EXAMINING HOW THE DODD-FRANK ACT COULD RESULT IN MORE TAXPAYER-FUNDED BAILOUTS

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EXAMINING HOW THE DODD-FRANK ACT COULD RESULT IN MORE TAXPAYER-FUNDED BAILOUTS

Wednesday, June 26, 2013

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10:04 a.m., in room 2128, Rayburn House Office Building, Hon. Jeb Hensarling [chairman of the committee] presiding.

Members present: Representatives Hensarling, Bachus, Royce, Capito, Garrett, McHenry, Campbell, Bachmann, Pearce, Posey, Westmoreland, Luetkemeyer, Huizenga, Duffy, Hurt, Grimm, Stivers, Stutzman, Mulvaney, Hultgren, Ross, Pittenger, Wagner, Barr, Cotton, Rothfus; Waters, Maloney, Meeks, Capuano, Hinojosa, Clay, Lynch, Scott, Green, Cleaver, Moore, Perlmutter, Himes, Carney, Sewell, Foster, Kildee, Sinema, Beatty, and Heck.

Chairman HENSARLING. The committee will come to order. Without objection, the Chair is authorized to declare a recess of the committee at any time. The Chair now recognizes himself for 5 minutes for an opening statement.

Not long after the financial crisis arose in 2008, we heard the cry, "Occupy Wall Street." Most Americans have never wanted to occupy Wall Street; they just want to quit bailing it out. Today, though, there is a growing bipartisan consensus that the Dodd-Frank Act, regrettably, did not end the too-big-to-fail phenomena or its consequent bailouts. Thus, we have much work ahead of us. I want to thank Chairman McHenry and the members of the Oversight and Investigations Subcommittee for their work so far on this subject.

Ending taxpayer-funded bailouts is one of the reasons why this committee has invested so much time on sustainable housing reform. The GSEs, Fannie Mae and Freddie Mac, are the original too-big-to-fail poster children, yet were untouched and unreformed in Dodd-Frank. They have received the largest taxpayer bailout ever, nearly $200 billion, and along with the FHA, the government now controls more than 90 percent of our Nation's mortgage finance market with no end in sight.

One of the most important steps we can take in ending too-big-to-fail institutions is to remove the permanent taxpayer-backed government guarantee of Fannie and Freddie. For far too long, Fannie and Freddie have been where Wall Street and foreign banks go to offload their financial risk on Main Street taxpayers.

This must stop, and soon it will as part of our committee's sustainable housing legislation: sustainable for homeowners so they can have the opportunity to buy homes they can actually afford to keep; sustainable for taxpayers so they are never again forced to fund another Washington bailout; and sustainable for our Nation's economy so we avoid the boom-bust housing cycles that have hurt so many in the past.

Regrettably, Dodd-Frank not only fails to end too-big-to-fail and its attendant taxpayer bailouts; it actually codifies them into law. Title I, Section 113 allows the Federal Government to actually designate too-big-to-fail firms, also known as Systemically Important Financial Institutions (SIFIs). In turn, Title II, Section 210, notwithstanding its ex post funding language, clearly creates a taxpayer-funded bailout system that the CBO estimates will cost taxpayers over $20 billion.

Designating any firm as too-big-to-fail is bad policy and worse economics. It causes the erosion of market discipline and risks further bailouts paid in full by hard-working Americans. It also becomes a self-fulfilling prophecy, helping make firms bigger and riskier than they would be otherwise. Since the passage of Dodd-Frank, the big financial institutions have gotten bigger, the small financial institutions have become fewer, the taxpayer has become poorer, and credit allocation has become more political.

Even if some conclude that certain financial firms are indeed too-big-to-fail, and I am not in that camp, it begs the question of whether Washington is even competent to manage their risk or whether the American people, in light of the recent revelations about the IRS and the DOJ, can trust Washington to do so.

A review of the Federal Government's risk-management record does not inspire confidence. The Federal Housing Administration's poor risk management has left it severely undercapitalized. The Pension Benefit Guaranty Corp has an unfunded obligation of $34 billion. Even the National Flood Insurance Program is $24 billion underwater—yes, pun intended. And, of course, regulators encourage banks to load up on sovereign debt and agency MBS by requiring little or no capital to be reserved against them. Think Greek debt and Fannie and Freddie.

We should recall it was the government's misguided and risky affordable housing mandate that principally loosened prudent underwriting standards in the first place. Government not only did not mitigate the risk; it created the risk.

We have to keep our focus on the right questions if we are to achieve the right solutions. As a society, what are we willing to pay for stability? Are we trading long-term instability for moral hazard and short-term stability? Why should the government have to protect Wall Street firms from taking losses? Do we really want a Solyndra-like economy in which risk management is guided more by government politics than market economics and taxpayers are left to hold the bag? And perhaps more fundamentally, don't we want financial firms to take risk? In the not-too-distant past, one of the large investment banks took a risk on Apple when it was floundering. Now Apple is one of the most valuable companies in the world and its products have revolutionized our lives and our economy.

Without financial risk, we lose out on innovation. Under too-big-to-fail, we also risk encouraging irresponsibility and moral hazard. Bailouts beget bailouts. And the most fundamental issue is this: If we lose our ability to fail in America, then one day we may just lose our ability to succeed. That is what this debate should really be about.

I now recognize the ranking member for 5 minutes for an opening statement.

Ms. WATERS. Thank you, Mr. Chairman. I welcome today's hearing as an opportunity to examine Titles I and II of Dodd-Frank and assess whether these provisions will achieve their intended goals of protecting taxpayers and preserving financial stability. I want to thank our esteemed panel of witnesses for joining us today, and I look forward to their insight and testimony on these critical issues.

While there has been significant public debate regarding Wall Street reform, I have found that not enough attention has been paid to the actual legislative text. I believe the law may provide answers to many of our questions today, which is why I would encourage my colleagues to read the law.

Title I of Dodd-Frank established the Financial Stability Oversight Council (FSOC), and the Office of Financial Research (OFR), to monitor systemic risk and potential threats to financial stability. Title I also gives Federal regulators enhanced prudential authorities over systemically significant financial institutions and requires these firms to submit credible resolution plans, known as living wills.

The living wills are intended to reveal weaknesses and complexities, as well as provide a roadmap for how these institutions may be orderly liquidated. The law requires firms to pursue bankruptcy as a first resort. However, if bankruptcy compromises financial stability, the statute authorizes regulators to use an alternative tool for resolving systemically complex firms.

Title II of Dodd-Frank created the Orderly Liquidation Authority (OLA). According to Section 204 of Title II, the purpose of the Orderly Liquidation Authority is to provide banking regulators with the necessary authority to liquidate failing financial companies which pose a significant risk to the financial stability of the United States in a manner that mitigates such risks and minimizes moral hazard.

