Too big to live

Why we must stamp out State Monopoly Capitalism

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FOREWORD

The problems of excessive economic concentration, so lucidly and incisively analysed here, are not limited to the financial services industry. For the problem is now widespread: while five firms control 80% of the banking industry, a similar or greater concentration is found in industries ranging from energy and telecommunications to tobacco and soft drinks. The dangers of excessive market concentration are greater in finance, however, because of the systemic importance of credit to the economy and the now widely-held belief that governments must intervene to prevent the failure of big banks.

But what is to be done? if we are to break up the institutions that are “Too Big To Fail”, does that contradict the benefits of economies of scale, the driving force of globalization? Or, if these huge firms are to be left as they are, and we are to rely on tighter, better regulation to control them, will not human creativity and ingenuity always find a way around any new rules, as it did in this last crisis? And finally, how can – in practical terms – we get rid of the Too Big to Fails without increasing state intervention further?

Believers in free market capitalism now face many such questions – philosophical, legal, regulatory and financial. That is why this publication is only a first step towards redefining Conservative economic policy.

It is also an invitation to those who support the free market to help the Centre for Policy Studies in the hard work ahead: to develop policies that will allow free competition and enterprise to flourish, policies which will prevent overwhelming market concentration and which will end "Too Big To Fail" and state monopoly capitalism.

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October 2009

I

For conservatives, the financial crisis that began in the summer of 2007 has posed a major problem. We had grown rather accustomed to singing the praises of free financial markets and the institutions that flourish in them. The crisis threatens to discredit the very idea of capitalism – even to vindicate the old Marxists who, we had assumed, were about to fade into extinction. It is therefore vital that we understand the true character of the crisis, and do not fall into the trap of accepting that it was the result of deregulation and market failure.

In reality, this was a crisis born of a highly distorted financial market, in which excessive concentration, excessive leverage, spurious theories of risk management and, above all, moral hazard in the form of implicit state guarantees, combined to create huge ticking time-bombs on both sides of the Atlantic. Unanticipated losses on US subprime mortgages were merely the catalyst for an implosion that was bound to come sooner or later. The greatest danger we currently face is that the emergency measures adopted to remedy the crisis have made matters even worse by increasing concentration, scarcely

reducing leverage, leaving the spurious theories in place and making the state guarantees explicit.

It has often been said since the crisis began that an institution that is "too big to fail" (TBTF) is too big to exist.[1] I agree. The question is how we can best get rid of the "TBTFs" without increasing the power of government in the economy still further. This should be among the first priorities of an incoming Conservative Chancellor of the Exchequer, or indeed any western leader committed to free market principles.

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1 Simon Johnson, "The Quiet Coup", *Atlantic Monthly*, May 2009.

II

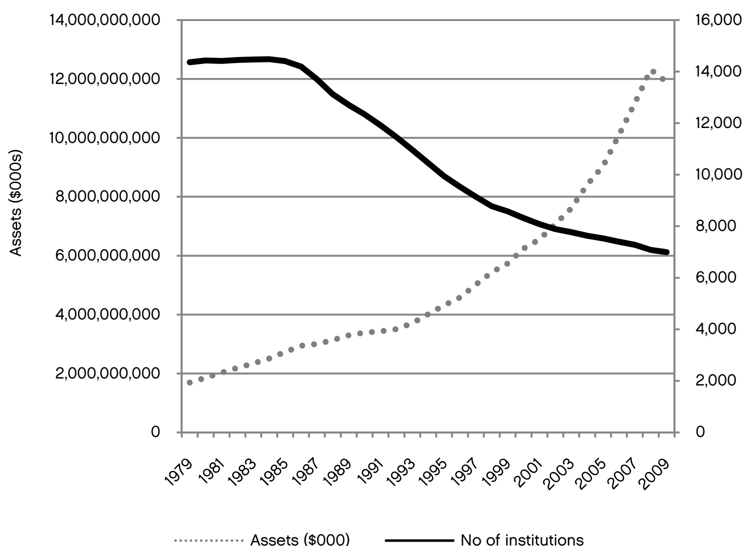
It was almost exactly 11 years ago that the Federal Reserve Board approved Travelers' takeover of Citibank. Slightly more than a year later, on 4 November 1999, both Houses of Congress retrospectively legalized the creation of "Citicorp" by repealing the Glass-Steagall Act, passed during the Great Depression to separate commercial and investment banking. It has been suggested that this legislative change paved the way for the financial crisis that began two years ago and reached its nadir in the months following the bankruptcy of Lehman Brothers in September 2008. But in truth the repeal of Glass-Steagall merely facilitated a trend that can be dated back to the mid-1980s. It was a trend that was not confined to the US, but rather occurred in nearly all the major economies of the Western world. That trend was for certain financial institutions to get much too big.

