the Federal Reserve have been edging ever closer to expanding the federal safety net to include ... well, just about anyone. Insurance companies, hedge funds, private equity companies, investment advisers — name a type of firm, the Dodd-Frank "reform" legislation has potentially put taxpayers on the hook to backstop its losses.

Dodd-Frank gave the Treasury the power to label "nonbank financial companies" — basically anyone involved in finance or insurance — as "systemic," a euphemism for "too big to fail." But determining what makes a company "systemic" is rather difficult.

Dodd-Frank defines it as a company whose "failure would threaten the financial stability of the United States."

That description is deliberately anxiety-inducing, and also subjective. As we saw in 2008, one person's systemic event is another's market correction.

In the absence of any clear guidelines, regulators have decided to put the "big" back into TBTF, and are reportedly targeting the largest players in each financial sector.

But they have failed to explain why the firms and industries in their crosshairs would pose any threat to the U.S. economy were they to fail.

Take insurance. The obsession with insurance companies undoubtedly stems from Treasury's 2008 AIG bailout (some would say "takeover").

This is a classic example of bad facts making bad law. The problems posed by AIG weren't a result of its traditional insurance activities, but rather its "financial products" arm, a repository for subprime mortgage-backed derivative products. And taken alone, even the failure of this key business was not sufficient to pose a risk to the system.

In congressional testimony following the bailout, several bank heads confirmed that absent other factors, AIG's failure would not have threatened the health of their firms.

Instead, Treasury officials were concerned that the failure of AIG, on top of the already weakened state of several large investment banks and the general market chaos, would heighten the panic. That's an accident of timing, not an indicator of importance.

There is no clear reason why traditional insurance activities should be "systemic" or why an insurance company should be stamped with the TBTF label. If a Prudential, a Metlife or an AIG goes bankrupt, customers may lose their premiums or their coverage. But it is unlikely to spark a market-wide panic, unless it is also accompanied by a major natural

disaster, war and terrorist attack. Even the IAIS, the international body of insurance regulators, has said as much.

As for hedge funds, they weathered the 2008 crisis rather well. That sector — designed to provide short-term funds to the market — has always been more fluid than its banking counterparts. Hedge funds operate with the moneys of highly sophisticated investors, have very low leverage and go in and out of business without anyone really noticing. The failure of a large fund may be painful for a few investors, but it is hardly likely to spark the end of the world as we know it.

So what is the effect of all this? Aside from the implicit government guarantee that goes along with being too big to fail, the "systemic" label carries with it some heavy burdens.

Not least is the extension of bank-like supervision to nonbanks — a questionable development, when it is not clear that banking supervision has yielded particularly good results.

The "systemic" label also creates confusion in the event that one of these firms goes bankrupt. Will they be subject to the usual bankruptcy laws (Ch. 11, or a state-based insurance wind-down), or the "orderly liquidation authority" created by Dodd-Frank?

Talk about heightening market panic: Nothing scares creditors more than not knowing where they stand.

The issue is simple. By forcing insurance companies, hedge funds and other financial market participants to look more like banks, Congress and regulators are hammering a square peg into a round hole. It won't work.

Too big to fail has always been a policy, not a state of nature, and the only way to deal with it is to delete it from the policymaking lexicon for good.

On this issue, as many others, Dodd-Frank gets it completely backwards.