Moreover, Title II, Section 214, of Dodd-Frank provides that all financial companies placed into receivership under this Title shall be liquidated. No taxpayer funds shall be used to prevent the liquidation of any financial company. The law also requires that any funds expended in the liquidation of a financial firm must be recovered through assessments on the financial sector.

Title XI, Section 1101, repeals the financing mechanisms the Federal Reserve used to bail out financial institutions in 2008. The law mandates that any new Federal Reserve policies governing emergency lending serve the purpose of providing liquidity to the financial system, not one failing firm in particular, and that such policies must protect taxpayers from losses.

Repealing Title II of the Dodd-Frank Act will make the financial system less stable and invite the chaos of the 2008 crisis on our current recovery and would be a huge step in the wrong direction if it will not make megabanks any less large or any less complex. In fact, repealing Title II would take us back to the status quo use of the Bankruptcy Code, which would put taxpayers and the financial system at risk.

My colleagues and I are going to use today's hearing as an opportunity to incorporate the relevant provisions of Titles I and II outlining regulators' new systemic risk and resolution authorities. Each of us will focus on a particular section of the law, explain what the provisions of the law authorize, and at times we will ask witnesses to expound on any ambiguity concerning how regulators may interpret their enumerated authorities. It is my hope that this will facilitate a rational discussion of important issues based on actual provisions within the law.

Mr. Chairman, I yield back the balance of my time.

Chairman HENSARLING. The gentlelady yields back.

The Chair now recognizes the gentleman from North Carolina, Mr. McHenry, the chairman of the Oversight and Investigations Subcommittee, for 3 minutes.

Mr. MCHENRY. Thank you, Mr. Chairman. And I want to thank our panel for being here today.

Two-and-a-half years ago, President Obama, when he signed the Dodd-Frank Act, said that this would end too-big-to-fail. Across the ideological spectrum we hear debate, but greater consensus on the side that Dodd-Frank did not end too-big-to-fail. I appreciate the ranking member's opening statement, and in fact in the Oversight Subcommittee, which I chair, we have gone section by section in the text of Dodd-Frank and we have heard from a variety of witnesses over the previous few months that Dodd-Frank does not end too-big-to-fail, and systemically we went through those section by sections of Dodd-Frank. This is very important.

From these hearings we identified, among other things, the shocking inability of the Financial Stability Oversight Council to perform one of its core functions: identifying new risks to the economy. We have learned that nearly 3 years after enactment of Dodd-Frank, the Federal Reserve has not considered nor made public how it will apply its broad new authorities to prevent future financial crises.

We have heard from legal scholars and economic experts on Dodd-Frank's new resolution authority, the Orderly Liquidation Authority, and what it will mean in future bailouts as the bailout mechanism when the taxpayer will provide liquidity to these failed firms. The subcommittee learned that far from creating greater clarity and certainty in the marketplace, the Dodd-Frank law simply granted an incredible amount of power and discretion to Federal regulators to enshrine future taxpayer bailouts for specially designated large institutions. Now, that designation we have had a lot of discussion about, as well.

Finally we heard testimony, shockingly, from the Justice Department regarding their obvious reluctance to prosecute large financial institutions, which may be the best evidence yet that this Administration doesn't even believe that the Dodd-Frank Act ends too-big-to-fail.

The fact is that Dodd-Frank did not end too-big-to-fail; it guaranteed it. Instead of making it implicit, it now has made it explicit.

That is a problem and we need to address it. And the message that it has sent to the marketplace has created a perverse incentive to the creditors of the largest financial firms. Now, this undermines the taxpayer, it undermines small financial institutions, and it undermines a truly competitive and fair marketplace. Too-big-to-fail must end, and that is what we must begin to discuss in this hearing.

Thanks so much, Mr. Chairman.

Chairman HENSARLING. The Chair now recognizes the gentlelady from New York, Mrs. Maloney, for 2 minutes.

Mrs. MALONEY. Thank you, and welcome to the panelists.

In 2008, when a large financial institution was on the verge of failing, regulators had two options. They could allow it to fail and go into bankruptcy, as Lehman did, or they could bail it out, as we did with AIG. Neither was a good option.

Dodd-Frank gave regulators a third option by creating an orderly liquidation process for large financial companies. This gives regulators the tools to successfully wind down large financial companies similar to the FDIC's longstanding practice of winding down failed commercial banks that worked so well during the crisis.

Now, some of my colleagues say that we should just have bankruptcy, just let them fail. But we tried that. That is what we did with Lehman, and look at the results. We got a massive crisis and failure in the financial system, a massive financial crisis. This is not an acceptable solution.

Economist Alan Blinder in his book says that too-big-to-fail should be called too-big-to-fail messily, that we have to have a process to orderly, in an organized way, wind down large institutions, to put foam on the runway, and to orderly wind them down. It could not be clearer. In Section 214, it says that there is a prohibition of any taxpayer funds: "No taxpayer funds shall be used to prevent the liquidation of any financial company under this title." It could not be clearer. It is against the law to use any taxpayer money to fund any bailout.

But Dodd-Frank gave us a third option. Under Title II, which was largely written by Sheila Bair, and she can talk about it, we can now wind them down. And under Title II there was enhanced supervision calling for greater capital requirements, stress tests, living wills, and other tools to manage the wind-down of failed institutions.

I yield back.

Chairman HENSARLING. The Chair now recognizes the gentleman from New Jersey, Mr. Garrett, for 1 minute.

Mr. GARRETT. Thank you.

There is an old saying that you can't have your cake and eat it too, but, unfortunately, that is exactly what the other side of the aisle is trying to do. You can't, on the one hand, say that banks are no longer too-big-to-fail, and then, on the other hand, bemoan the fact that they still are whenever one of them has a significant trading loss.

You can't, on the one hand, say that there is an appropriate resolution process that allows these banks to be wound down without taxpayer support, but then, on the other hand, tell those same banks exactly how they are to run their business because you are worried about their systemic risk and the costs to U.S. taxpayers.

You can't, on the one hand, also say that you have eliminated too-big-to-fail, and then, on the other hand, specifically designate companies as too-big-to-fail and give them new access to the Fed's discount window.

Unfortunately, Dodd-Frank continued the long-term goal of many to essentially turn the banks into utilities backed by the government that regulators can control and use to fund the government and allocate resources to their favorite constituencies.

We must finally reform the system to restore market discipline to our financial system, and this means ensuring that we have a credible resolution process, free of picking winners and losers.

Chairman HENSARLING. Apparently, the gentleman is done.

The Chair now recognizes the gentleman from New York, Mr. Meeks, for 2 minutes.

Mr. MEEKS. Thank you, Mr. Chairman. I appreciate that today's hearing has provided an opportunity to discuss the contours of Title II of Dodd-Frank, which deals with the Orderly Liquidation Authority, and I especially thank the ranking member for finally focusing our attention on the actual law itself.