The past two decades witnessed an unprecedented concentration in the traditionally fragmented US financial services sector. With the creation of behemoths like Citigroup and Bank of America, a few institutions came to control an astonishingly large proportion of commercial bank deposits and loans. These same institutions also became involved in asset

management, credit cards, insurance, leasing, mortgages, mutual funds, securities trading and underwriting. Between 1990 and 2008, the share of financial assets held by the ten largest US financial institutions rose from 10 per cent to 50 per cent, even as the number of banks fell from over 15,000 to around 8,000 (see figure 1).[2] With the exception of retail banking, concentration increased across the board: in mortgage origination, credit cards, corporate lending, custody banking and investment banking.[3]

Figure 1

The number and assets of US commercial banks, 1979-2009



Source: Federal Deposit Insurance Corporation.

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2 Henry Kaufman, *The Road to Financial Reformation: Warnings, Consequences, Reforms*, John Wiley & Sons, 2009.

3 Ingo Walter, *Mergers and Acquisitions in Banking and Finance: What Works, What Fails, and Why* (New York: Oxford University Press, 2004), p, 82.

But it was not only the scale and scope of financial institutions that changed. The growth of securitization of mortgages and other forms of consumer debt (pioneered by Salomon Brothers in the 1980s), the explosion of derivatives traded on exchanges or sold "over-the-counter", the doubling of turnover on the stock market and, above all, the vast increase of leverage on bank balance sheets – all these changes added to the concentration of the financial system, and thereby increased its vulnerability. Contrary to the self-serving cliché of the time, which maintained that risk was being optimally distributed to "those best able to bear it", risk was in fact being dangerously concentrated on (and off) the balance sheets of around 15 institutions.

By the end of 2007, these megabanks, with combined shareholder equity of $857 billion, had total assets of $13.6 trillion and off-balance-sheet commitments of $5.8 trillion – an aggregate leverage ratio of 23 to 1. They also had underwritten derivatives with a gross notional value of $216 trillion – more than a third of the total.

It is not convincing to blame "deregulation" for the crisis, though this has fast become the orthodox interpretation.[4] It was not the least regulated parts of the financial system – hedge funds and private equity partnerships – that proved to be the problem, but the most regulated: precisely these megabanks, not to forget the even more regulated mortgage market-makers, Fannie Mae and Freddie Mac. There are, after all, international rules governing bank capital adequacy. They are set out in the Basel I and Basel II accords and applied with varying degrees of rigour by a host of

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[4] For the best statement of this case, see David Moss, "An Ounce of Prevention: The Power of Public Risk Management in Stabilizing the Financial System", Harvard Business School Working Paper, 09-087 (2009).

national regulators. It was the Basel system of weighting assets by their supposed riskiness that permitted the Enronization of bank balance sheets, so that (for example) the ratio of Citigroup's tangible on- and off-balance-sheet assets to its common equity reached a staggering 56 to 1 at one point last year. It was also the Basel system that enshrined the credit rating agencies as semi-official arbiters of risk, despite the obvious incentive these agencies have to please the issuers of securities who pay their fees. Banks were encouraged by regulators to use credit ratings when calculating their capital requirements. The more assets could be rated AAA, the less capital they needed to hold. In January year the agencies had conferred triple-A ratings on more than 64,000 structured financial instruments, at a time when just 12 corporations qualified for that rating.

