TOO BIG TO SAVE? HOW TO FIX THE U.S. FINANCIAL SYSTEM, Robert Pozen, John Wiley & Sons, Inc., 2009; ISBN: 978-0-470-49905-4, 480 pages.

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Since the unfolding of the subprime crisis close to three years ago, authors and publishers have worked hand in hand to produce a considerable amount of crisis literature. As compelling as those works can be, one that caught my attention was *Too Big to Save*, by Robert Pozen, chairman of MFS Investment Management—a mutual fund company—and senior lecturer at Harvard Business School. Writing with a clear focus and addressed to "intelligent readers" rather than financial experts, Pozen wasted no time in announcing that the financial crisis was a result of "powerful economic forces—such as low interest rate, excessive debt, and weak regulation" (p. xvi).

Organizing his book around three key questions about the financial crisis—how the U.S. got itself into trouble, examining the government response to the crisis, and suggestions on policy and regulatory reforms—Pozen makes it very clear that his book is not targeted towards readers who are seeking new information. Instead, what Pozen did was to bring together the innumerable amount of information that is widely available and to create a thorough analysis of the relevant materials. The end result, therefore, is a handbook of useful analysis of the crisis and practical policy recommendations from the author.

Key to this book is the recognition of how poor regulation played a part in this crisis. Pozen brings to our attention the fact that banks, albeit being important actors in the financial system, only supplied 22 percent of all credit in the United States. The majority of the subprime mortgages are in fact being issued by independent mortgage lenders and brokers, known as nonbank lenders. Although the licensing of the nonbank lenders was supposedly the states' responsibility, these nonbank lenders were "essentially unregulated until quite recently" (p. 16).

In Pozen's view, the role of credit rating agencies in this crisis deserves severe condemnation. As the credit rating agencies are paid by issuers to rate the securities, a fundamental conflict of interest appears: should the credit rating agencies award a high rating to an undeserved securities or risk losing the clients to a competitor? These credit rating agencies, under the given circumstances, begin to award top ratings to securities that were of poor quality. Unlike large investment banks and arms that have the ability to house their own financial analysts, most investors rely on and expect credit rating agencies to provide accurate ratings on investment products. The securities that first appear to be quality investment soon turned out to default at a fast pace. Although the SEC has taken measures to improve the regulatory lapse and reduce the conflict of interest that the credit-rating agencies face, Pozen feels that more could be done. Having investors pay for credit ratings is his first recommendation. But he acknowledges that it is impractical to implement such a radical approach, and instead, proposes that a neutral third party be given the task of choosing a rating agency and negotiating the fees for every bond offering.

According to Pozen, while the Basel I accord was supposed to be a model for the U.S. bank capital requirements, the accord itself was poorly designed. Rather than taking into account the actual risk of the assets while calculating capital requirement, Basel I assumes the same risk rating for any asset that falls within the broader category. Furthermore, instead of the normal 8 percent capital requirement of risk-weighted assets, banks were only required to adhere to a 4 percent capital requirement without even having to consider the risk level of the mortgage. The Basel II accord, currently in the works of being phased into practice, receives its fair share of criticism by Pozen as well. Because of the deficiency of the credit-rating agencies and the processes, Pozen argues that Basel II should be less dependent on the ratings of securities while calculating capital requirements.

Another criticism of Basel II was its heavy reliance on the internal risk models of banks. Pozen felt that banks risk model appears to be complex and subjective, and is also suspicious of the unrealistic assumptions made by them. Pozen proposes a middle ground between Basel I and Basel II; rely less on internal risk model and credit ratings, while creating a set of capital rules with subcategories having its own risk rating. Being procyclical, Basel II encourages banks to expand at a rapid pace during good times and requires them to face a fire sale to raise capital in bad times—creating a downward spiral in asset prices. A better approach, as raised by Pozen, would be to encourage banks to adopt counter-cyclical measures. To reduce excess leverage, Pozen calls for bank regulations to increase capital requirements in good times to allow for sufficient loss allowances in bad times — a rather Minskian idea. Acknowledging two decades ago that the authorities can never beat the financial institutions at their game, Hyman P. Minsky had a similar idea in mind: "keep the asset-equity ratio of banks within bounds by setting equity-absorption ratios for various types of assets. If the authorities constrain banks and are aware of the activities of fringe banks and other financial institutions, they are in a better position to attenuate the disruptive expansionary tendencies of our economy" (Minsky 1986, 281).

Moving on to address a current theme that is still widely debated in congress today, Pozen states his opinion: "The Glass Steagall Act was at most a minor factor contributing to the current financial crisis" (p. 151). Pozen argues that reinstating the Glass Steagall Act would result in greater systemic risk, because a universal bank with traditional banking facilities and securities activities is less prone to failure than a stand-alone investment bank. Rather, Pozen is in favor of the current universal banking model in the U.S., but points to the effective regulatory constraints in Canada as the ideal example.

In a rebuttal against critics of nationalization, Pozen criticizes the federal government's "exceptional-assistance model" provided to Bank of America and Citigroup. Pozen claims that this model gives taxpayers full exposure to huge loses of the bank's downside but little benefit of the bank's reverse in fortune if it becomes profitable. The majority-ownership model, which would allow the Treasury to own not more than 80 percent of common shares, would be a more viable option for the benefit of taxpayers.

Restating his stand through the book, Pozen realizes that it is not logical to retain a competitive financial sector after breaking up existing large banks into smaller banks. He comes to a middle ground solution, however, with his justification and calls for the rejection of the creation of large banks or further expansion of an existing one; he feels that the financial system is already being dominated by only a handful of large banks and should never be allowed to get even more concentrated at the top.

As the title of the book suggests, Pozen tells us that there are only two valid justifications for the federal government to initiate a bail-out. First, the government should only protect a core group of payment processors such that the key functions of the banking system would not be disrupted in any event. Second, only banks that are too interconnected to fail should be a candidate for bail out by the government. In making this claim, Pozen argues that the case for bailing out life insurers other than A.I.G., and credit card companies such as American Express and Discover Financial was not justified.

Providing a recommendation for the reform of the boards of banks, Pozen proposes the adoption of the private equity fund board model. Instead of having close to 20 directors, Pozen feels that a board that consists of five or six directors with "extensive expertise in the relevant industry" would function more effectively (p. 387). Also, given that directors in the private equity fund board model receive most of their compensation in the form of stock grants, they would be more diligent in their roles and be more concerned with the companies' activities. However, such a model of board of directors focused on "maximizing long-term profits for its shareholders without taking risks that would materially jeopardize the bank's solvency" seems too good to be true (p. 391).

In his closing chapter, Robert Pozen acknowledges that "there are limits to the effectiveness of any federal regulator in light of the fast pace of financial innovation and complexity of financial transactions." *Too Big to Save* presents a thorough and thoughtful explanation, the causes, and recommendations with regards to the current crisis to the general public. The book, however, becomes even more effective when one has some knowledge about the crisis, and more importantly, interest in finding out what lies ahead for the future of the financial system. But as Minsky warned us before, "After an initial interval, the basic disequilibrating tendencies of capitalist finance will once again push the financial structure to the brink of fragility. When that occurs, a new era of reform will be needed. There is no possibility that we can ever set things right once and for all; instability, put to rest by one set of reforms will, after time, emerge in a new guise" (Minsky 1986, 370). For now, this book is definitely a worthy read for heterodox economists, students, and policymakers.

## *References*

Minsky, Hyman P. 1986. *Stabilizing an Unstable Economy.* USA: McGraw-Hill, 2008.