One of the objectives of the Dodd-Frank Act was to address our financial services' exposure to systemic risk arising from complex, interconnected, qualified financial contracts which represent a significant activity of too-big-to-fail institutions. These contracts include security contracts, commodity contracts, repurchase agreements, and derivative contracts.

It is precisely the exponential growth, the financial and legal complexity, and the interconnectedness of these contracts that have magnified the severity of the 2008 financial crisis and nearly brought our economy to its knees. The Dodd-Frank Act addressed this risk by providing the FDIC the powers to mitigate this contagious effect. Section 210, Subsection 16 of the Act reads, "The corporation as receiver for a covered financial company or as receiver for a subsidiary of a covered financial company shall have the power to enforce contracts of subsidiaries or affiliates of the covered financial company, the obligations under which are guaranteed or otherwise supported or linked to the covered financial company."

In effect, these provisions give the FDIC, acting as receiver for a financial company whose failure would pose a significant risk to the financial stability of the United States, the power to maintain continuity and financial contracts and limit the disruption and failure of interconnected institutions.

As we observed during the failure of Lehman Brothers in 2008, our ability to isolate contagion embedded in these contracts and counterpart financial obligations could mean the difference between experiencing a contained failure of a single financial institution versus experiencing another mammoth financial crisis. Unfortunately, the regulators did not have this tool then, but I am convinced that our economy is better protected from the concept of too-big-to-fail because of the Dodd-Frank legislation.

I yield back.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentlelady from Minnesota, Ms. Bachmann, for 1 minute.

Mrs. BACHMANN. Thank you, Mr. Chairman.

Just this month we received a progress report regarding the Dodd-Frank rulemaking; 279 rules had a deadline and they were passed, 63 percent of those deadlines were missed. Specifically, 64 which came from the bank regulators were missed, the CFTC missed 17, the SEC missed 49, and 35 deadlines were missed by other regulators.

Now, interestingly, supporters of Dodd-Frank claim that these regulations prevent taxpayer bailouts, but these regulations aren't even implemented. So the point is, if the regulatory agencies are finding that the rulemaking is too onerous for they, themselves, to manage, imagine the burden of compliance on the financial services industry and on its customers.

This is a bill that is so big it is already failing itself and failing the American financial services industry. That is why I introduced H.R. 46, which would fully repeal Dodd-Frank, and my hope is that we do exactly that.

I yield back.

Chairman HENSARLING. The time of the gentlelady has expired.

The Chair now recognizes the gentleman from Texas, Mr. Green, for 1 minute.

Mr. GREEN. Thank you, Mr. Chairman.

I am so pleased that medicine is very unlike politics. In medicine, if a drug proves to be efficacious, we market it, we extol its virtues. In politics, if a law proves to be efficacious, we repeal it. One example might be what happened yesterday with the civil rights law.

However, I would like to focus for just a moment on Glass-Steagall. It served us efficaciously for decades, and was a great piece of law. It was repealed because it succeeded. Now, of course, we have the Volcker Rule, which is similar but not the same.

This is what is happening to Dodd-Frank. It is going to be emasculated by some who would do so. At some point, if it succeeds, it will be said that we no longer need it. If it is emasculated and it fails, it will be said that it was never a success, and should not have been implemented in the first place.

I stand with the ranking member. Only yesterday, I was here with Mr. Frank himself when his portrait was revealed, so it is ironic that we would have this hearing today.

I yield back.

Chairman HENSARLING. The gentleman yields back.

We now welcome our distinguished witnesses for today's hearing. From my left to my right, first, Thomas Hoenig currently serves as the Vice Chairman of the FDIC. Prior to joining the FDIC in 2012, Mr. Hoenig was the President of the Federal Reserve Bank of Kansas City, a Member of the FOMC from 1991 to 2011, and served the Fed for almost 40 years. He earned his Ph.D. in economics from Iowa State University, and an undergraduate degree from St. Benedict's College in Kansas.

Next, I am happy to welcome my friend and fellow "Dallas-ite," Richard Fisher, who is the President and CEO of the Federal Reserve Bank of Dallas. You know what, I am going to end this introduction halfway through because I made a mistake. The gentleman from Missouri needed to be recognized also to welcome Mr. Hoenig. My apologies to the gentleman from Missouri.

Mr. Cleaver, you are recognized.

Mr. CLEAVER. This will be short, Mr. Chairman, since somebody has already done it. But I do want to take the opportunity to introduce Thomas Hoenig, who became the Chair of the Kansas City Fed the same year that I became Mayor of Kansas City. He is a man of great integrity and we respect him a great deal in Kansas City. He was with the Federal Reserve for 38 years and then last year came to the FDIC Board.

I have had the pleasure of working with him over the years. I even know his newspaper deliveryman who comes by his house every morning and places the newspaper on his front porch.

So we welcome you, Mr. Hoenig, to the Financial Services Committee.

Thank you, Mr. Chairman.

Chairman HENSARLING. Meanwhile, back to Mr. Fisher, sorry about that. Prior to his appointment, President Fisher worked in the private sector. Before that, he served as the Deputy U.S. Trade Representative from 1997 to 2001. He earned his MBA from Stanford, and his undergraduate degree in economics from Harvard.

On a personal note, he just flew in from the U.K., and as soon as he finishes with his testimony, he is headed back to Lone Star soil where he will meet his brand new grandson, William Weir Smith IV. Congratulations.

And now, hopefully not making the same mistake twice, the gentleman from Texas, Mr. Green, is allocated 30 seconds for an introduction.

Mr. GREEN. Thank you, Mr. Chairman. It is nice to have a great Texan introduced twice. And I want you to know, Mr. Chairman, that while he is from a small town just outside of Houston known as Dallas, we don't hold it against him. He attended the Naval Academy, graduated with honors from Harvard, has an MBA from Stanford, and is a great and noble American.

We welcome you to the committee.

And, Mr. Chairman, I yield back.

Chairman HENSARLING. Be careful. I made an inquiry to the parliamentarian as to whether I could have your words taken down for besmirching Dallas, but fortunately for you, I could not.

Our next witness, Jeffrey Lacker, is the President and CEO of the Federal Reserve Bank of Richmond, a position he assumed in 2004. President Lacker has held various positions within the bank since he joined as an economist in 1989. Before that, he taught economics at the Krannert School of Management at Purdue University. He holds a Ph.D. in economics from the University of Wisconsin, Madison, and a bachelor's degree from Franklin and Marshall College.

Last but not least, and certainly no stranger to this committee, we are happy to welcome back Sheila Bair, who most recently served as the Chairman of the FDIC, a position that she was appointed to in 2006, and she held that position during the worst years of the financial crisis. Before that, she held a number of various public and private sector positions in the financial industry.