It was not so much deregulation that caused the crisis as excessive concentration, combined with regulatory capture or regulatory arbitrage as the big banks schmoozed their supposed supervisors or shopped around for the softest touch. This phenomenon was far from being a purely American phenomenon. On the contrary, precisely the same tendencies were in evidence in Europe. As is well known, British banking has long been more concentrated than US banking. There has never been an equivalent of Glass-Steagall to prevent the big "high street" banks from extending their operations beyond deposit-taking and loan-making. But the reforms of the City of London known as "Big Bang" created a wide range of new opportunities for big banks in the hitherto tightly regulated and institutionally fragmented stock market.

The rise of Royal Bank of Scotland to become at one time the world's largest financial institution in terms of assets epitomized the "supersize" mania that gripped British finance in recent years.

By the end of 2007, the RBS Group had assets of £1.9 trillion – a sum larger than the gross domestic product of the entire United Kingdom – and equity of just £91 billion, implying a leverage ratio of 21:1.[5] The merger of the Halifax with RBS's traditional rival, Bank of Scotland, was another sign of the bloated times. Between 1989 and 2003 there was a clear trend towards financial sector concentration, by almost any measure, including the widely used Herfindahl-Hirschman Index (HHI).[6] By 2003 the five largest banking groups in the UK accounted for 71 per cent of deposits and 75 per cent of loans. The HHI for deposit concentration rose markedly in 1995 and 2000-1.[7]

Yet it was not only in the English-speaking world that outsized institutions came to the fore in the years before 2007. To be sure, the German banking system remains relatively decentralized. HHI scores for 2005 were even lower for Austria, Spain and Italy. But other continental countries – notably Belgium, Denmark, Finland, the Netherlands and Sweden – have an even greater banking concentration than the UK.[8] And all the

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5 John Lanchester, "It's Finished", *London Review of Books*, 28 May 2009.

6 The HHI is the sum of banks' squared market shares (whether of deposits, assets or capital). The higher the value the greater the concentration. Typically it lies between a notional minimum of zero and a notional maximum of 10,000.

7 Andrew Logan, "Banking Concentration in the UK", *Bank of England Financial Stability Review*, June 2004, pp. 129-135.

8 Donato Masciandaro, *Handbook of Central Banking and Financial Authorities in Europe: New Architectures in the Supervision of Financial Markets*, Edward Elgar, 2005, pp. 320f. See also Walter, *Mergers and Acquisitions*, p. 78.

major continental economies saw significant increases in concentration after 1997.[9]

Concentration is, of course, not unique to financial services. There are many countries in which other economic sectors are more concentrated.[10] By the standards of the Office of Fair Trading, the HHI score for UK banks is not exceptionally high; adjusted for the impact of building society de-mutualizations, it was still only around 1,600 in 2003, whereas 1,800 is regarded by the OFT as the threshold above which a sector is defined as "highly concentrated".[11]

Nor is it self-evident that even a highly concentrated banking system is likely to be a source of economic instability. The empirical evidence on this score is ambiguous. Canada has a far more concentrated banking sector than the US. Yet Canada's banks have been among the world's least troubled and troublesome in the past two years. One study using data from 79 countries over the period 1980-1997 concluded that crises were *less* likely in more concentrated banking systems.[12] Since many of the countries in the sample were less developed economies with primitive banking systems, the result seems of limited value, however. A more recent analysis of the European

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9 Andrea Cipollini and Franco Fiordelisi, "The Impact of Bank Concentration on Financial Distress: The Case of the European Banking System", Working paper, October 2008.

10 William J Baumol and Alan S Blinder, *Economics: Principles and Policy*, Cengage Learning, 2008, pp. 269f.

11 Logan, "Banking Concentration", p. 133.

12 Thorsten Beck, Asli Demirguc-Kunt and Ross Levine, "Bank Concentration and Crises", Working paper, January 2003.

experience between 1997 and 2005 shows that concentration in the commercial banking sector increases the probability of financial distress.[13]

The best explanation for this is that concentration in banking in most developed economies – including Canada – has not gone so far as to eliminate competition. On the contrary, banking remains a highly competitive business. Indeed, it was precisely this competition that encouraged bank executives aggressively to pursue economies of scale, to increase leverage (see figure 2) and to take on increasingly risky positions. To some extent, the excessive risks taken in the period leading up to 2007 can be blamed on defective mathematical models of risk assessment such as those based on the concept of "Value at Risk" (VaR). As the experience of Lehman Brothers in 2007 and 2008 made abundantly clear, things can go much more wrong than these models predict.[14] However, another explanation is that big financial institutions had reason to believe they enjoy a privileged and in some measure protected position.

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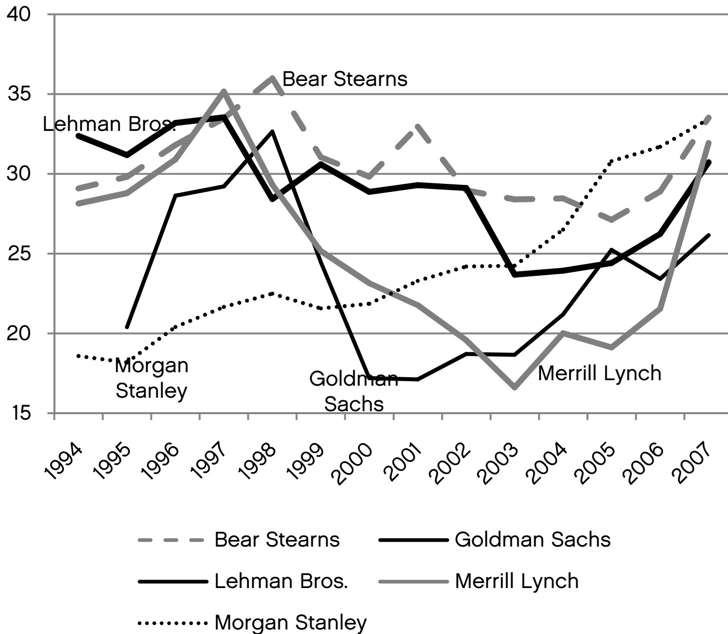
[13] Cipollini and Fiordelisi, "The Impact of Bank Concentration".

[14] Pablio Triana, *Lecturing Birds on Flying: Can Mathematical Theories Destroy the Financial Markets?*, John Wiley & Sons, 2009.

Figure 2



Sources:

1993-2002: Bob Lockner, Chapman and Cutler LLP, private communication, 10 March 2009;

2003-07: http://en.wikipedia.org/wiki/File:Source__Data__-__Leverage__Ratios.png

Economic theory since the time of Milton Friedman, if not Walter Bagehot, has held that bank failures pose a "systemic" economic risk, because failed banks are associated with monetary contractions and financing difficulties for the economy as a whole. There is therefore a presumption that, if big banks are threatened with liquidity or solvency problems, they should be bailed out in some way by the action of the central bank or government. Despite much pious talk of "moral hazard" prior to 2007, little was done to disabuse big financial institutions of this notion. They could and did assume that they enjoyed an implicit government guarantee.

III

The crisis that began with defaults in the US subprime mortgage market implied calamity for virtually all the big financial institutions on both sides of the Atlantic. This was for three reasons. First, the liabilities side of their balance sheet was highly vulnerable to a liquidity crisis. When the market for inter-banking lending and commercial paper essentially froze in mid-2007 and again in September-October 2008, the most highly leveraged, least reputable firms struggled to roll over their short-term debt. Secondly, at the same time, the big banks' large proprietary holdings of mortgage-backed securities and collateralized debt obligations were collapsing in value as US house prices fell steeply. Thirdly, the banks began to lose faith in the insurance-like instruments they had bought to protect themselves against a financial crisis, such as credit default swaps. "Counter-party risk" was a euphemism for the fact that, without massive government aid, they might all go down together.