She earned her law degree and undergraduate degree from the University of Kansas.

I believe each and every one of you is a veteran of testifying before the committee. You will each be given 5 minutes for an oral presentation of your written testimony. And without objection, each of your written statements will be made a part of the record. Hopefully, you are familiar with our lighting system. When you have finished, members of the committee will have an opportunity to ask you questions.

Vice Chairman Hoenig, you are now recognized for 5 minutes.

STATEMENT OF THE HONORABLE THOMAS M. HOENIG, VICE CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC)

Mr. HOENIG. Thank you. Chairman Hensarling, Ranking Member Waters, and members of the committee, I appreciate the opportunity to testify on issues relating to improving the safety and soundness of our Nation's banking system.

How policymakers and regulators choose to structure the financial system to allocate the use of government facilities and subsidy will define the long-run stability and success of the economy. My testimony today is based on a paper entitled, "Restructuring the Banking System to Improve Safety and Soundness," that I prepared with my colleague Chuck Morris in May of 2011. I welcome this opportunity to explain what I think are pro-growth and pro-competition recommendations for the financial system in that paper, which I have attached to my written statement. Although I am a Board Member of the FDIC, I speak only for myself at this hearing.

Today, the largest U.S. financial holding company has nearly $2.5 trillion of assets using U.S. accounting, which is the equivalent of 16 percent of our nominal gross domestic product. The largest eight U.S. global systemically important financial institutions hold in tandem $10 trillion of assets under U.S. accounting, or the equivalent of two-thirds of our national income, and $16 trillion of assets if we were to include the fair value of derivatives, which then would place them at 100 percent of our gross domestic product.

Whether resolved under bankruptcy or otherwise, problem institutions of this size relative to our national income will have systemic consequences. But I must add that my concern with the largest firms is not just their size, but their complexity. Over time, the government's safety net of deposit insurance, Federal Reserve lending, and direct investment has been expanded to an ever-broader array of activities outside the historic role of commercial banks.

In the United States, the Gramm-Leach-Bliley Act allowed commercial banks to engage in a host of broker-dealer activities, including propriety trading derivatives and swaps activities, all within the Federal safety net. Because these kinds of activities were allowed to remain within the banking organization, the perception persists that despite Dodd-Frank the government will likely support these dominant and highly complex firms because of their outsized impact on the broader economy. This support translates into a subsidy worth billions of dollars, and I have provided a list, a summary of independent studies, documenting this subsidy.

My proposal then is simple: To improve the chances of achieving long-run financial stability and make the largest financial firms more market-driven, we must change the structure and the incentives driving behavior. The safety net should be narrowly confined to commercial banking activities, as intended when it was implemented with the Federal Reserve Act and deposit insurance was introduced.

Commercial banking organizations that are afforded access to the safety net should be limited to conducting the following activities: commercial banking, underwriting some securities and advisory service, and asset and wealth management. Also, for such reforms to be effective, the shadow banking system, I realize, must be reformed and its activities subjected to more market discipline.

First, money market funds and other investments that are allowed to maintain a fixed net asset value of $1 should be required to have floating net asset values. Shadow banks' reliance on this source of short-term funding would be greatly reduced by requiring share values to float with their market value and be reported accurately.

Second, we should change the bankruptcy laws to eliminate the automatic stay exemption for mortgage-related repurchase agreement collateral. This exemption resulted in a proliferation in the use of repo based on mortgage-related collateral. One of the sources of instability during the recent financial crisis was repo runs, particularly on repo borrowers using subprime mortgage-related assets as collateral.

Reforms specified in the proposal I am describing today would not, and are not intended to, eliminate natural market-driven risk in the financial system. They do address the misaligned incentives causing much of the extreme risk stemming from the safety net's coverage of nonbank activities.

In addition, this proposal would facilitate the implementation of Titles I and II of the Dodd-Frank Act to resolve failed systemically important firms by rationalizing the structure of the financial system, making it more manageable through crisis.

Market participants argue that this proposal would stifle their ability to complete globally. These largest firms understandably are driven by profit motives and the subsidy enhances their profits. I suggest that the proposal I offer would shrink the subsidy and enhance competition, which is what policymakers owe the American public. This structure will also provide much stronger protection from the possibility of future government intervention.

I conclude my oral remarks by emphasizing again that the choices we make today are critical to the future success of our economy. Rationalizing the structure of the financial conglomerates, making them more market-driven, will create a more stable, more innovative, more competitive system that will serve to support the largest, most successful economy in the world.

Thank you very much for this opportunity, and I look forward to your questions.

[The prepared statement of Vice Chairman Hoenig can be found on page 94 of the appendix.]

Chairman HENSARLING. Mr. Fisher, you are now recognized for 5 minutes.

STATEMENT OF RICHARD W. FISHER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, FEDERAL RESERVE BANK OF DALLAS

Mr. FISHER. Thank you, Chairman Hensarling, Ranking Member Waters, and members of the committee.

We all share the goal of ending taxpayer bailouts of large financial institutions considered too-big-to-fail. However, as the iconic Patrick Henry, not Patrick McHenry, said in one of his greatest speeches, "Different men often see the same subject in different lights." So I recognize and respect the difference of opinion on this critical issue of how to eliminate taxpayer bailout funds, including the different perspectives of the members of this committee, other observers, and the members of this panel.

It is our view at the Dallas Fed, however, that Dodd-Frank, despite its very best intentions, does not do the job it set out to do. It does not end too-big-to-fail and it does not prevent more taxpayer-funded payouts.

First, some quick facts. There are less than a dozen megabanks, a mere 0.2 percent of all banking organizations. The concentration of assets in their hands was greatly intensified during the 2008–2009 financial crisis when several failing giants were absorbed, with taxpayer support, by larger, presumably healthier ones.

Today, we have about 5,500 banking organization; that is 5,500 banks in the United States. Most of these are bank holding companies and they represent no threat to the survival of our economic system. But less than a dozen of the largest and most complex banks are each capable, through a series of missteps by their management, of seriously damaging the vitality and the resilience and the prosperity of the U.S. economy. Any of these megabanks, given their systemic footprint and their interconnectedness with other large financial institutions, could threaten to bring the economy down.

These 0.2 percent of banks, the too-big-to-fail megabanks, are treated differently from the other 99.8 percent and differently from other businesses, and under Dodd-Frank, unfortunately, we believe this imbalance of treatment has been unwittingly perpetuated.

I have submitted a lengthy, detailed statement as to the drawbacks of the Act, developed with my colleague sitting behind me, Harvey Rosenblum, a great economist at the Federal Reserve Bank of Dallas, and with our staff. Today, at Ms. Waters' suggestion, I am going to specifically address Title I and Title II, and then if I have time, I will summarize the Dallas Fed's proposal to remedy the pathology of too-big-to-fail.