To an extent that is truly astonishing, the greater part of the losses suffered by financial institutions over the past two years were due to grotesque miscalculations by the biggest banks. In

the US, 80 per cent of losses were accounted for by just ten institutions. The equivalent figure for the top ten losers in Europe was 60 per cent. In view of the magnitude of the losses suffered since the financial crisis began – an estimated $626 billion in the US and $456 billion in Europe (including the UK) – the culpability of the biggest institutions is great indeed. Governments on both sides of the Atlantic have so far committed $361 billion to recapitalizing the Western banking system. Yet there are more losses still to come: perhaps as much as $323 billion. At this rate, total financial losses could approach $1 trillion, with around 20 institutions responsible for around three-quarters of the damage.[15] By the end of 2008 the US government alone had been forced to make a total potential commitment to the financial system of nearly $11 trillion.[16]

Beginning with the British Government's takeover of Northern Rock in 2007 and culminating in the US Government's vast injections of capital into AIG, Citigroup and other institutions, the Western world has witnessed a succession of government interventions in the banking system unprecedented other than in time of war. These measures can be justified on the ground that without them there would have been a banking crisis comparable with that of 1931, which did as much as the 1929 stock market crash to plunge the world into a Great Depression. In many ways, central bankers and finance ministers have done exactly what Milton Friedman would have recommended: they

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15 Bruce Steinberg, Phil Dobrin and Karen Karniol-Tambour, "A Scan Through the European Banking Picture", *Bridgewater Daily Observations*, 14 September 2009.

16 Moss, "Ounce of Prevention", p. 6.

have injected liquidity with every conceivable means to prevent a chain reaction of bank failures and monetary contraction.

But there is a danger that justified emergency measures give rise to unjustifiable permanent conditions. It is far from clear that it is time to start discussing an “exit strategy” in terms of macroeconomic stimulus. It is certainly high time we started discussing an exit strategy from state monopoly capitalism.

IV

The sequence of events described above provided a belated vindication for one of the central tenets of Marxism-Leninism. It was the German Social Democrat theorist Rudolf Hilferding whose 1910 book *Finanzkapital* predicted that increasing concentration of financial capital would lead ultimately to crisis, followed by the socialization of the banking system. The idea appealed to Lenin, who recycled it in his *Imperialism: The Highest Stage of Capitalism*. Here is how Lenin put it:[17]

> As banking develops and becomes concentrated in a small number of establishments, the banks grow from modest middlemen into powerful monopolies having at their command almost the whole of the money capital of all the capitalists and small businessmen and also the larger part of the means of production and sources of raw materials in any one country and in a number of countries. This transformation of numerous modest middlemen into

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[17] V.I. Lenin, *Imperialism, the Highest Stage of Capitalism,* 1963 [1917], ch. 2.

> a handful of monopolists is one of the fundamental processes in the growth of capitalism into capitalist imperialism. … Scattered capitalists are transformed into a single collective capitalist. … banks greatly intensify and accelerate the process of concentration of capital and the formation of monopolies in all capitalist countries, notwithstanding all the differences in their banking laws. …
>
> In other words, the old capitalism, the capitalism of free competition … is passing away. A new capitalism has come to take its place, bearing obvious features of something transient, a mixture of free competition and monopoly. The question naturally arises: into what is this new capitalism "developing"?

The answer, Lenin argued, was that a "financial oligarchy" was becoming increasingly powerful not only economically but also politically, establishing "a close network of dependence relationships over all the economic and political institutions of present-day bourgeois society without exception" and promoting foreign policies based on imperialism – the export of finance capital to the less developed world.[18] However, this concentration of power was merely the prelude to that takeover of capitalism by the state which Lenin believed would be the next stage of the historical process. Later East German authorities would coin the phrase "State Monopoly Capitalism"

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[18] Ibid., conclusion.

(*Stamokap* for short) to describe this way-station on the road to "real existing socialism".

It is not often that I quote Lenin approvingly. But one of the lessons of the recent – and in my view continuing – financial crisis is that not everything the Marxists said was wrong, even if the normative conclusions they draw from their observations certainly were. As a believer in what Lenin disapprovingly called "the capitalism of free competition", I regard the emergence of excessively large, government-guaranteed financial conglomerates in a very different light – not as a prelude to socialism but as a massive distortion of the market, similar to that which Adam Smith deplored when he considered the role of quasi-governmental monopolies like the East India Company in his own time. But I wholly share Lenin's view that the rise to power of a financial oligarchy is undesirable and should be as far as possible a transient phenomenon. The question is how we can extricate ourselves from *Stamokap* and return to the capitalism of free competition. It will not be easy.

V

The crisis has made the problem of excessive concentration worse in two ways. First, it wiped out three of the biggest US banks – Bear, Merrill, and Lehman – while at the same time condemning more than 140 (and still counting) smaller regional and local banks to oblivion. Secondly, because the failure of Lehman was so economically disastrous, it established what had previously only been suspected – that the survivors were Too Big To Fail and were effectively guaranteed by the full faith and credit of the US. In other words, it became official: heads, they win; tails, taxpayers lose. And in return, taxpayers – in their capacity as bank customers – get a $30 charge if they inadvertently run up a $1 overdraft with their debit card. Meanwhile, JP Morgan and Goldman Sachs executives get million-dollar bonuses.

That glaring injustice is a consequence of policy. The money available to big banks from the Federal Reserve is virtually free. The spreads on most forms of lending are therefore well above average. Meanwhile, having been branded TBTF, the big banks can afford to take on even more risk than in the past. In the second quarter of this year, according to Value at Risk measures (for what little they are worth), the top five US banks stood to lose

up to $1 billion on an average day in the second quarter – an 18 per cent increase in VaR compared with the same period last year and a 75 per cent increase on the first half of 2007.[19] In rallying financial markets – such as we have seen since March – higher risk translates into higher reward: hence the large second-quarter profits reported by a number of big banks, most of which was derived from proprietary trading, rather than providing financial services to customers.

The lesson has apparently not been learned that VaR is a highly unreliable measure of risk. But why worry? None of the survivors is going to go the way of Lehman. The system, in other words, is more unstable than ever. This is moral hazard run mad – a system in which a few giant banks get to operate as hedge funds with a government guarantee that if they blow up, their losses will be socialized.

Few of the regulatory reforms proposed so far do anything to address the central problem of the TBTFs. Consider the proposals outlined by Treasury Secretary Timothy Geithner in the summer:

- The Federal Reserve should become the "system risk regulator" with power over certain institutions identified as "systemically important", a.k.a. TBTFs. But wasn't it that already?

- The originators of securitized products should be required to retain "skin in the game" (5 per cent of the securities they sell). What, like Bear and Lehman did?

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19 David Enrich and Damian Paletta, "Finance Overhaul Falters as '08 Shock Fades", *Wall Street Journal*, 9 September 2009.

- There should be a new Consumer Financial Protection Agency. So what were the other regulatory agencies doing? Presumably protecting the TBTFs.

- There should be a new "resolution authority" for the swift closing down of big banks that fail. But such an authority already exists and was used when Continental Illinois failed in 1984.

- And "federal regulators should issue standards and guidelines to better align executive compensation practices of financial firms with long-term shareholder value." It is hard to believe that a better system could be devised to achieve such an alignment than the system of compensating executives with shares or options to buy shares in their own companies. Yet not even the ownership of $1 billion of Lehman Brothers' stock deterred Dick Fuld from blowing up his own firm.

Among many omissions, it was especially striking that these proposals made no mention of the egregious role of the ratings agencies in supplying the banks with bogus AAA-rated securities.

Admittedly, Secretary Geithner went several steps further in his Congressional testimony of 23 September:

- There will be a new National Bank Supervisor, merging the Office of the Comptroller of the Currency and the Office of Thrift Supervision. However, it appears that responsibility for regulating the TBTFs will lie elsewhere, by implication with the Federal Reserve or the Treasury, the institutions that have dominated the government response to the financial crisis.

- The administration intends to "tighten constraints on leverage … by requiring that all financial firms hold higher

capital and liquidity buffers". But TBTFs will be asked to do more, in at least two respects:

- First, following a suggestion by the Governor of the Bank of England,[20] they will be asked to prepare "living wills" – plans for how they should be "dismantled in case of failure … in a way that protects taxpayers and the broader economy while ensuring that losses are borne by creditors and other stakeholders". These plans will be subject to "careful evaluation … on an ongoing basis" by "supervisors".
- Secondly, they will also be subject to "very strong government oversight" in the form of a "common framework of supervision and regulation". The "tough rules" would include not only the aforementioned increases in capital but also a "comprehensive regulation" of the over-the-counter derivative markets to encourage the use of exchanges.