With regard to Title I, based on my experience working the financial markets since 1975, as soon as a financial institution is designated systemically important, as required under Title I of the Dodd-Frank Act, and becomes known by the acronym SIFI, it is viewed by the market as being the first to be saved by the first responders in a financial crisis. In other words, the SIFIs occupy a privileged position in the financial system. One wag refers to the acronym SIFI as meaning "save if failure impending."

A banking customer has a disincentive to do business with smaller competitors because a non-SIFI does not have an implied government funding lifeline. Even if a SIFI ends up finding itself with more equity capital than a smaller competitor, the choice remains of where you would like to hold important financial relationships: with an institution with a government backstop; or with an institution without it? Thus, the advantages of size and perceived subsidies accrue to the behemoth banks. Dodd-Frank does not eliminate this perception, and, again, it wasn't intended to, but in many ways it perpetuates its reality.

Some have held out hope that a key business provision of Title I requiring banking organizations to submit detailed plans or so-called living wills for their orderly resolution in bankruptcy, without government assistance, will provide for a roadmap to avoid bailouts. However, these living wills are likely to prove futile in helping navigate a real-time systemic failure, in my experience.

Given the complexity and opacity of the too-big-to-fail institutions, and their ability to move assets and liabilities across subsidiaries and affiliates, as well as off balance sheet, a living will would likely be ineffective when it really mattered. I don't have much faith in the living will process to make a material difference in too-big-to-fail risks and behaviors. The bank would run out of liquidity, not necessarily capital, due to reputational risk quicker than management would work with regulators to execute a living will blueprint.

With regard to Title II, Dodd-Frank describes and designates the Orderly Liquidation Authority as the resolution mechanism to handle the disposal of a giant systemically disruptive financial enterprise. These three letters themselves evoke the deceptive doublespeak of what I consider to be an Orwellian nightmare. The "L," which stands for liquidation, will in practice become a simulated restructuring, as would occur in a Chapter 11 bankruptcy. But under the OLA of Dodd-Frank, the U.S. Treasury will likely provide, through the FDIC, what is essentially debtor-in-possession financing from the yet-to-be-funded Orderly Liquidation Fund, the OLF, located in the United States Treasury, to the failed companies' artificially kept alive operating subsidiaries for up to 5 years, perhaps longer.

Under the single point of entry method, the operating subsidiaries remain protected as the holding company is restructured. So if a company does business with operating subsidiaries, then this company is even more confident their counterparty is too-big-to-fail. Some officials refer to this procedure as a liquidity provision rather than a bailout. Whatever you call it, this is taxpayer funding at below market rates. At the Dallas Fed, we would call this form of liquidation a nationalization of a financial institution.

During the 5-year resolution period, incidentally, this nationalized institution does not have to pay taxes of any kind to any government entity, and to us this looks, sounds, and tastes like a taxpayer bailout just hidden behind the opaque and very difficult language, Mr. Chairman, of Section 210 of Title II.

I will stop there, Mr. Chairman. I would say after a careful reading of Title II, to us, with all due respect to those who would argue otherwise, this is basically a "rob Peter to pay Paul" chain of events with the taxpayer paying the role of Peter. And we have made a proposal that would amend and summarize and simplify Dodd-Frank.

I will just say one thing in conclusion. Despite its 849-page proscription, it has thus far spawned more than 9,000 pages of regulation that this very committee estimates will take 24,180,856 hours each year to comply with. Market discipline is still lacking for the large financial institution, as it was during the last financial crisis, and we need to improve upon Dodd-Frank.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Fisher can be found on page 72 of the appendix.]

Chairman HENSARLING. The Chair now recognizes Mr. Lacker.

STATEMENT OF JEFFREY M. LACKER, PRESIDENT, FEDERAL RESERVE BANK OF RICHMOND

Mr. LACKER. Thank you, Chairman Hensarling, Ranking Member Waters, and members of the committee. It is an honor to speak before the committee on the Dodd-Frank Act and the persistence of "too-big-to-fail." At the outset, I should say that my comments today are my own views and do not necessarily reflect those of my colleagues in the Federal Reserve System.

The problem known as too-big-to-fail consists of two mutually reinforcing expectations. First, some financial institution creditors feel protected by an implicit government commitment of support should the institution face financial distress. This belief dampens creditors' attention to risk and makes debt financing artificially cheap for borrowing firms, leading to excessive leverage and the overuse of forms of debt, such as short-term wholesale funding, that are most likely to enjoy such protection.

Second, policymakers at times believe that the failure of a large financial firm with a high reliance on short-term funding would result in undesirable disruptions of financial markets and economic activity. This expectation induces policymakers to intervene in ways that let short-term creditors escape losses, thus reinforcing creditors' expectations of support and firms' incentives to rely on short-term funding. The result is more financial fragility and more rescues.

The Orderly Liquidation Authority of Title II of the Dodd-Frank Act gives the FDIC the ability, with the agreement of other financial regulators, to take a firm into receivership if it believes the firm's failure poses a threat to financial stability. Title II gives the FDIC the ability to borrow funds from the Treasury to make payments to creditors of the failed firm. This encourages short-term creditors to believe that they would benefit from such treatment. They would therefore continue to pay insufficient attention to risk and to invest in fragile funding relationships.

Given widespread expectations of support for financially distressed institutions in orderly Title II liquidations, regulators will likely feel forced to provide support simply to avoid the turbulence of disappointing expectations. We appear to have replicated the two mutually reinforcing expectations that define too-big-to-fail.

Expectations of creditor rescues have arisen over the last 4 decades through the gradual accretion of precedents. Research at the

Richmond Fed has estimated that one-third of the financial sector's liabilities are perceived to benefit from implicit protection, and that is based on actual government actions and actual policy statements.

Adding implicit protection to the explicit protection of programs such as deposit insurance, we found that 57 percent of the financial sector's liabilities were expected to benefit from government guarantees as of the end of 2011. Reducing the probability that a large financial firm becomes financially distressed, through enhanced standards for capital and liquidity, for example, are useful but will never be enough. The path towards a stable financial system requires that the unassisted failure of financial firms does not put the financial system at risk. The resolution planning process prescribed by Section 165(d) of Title I of Dodd-Frank provides a roadmap for this journey.

A resolution plan or living will is a description of the firm's strategy for rapid and orderly resolution under the U.S. Bankruptcy Code without government assistance in the event of material financial distress or failure. It spells out the firm's organizational structure, key management information systems, critical operations, and a mapping of the relationship between core business lines and legal entities.

The Federal Reserve and the FDIC can jointly determine that a plan is not credible or would not facilitate an orderly resolution under the Bankruptcy Code, in which case the firm would be required to submit a revised plan to address identified deficiencies.