Are these measures sufficient? Britain's Labour Government apparently thinks they go too far. Speaking in the House of Commons on 8 July, the Chancellor of the Exchequer declared that he feared:[21]

> ...the consequences of telling a large bank that it is too big. In response to that, the bank might say, 'We're too big, so we'll go somewhere else.'

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[20] Mervyn King, "Blaming Individuals is No Substitute for Acknowledging the Failure of a System", *Financial Times*, 17 June 2009.

[21] www.parliament.the-stationery-office.co.uk/pa/cm200809/cmhansrd/cm090708/debtext/90708-0005.htm.

Although prepared to countenance tighter regulation for big financial institutions, the Government made it clear in its White Paper of the same date that it was "not persuaded that artificial limits should be placed on firms to restrict their size or complexity".[22]

By contrast, some continental European governments, notably the French and the German, would like to go further than the Geithner proposals. In particular, the egalitarian-minded continentals are itching to impose some kind of international cap on bankers' compensation. Another idea, floated by the head of the UK Financial Services Authority, Lord Turner, is to levy a low but pervasive tax on all financial transactions (sometimes known as a "Tobin tax"), a little like the stamp duty paid when a house changes hands, though at a much lower rate. This too has won French and German support. (Earlier this year, Lord Turner produced a much better set of proposals for regulatory reform that focused on reducing bank leverage as well as varying rules on bank capital adequacy to make them counter-cyclical rather than pro-cyclical.)[23] Then there are those traditionalists like Henry Kaufman and (by implication) Paul Volcker who would like to see a return to the separation of commercial banking and investment banking along the lines of Glass-Steagall.[24] A case could also be made for tightening anti-trust rules for the financial services sector, on the ground that the degree of concentration that has

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22 www.hm-treasury.gov.uk/d/reforming__financial__markets080709.pdf, p. 69.

23 Financial Services Authority, *The Turner Review: A Regulatory Response to the Global Banking Crisis*, March 2009.

24 Paul A Volcker, "Statement before the Committee on Banking and Financial Services of the House of Representatives", 24 September, 2009.

been attained in the banking system is inimical to financial stability, if not to competition. This is roughly the position of the EU Commissioner Neelie Kroes. Finally, a few economists on both sides of the Atlantic have begun arguing for "narrow" or "limited purpose" banking, which would limit the ability of deposit-taking institutions to engage in risky business.[25]

All of this is manna from heaven for policy wonks. There is, however, a danger that the essential goal – the euthanasia of the TBTFs – will vanish from sight as the number of proposals increases. So let us dismiss the various red herrings:

- The headline-grabbing compensation issue, it should be noted, is the reddest of the lot. Politicians like to focus on bankers' bonuses, because everyone can be shocked by the fact that Lloyd Blankfein, the Goldman CEO, gets paid 2,000 times what Joe the Plumber gets. But that differential is a symptom, not a cause, of the deep-rooted problem. The TBTFs are able to pay big bonuses because they reap all the benefits of risk-taking without running the risk of going bust. (Ask yourself, how did Goldman make those handsome second-quarter profits of $3.4 billion? Answer: by taking on more risk.)

- Almost as red a herring is the Tobin tax. Raising transactions costs in the financial sector, even if there were a successful international agreement to do so in all markets, would help rather than hinder the TBTFs. It would be the biggest firms,

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[25] See for example Laurence J Kotlikoff and John C Goodman, "Solving Our Nation's Financial Crisis with Limited Purpose Banking", Boston University Working Paper, 15 April, 2009. See also John Kay, *Narrow Banking: The Reform of Banking Regulation*, Centre for the Study of Financial Innovation, 2009.

exploiting economies of scale, who could most easily cope with such a change.

- Also a herring, though more pink in hue, is Secretary Geithner's pledge to regulate the big banks more tightly at the level of the federal government. It is impossible to be impressed by such pledges when, as we have seen, it was the most regulated institutions in the financial system that were the most disaster-prone. It is more than a little convenient for America's political class to blame this financial crisis on deregulation and the resulting excesses of the free market. Not only does that neatly pass the buck. It also creates a justification for … more regulation. The old Latin question is apposite here: *quis custodiet ipsos custodes*? Who regulates the regulators? Until that question is answered, calls for more regulation are symptoms of the very disease they purport to cure.

- The most appealing fish on offer – but still a herring – is the idea of "narrow" banking. The problem with this is that it would turn the clock back not to the 1930s but to the 1650s – to the period before fractional reserve banking began to spread through the Western world. I remain unpersuaded that we need to jettison so much of what financial evolution has achieved over three and a half centuries, especially since two of the most systematically dangerous firms in the crisis were not deposit-taking institutions.

There is in fact one simple insight, buried in Secretary Geithner's testimony, upon which we need to build. Instead of trying to regulate each banker's compensation or to tax every dollar that moves in financial markets, governments merely need to clarify that public insurance applies only to bank deposits and that bank bondholders will no longer be protected, as they have been in this

crisis. In other words, when a bank goes bankrupt, the creditors should take the hit, not the taxpayers. This is in fact the key to Secretary Geithner's testimony. As he clearly understands, the real aim of government should be to give the TBTFs "positive incentives … to shrink and to reduce their leverage, complexity, and interconnectedness".[26] The best way of creating such incentives is to reiterate, preferably once a week, this key point: in case of failure, "the largest, most interconnected firms" should in future be wound up "in a way that protects taxpayers and the broader economy while ensuring that *losses are borne by creditors* and other stakeholders". That was the principle that was thrown overboard in the crisis, when it was decided to prevent the holders of bank bonds (apart from those of Lehman Brothers) from losing their money or even suffering a "haircut".

Increasing the big banks' cost of capital by removing their TBTF status would at a stroke undermine their *raison d'être*. We can already see how this would work. At the recent G20 finance ministers' meeting there was an unequivocal call for the big banks to raise more capital and become less leveraged, albeit "once recovery is assured", whenever that might be. Even this elicited protests from the bankers. Before the ink was dry on the G20 communiqué, JP Morgan published a report warning that proposed regulatory changes would reduce the profitability of the investment-banking operations of Deutsche Bank, Goldman, and Barclays by as much as a third. Such a reduction is in fact highly desirable.

There are of course various ways in which increasing the cost of capital might be achieved. David Moss has proposed having

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[26] Secretary Timothy F Geithner, "Written Testimony on Financial Regulatory Reform", House Financial Services Committee, 23 September 2009.

tighter capital adequacy, leverage and liquidity standards for systemically important firms, as well as making them pay insurance premiums against future federal bailouts. They might also be required to hold a significant proportion of their debt in the form of convertible instruments, which would switch from debt into equity in a serious financial crisis. The aim, as Moss rightly says, should be to "provide financial institutions with a strong incentive to avoid becoming systemically significant".[27]

In my view, the ideal must be to get rid of the TBTFs with less rather than more government intervention in the financial system. Explicit denial of future bailouts for bank bondholders ought to suffice, though Moss's penalties for TBTFs may be necessary to speed the process. The problem clearly remains that very large financial institutions can be very profitable for considerable periods of time before their risky strategies drive them into insolvency. Even after explicit changes to the rules, firms may be tempted to call the government's bluff, on the ground that posing a systemic risk should ensure a bailout. Despite being rivals, the TBTFs are also partners in crime, since the failure of one (as the case of Lehman made clear) threatens the survival of all.

Yet these are not arguments for fatalism. They are arguments for emphatic action. The economies of the developed world cannot be left at the mercy of a gang of super-sized, government-sponsored megabanks. During the crisis it was often said that officials at the Federal Reserve and Treasury would do "whatever it takes" to avoid a Great Depression. Now they must do whatever it takes to address one of the key causes of the financial crisis: the existence of financial

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[27] Moss, "Ounce of Prevention".

institutions that consider themselves too big to fail – but which are run in such a way that they are bound to do so. Such institutions not only pose a threat to the functioning of the free market system. By saddling taxpayers with mind-boggling bailout bills, they also pose a threat to its very legitimacy.

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