In essence, regulators can order changes in the structure and operations of a firm to make it resolvable in bankruptcy without government assistance. It is important to remember that all features of a large financial firm that render it hard to contemplate putting it through unassisted bankruptcy are under our control now before the next crisis.

Resolution planning will require a great deal of hard work, but I see no other way to ensure that policymakers have confidence in unassisted bankruptcy and that investors are convinced that unassisted bankruptcy is the norm. Resolution planning provides the framework for identifying the actions we need to take now to ensure that the next financial crisis is handled appropriately, in a way that is fair to taxpayers, and in a way that establishes the right incentives.

Thank you.

[The prepared statement of Mr. Lacker can be found on page 150 of the appendix.]

Chairman HENSARLING. The Chair now recognizes Chairman Bair for 5 minutes.

STATEMENT OF THE HONORABLE SHEILA BAIR, CHAIR, SYSTEMIC RISK COUNCIL, AND FORMER CHAIR, FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC)

Ms. BAIR. Thank you, Mr. Chairman. Thank you for the opportunity to appear here today to discuss the Dodd-Frank Act, too-big-to-fail, and the resolution of Large Complex Financial Institutions, or LCFIs.

No single issue is more important to the stability of our financial system than the regulatory regime applicable to these institutions. The role certain large mismanaged financial institutions played in the leadup to the financial crisis is clear, as is the need to take tough policy steps to ensure that taxpayers are never again forced to choose between bailing them out or financial collapse.

As our economy continues to slowly recover from the financial crisis, we cannot forget the lessons learned, nor can we afford a repeat of the regulatory and market failures which allowed that debacle to occur.

The Dodd-Frank Act requirements for the regulation and, if necessary, resolution of LCFIs are essential to address the problems of too-big-to-fail. I strongly disagree with the notion that the Orderly Liquidation Authority enshrines the bailout policies that prevailed in 2008 and 2009. Implicit and explicit too-big-to-fail policies were in effect under the legal structure that existed before Dodd-Frank. Dodd-Frank has abolished them. To be sure, more work needs to be done to reduce the risk of future LCFI failures and ensure that if an LCFI does fail, the process is smooth, well understood by the market, and minimizes unnecessary losses for creditors.

However, to the extent the perception of too-big-to-fail remains, it is because markets continue to question whether regulators or Congress can and will follow through on the law's clear prohibition on bailouts. I believe we are on the right track for addressing these realities, but more can and should be done.

First, regulators must ensure that LCFIs have sufficient long-term debt at the holding company level. The success of the FDIC's Orderly Liquidation Authority using the single point of entry strategy depends on the top-level holding company's ability to absorb losses and fund recapitalization of the surviving operating entities. Currently, we have no regulation that addresses this need and we must address this gap.

To avoid gaming, the senior unsecured long-term debt must be issued at the top level holding company and it should also be based on nonrisk-weighted assets. To limit the contagion or domino effect of an LCFI failure, the debt should not be held by other LCFIs or banks, nor should other LCFIs be permitted to write credit protection for or have other real or synthetic exposure to that debt. A well-designed, long-term debt cushion would support the FDIC's single point of entry resolution strategy and help assure the markets that the LCFI is indeed resolvable and not too-big-to-fail.

Second, the Financial Stability Oversight Council must continue to designate potentially systemic nonbank financial firms for heightened oversight. Title I of the Dodd-Frank Act requires that the FSOC designate firms for heightened supervision by the Federal Reserve. This enhanced supervision is designed to: first, improve regulation over large potentially systemic firms; second, provide regulators with important information to assess and plan for a potential failure; and third, reduce the likelihood that potential systemic risk will simply grow unnoticed outside of the traditional regulatory sphere.

While some have argued that the designation might be viewed as a positive and fuel market perception so the company is somehow backstopped by the government, I do disagree. This designation is not a badge of honor but a scarlet letter. It includes no benefits from the government. It only heightens the firm's required capital and supervision. It does not mean the firm will be resolved under OLA rather than bankruptcy. In fact, Section 165 requirements for resolutions are aimed at ensuring an orderly resolution under the Bankruptcy Code, not ordered to liquidation. This helps explain why most LCFIs have pushed back so strongly to avoid this designation.

Third, regulators should strengthen capital requirements so these firms have a meaningful buffer against losses. Our existing capital regime is incredibly complex, riddled with uncertainty, and results in a host of perverse incentives that encourage bad risk management and synthetic risk-taking at the expense of traditional lending. Not only would a stronger and simpler capital regime provide a meaningful buffer that reduces the likelihood of an LCFI failure, it would reduce the artificial funding advantages available to large firms and give regulators and counterparties a much better sense of a firm's financial health.

While current capital regimes continue to over-rely on risk weighting and internal modeling, a better approach is to simplify our capital rules, strengthen the leverage ratio, and eliminate regulatory reliance on a firm's internal models.

Fourth, regulators should improve public disclosure about large complex financial institutions' activities and risks so that investors can make better decisions about these companies and so that markets and policymakers can feel comfortable that a firm can fail in bankruptcy without destabilizing the financial system.

Improved disclosure about the level of the large financial institutions' unencumbered assets could increase the chances that debtor-in-possession financing could be seamlessly arranged in a bankruptcy process without disrupting payments processing and credit floats. In addition, greater disclosure about a firm's corporate structure and profitability by business line could facilitate the market's ability to determine the optimal size and structure for financial institutions. It would also allow investors to see if firms are too big or too complex to manage and would provide better shareholder value if broken up into smaller, simpler pieces.

So, thank you again for the opportunity to be here today. This remains an enormously important issue and the committee is right to keep a very close eye on it. Financial reform and system stability are not partisan issues. Both parties want to end too-big-to-fail, and though there may be different perspectives on how to achieve that goal, through open dialogue, discussion, and collaboration, we can achieve it. We must.

Thank you very much.

[The prepared statement of Chairman Bair can be found on page 60 of the appendix.]

Chairman HENSARLING. I thank each and every one of our witnesses. The Chair now recognizes himself for 5 minutes for questions.

Mr. Fisher, I will start with you. In your statement, you gave a group of statistics about the financial concentration in our largest money center banks. I assume implicit in that statistical rendition was that it is not natural market forces at work which has led to the concentration of these assets. Is that correct?

Mr. FISHER. Well, it is—

Chairman HENSARLING. Is your microphone on?

Mr. FISHER. Pardon me, Mr. Chairman. It has been occurring over time, but this process accelerated during the crisis, and indeed we have greater concentration today. Over two-thirds of the banking assets are concentrated in the hands of less than a dozen institutions. And in my formal presentation, I provide a little graph which explains that.

Chairman HENSARLING. Now, is it my understanding that you believe the Orderly Liquidation Authority will further hasten that process, leading to greater concentration within the financial services industry?

Mr. FISHER. It is my feeling that the Orderly Liquidation Authority does not end the concept of taxpayer-funded bailouts. Even if you go through Section 210, the wording is so opaque, so difficult. I will give you an example, Mr. Chairman. It says, "The assets from a failed firm must be sufficient to repay the Orderly Liquidation Fund. However, if a shortfall remains—"

How can it can be sufficient if a shortfall remains? There is a lot of contradictory verbiage in there. But essentially what happens is that you have a process that, even by the wording of Section 210, takes up to 5 years or more to occur, and if you do process that according to Section 210, what is interesting is that you end up, those institutions that might provide additional funding with assessments, that is a tax-deferred or business expense that is written off. So one way or another the Treasury ends up paying for it, the people of the country end up paying for it, and it is not not taxpayer funded. But I do believe that it does not solve the issue of leveling the playing field for the other 5,500 banks in the country. I hope that answers your question.

Chairman HENSARLING. Mr. Lacker, you have questioned the Orderly Liquidation Authority as well, and I believe you have stated previously that you see it as a codification of the government's longstanding policy of constructive ambiguity. Based upon our most recent financial crisis, how constructive do you find constructive ambiguity and does it remain in the Orderly Liquidation Authority?

Mr. LACKER. I think it is clear that in the Orderly Liquidation Authority and the use of the Orderly Liquidation Fund, the FDIC has a tremendous amount of discretion in the extent to which they provide creditors with returns that are greater than they would receive in bankruptcy. I think that discretion traps policymakers in a crisis. Expectations build up that they may use that discretion to rescue creditors and let them escape losses, and given that expectation, policymakers feel compelled to fulfill the expectation in order to avoid the disruption of markets pulling away from who they have lent to on the basis of that expected support.

So to me it does seem as if the discretion that is inherent in the Orderly Liquidation Authority and that is inherent in the way the FDIC has laid out their strategy, sort of the lack of specificity we have about the extent to which short-term creditors could or would get more than they would get in bankruptcy, I think that potential for trapping policymakers into rescuing more often than they want is quite there.

Chairman HENSARLING. Ostensibly, Dodd-Frank constrained the Fed's ability to exercise its 13(3) authority. Just how much constraint do you actually see there? Was it effective and, if not, has Dodd-Frank dealt with too-big-to-fail, if it has not constrained 13(3)?

Mr. LACKER. I commend the effort to rein in the 13(3) authority. I think it is unnecessary and its existence poses the same dynamic for the Fed that I described just now. It is not clear, I think it is an open question as to how constraining it is. It says it has to be a program of market-based access, but it doesn't say that more than one firm has to show up to use it. And it certainly seems conceivable to me that a program could be designed that essentially is only availed of by one firm.

Chairman HENSARLING. In the time the chairman doesn't have remaining, I just wanted to say to Chairman Bair that having read your testimony, I agreed with far more of it than I thought I would, and I hope in other questions you will discuss the need for a stronger yet simpler capital regime, since I believe an ounce of prevention is worth a pound of cure.

The Chair now recognizes the ranking member for 5 minutes.

Ms. WATERS. Thank you very much, Mr. Chairman. Mr. Hoenig, you mentioned the importance of activity limits for institutions that have access to the Federal safety net, and the first part of your proposal is to restrict bank activities to the core activities of making loans and taking deposits.

As you know, Section 165 of Dodd-Frank requires systemically important financial institutions to submit orderly resolution plans to regulators showing how they would be wound down under the bankruptcy process. If regulators judge that a plan is not credible, the law says they may impose more stringent capital, leverage or liquidity requirements or restriction on growth activities or operations of the company until the firm submits a credible plan. The law also states that if the firm doesn't fix the plan within 2 years, regulators can order divestiture of assets and operations again. This process is designed to ensure any of these large institutions could be resolved by normal bankruptcy proceedings. The Fed and the FDIC have extended the deadline for submission of these plans to October.

In your judgment, do the FDIC and the Fed have the authorities they need to limit activities if they find that the resolution plans wouldn't allow the banks to be wound down under an ordinary bankruptcy proceeding?

Mr. HOENIG. First of all, let me answer your question by first answering the chairman's question, and that is I think that the subsidy that is within the industry has allowed firms to be larger than they otherwise would have been and removed them from the market's discipline. I think it forced broker-dealers that were independent to come into the—

Ms. WATERS. Reclaiming my time.

Mr. HOENIG. Yes, I will be right with you.

Ms. WATERS. Reclaiming my time.

Chairman HENSARLING. It is the gentlelady's time.

Ms. WATERS. Reclaiming my time.

Mr. HOENIG. Now, to answer your question—

Ms. WATERS. Reclaiming my time.

Mr. HOENIG. Okay, sorry.

Ms. WATERS. I am going to address this question to Ms. Sheila Bair.

I don't know if you heard the question. I will go back over it again. As you know, Section 165 of Dodd-Frank requires systemically important financial institutions to submit orderly resolution plans to regulators showing how they would be wound down under the bankruptcy process. If regulators judge that a plan is not credible, the law says they may impose more stringent capital leverage or liquidity requirements. Going through that, the Fed and the FDIC have extended the deadline for submission of these plans to October. In your judgment, do the FDIC and the Fed have the authorities they need to limit activities if they find that the resolution plans wouldn't allow the banks to be wound down under an ordinary bankruptcy proceeding?

Ms. BAIR. Yes, I think there is very broad authority as part of the living will process, and I agree with Jeff Lacker that this is a very important—

Chairman HENSARLING. I'm sorry, Chairman Bair, can you pull the microphone a little closer to you there, please?

Ms. BAIR. So, yes. Section 165 gives the Fed and the FDIC a lot of authority as part of the living will process to require these banks to simplify their legal structure, to divide their activities, move the activities, high-risk activities outside of insured banks. The standard is resolvability in bankruptcy, and that is a very tough standard, particularly under the current bankruptcy rules. So I think there is tremendous authority there, which I hope both the Fed and the FDIC will aggressively use to get these banks to simplify their legal structures, divide them along business lines. I think Tom Hoenig's suggestions are great along those lines.

Ms. WATERS. Will the Fed and the FDIC take other actions if study of the resolution plans submitted in October shows they aren't credible? Back to Ms. Bair.

Ms. BAIR. I don't know. That might be better addressed directly to the FDIC. My personal view is that they should be as transparent as possible about the status and acceptability of these plans. And if their—I know that there is confidential information that they need to protect, but I would like to see more disclosure about what is in the living wills as well as the process for approving them.

Ms. WATERS. Mr. Lacker, would you like to comment? We have a few seconds left.

Mr. LACKER. I agree with Sheila Bair.

Ms. WATERS. That is a very safe thing to do.

I will yield back. Thank you.

Chairman HENSARLING. The gentlelady yields back.

The Chair now yields 5 minutes to the gentleman from North Carolina, Mr. McHenry, the chairman of the Oversight and Investigations Subcommittee.

Mr. MCHENRY. Thank you, Mr. Chairman.

Mr. Fisher, does Dodd-Frank end too-big-to-fail?

Mr. FISHER. No.
Mr. MCHENRY. Mr. Lacker?
Mr. LACKER. No.
Mr. MCHENRY. Ms. Bair?
Ms. BAIR. It provides the tools to end too-big-to-fail.
Mr. MCHENRY. Mr. Hoenig?
Mr. HOENIG. It does provide the tools.

Mr. MCHENRY. All right. So there is some disagreement here. Mr. Lacker, please explain the Orderly Liquidation Authority. You reference this in your writings, previous speeches, and your testimony today, but does the Orderly Liquidation Authority provide creditors with a different assumption about how they will be treated?

Mr. LACKER. There are three ways in which the returns to a creditor in the Orderly Liquidation Authority resolution would potentially differ from the returns to, going through a bankruptcy, unassisted bankruptcy. One is that the FDIC has the authority to provide creditors with more than they would get in liquidation. There are some conditions on that. It has to be if it is deemed to be minimizing the cost to the FDIC, but I think a fair reading of the history is that standard still provides a fair amount of latitude to the FDIC.

Mr. MCHENRY. And does that discretion provide greater certainty in the market or lead to more uncertainty?

Mr. LACKER. It is more uncertainty. In addition to that, they would potentially receive their money far earlier than they would in a resolution under the Bankruptcy Code in which there can be delays for good procedural reasons in the resolution of claims of creditors; and then, third, the discretion provides greater uncertainty or latitude relative to the relative adherence to absolute priority rules in unassisted bankruptcy.

Mr. MCHENRY. So, Mr. Fisher, the FDIC's authority, discretionary authority that Mr. Lacker speaks of within the Orderly Liquidation Authority, does it provide them wider latitude for bailouts?

Mr. FISHER. According to the way the law is written, there is substantial latitude certainly in terms of time. I mentioned this in my spoken statement in terms of the liquidation process and the time that it takes. I think it is important to realize that is one issue. We can have—given the way it is structured and the way the wording is stated, this can take up to 5 years or longer. This promotes and sustains an unusual longevity for a zombie financial institution. I believe it imposes a competitive disadvantage on small and medium-sized institutions, but one aspect I don't think anybody has discussed in any of the hearings that I have studied before this committee is that if the reorganized company under the process cannot repay the Treasury for its debtor-in-possession financing, which is essentially what it is, then Title II suggests the repayment should be clawed back via a special assessment on other SIFIs, other large bank competitors.

Mr. MCHENRY. So, in essence—
Mr. FISHER. That assessment—excuse me, Mr. McHenry.
Mr. MCHENRY. Go right ahead.

Mr. FISHER. —is then written off as a tax deductible business expense, thereby reducing revenue to the Treasury and to the people of the United States. So to say that there is no taxpayer funding I believe does not completely state it correctly. It may be reduced, but it is still carried by the taxpayers.

Mr. MCHENRY. So we are justified in saying that is, in fact, a bailout by the taxpayer?

Mr. FISHER. That is one way to describe taxpayer support.

Mr. MCHENRY. We are sensible people, we are Members of Congress, right? So, to this point, there is a lot of debate about this, do the large financial institutions have a funding advantage as a result of this?

Mr. FISHER. I believe what Mr. Hoenig was about to say earlier—at least I will give you my interpretation—is they presently have a huge funding advantage. There are studies by the BIS, the Bank for International Settlements, by the IMF, there is even one which is highly disputed by Bloomberg that shows they have an $83 billion per year advantage. The Bank of England under Andy Haldane states a much bigger number, in the $300 billion for the internationally systemically important financial institutions. But here is what I think is the fact. If you take, say, the work of Simon Johnson, a noted MIT economist, who was the chief economist at the IMF—that may discredit him in the eyes of some in this room, I don't know. But as he points out, all you have to do is ask a market operator, does a large institution have a funding advantage over a smaller one. The answer is yes.

Now, we at the Dallas Fed don't know what the number is, and I noticed under Brown-Vitter, there is an effort or under those two Senators to actually get the GAO to study the number, but I am here to tell you as a former practitioner with over 25 years experience in the business, having been a banker, having run financial funds, having been an investor, that there is a substantial advantage to these institutions, and just the name "systemically important financial institution," that is like saying, I bought it at Neiman Marcus. It attracts and brands and provides a special dispensation. And I believe that despite the industry's efforts, there is a funding advantage. And I believe it is measurable, and if it is not measurable, certainly you can feel it as a financial operator, and it buys, again, the smaller—

Chairman HENSARLING. The time of the gentleman has expired.

Mr. MCHENRY. Thank you.

Chairman HENSARLING. The Chair now recognizes the gentleman from Texas, Mr. Green, the ranking member of the Oversight and Investigations Subcommittee, for 5 minutes.

Mr. GREEN. Thank you, Mr. Chairman.

Let me start by calling Lehman to our attention. As you know, this was the largest bankruptcy in American history, and its failure created a chain reaction that had a tremendous impact on the economic order. In 2011, the FDIC examined how Lehman could have been wound down under Dodd-Frank, and I believe the report concluded that it could have been done in such a way as to allow taxpayers to be off the hook and cause creditors as well as investors, shareholders to share the burden of the cost.

My question, Ms. Bair, to you is, could you please elaborate on how this could have been accomplished such that we would have preserved economic stability and avoided having taxpayers bear the burden of the cost?

Ms. BAIR. So, yes, that report concluded that under Title II, systemic disruptions could have been avoided, and also that the losses for the creditors, for the bondholders would be substantially less. Lehman's bondholders still haven't been paid yet, and the losses are going to be substantial once that happens, and the strategy that was articulated in that paper is the one the FDIC says it won't use, which is single point of entry, taking control of the holding company, continuing to fund the healthy portions of the operation to avoid systemic reduction, to maintain the credit flows, require derivatives counterparties to continue to perform on their contracts, whereas in bankruptcy, they have this privileged status where they can repudiate their contracts, grab their collateral and go, which creates a lot more losses for bondholders, and that is one of the reasons why the bondholders are going to be suffering such severe losses in Lehman.

So I think it is a viable strategy. Is it perfect? No. Is there a lot more work to be done to make it work as well as it should? Yes. But I do think we would have had a much different result, and ironically, bankruptcy proponents, those who want to change bankruptcy to make it work for financial institutions, which I am all for, be careful with that because one of the things some of them want to do is provide government funding into a bankruptcy process. So if you don't like the fact that the government can provide some liquidity support in a Title II process, which will be repaid off the top, be careful because the bankruptcy folks want that same kind of mechanism in a bankruptcy process, and the reason they want to do that is because a financial institution, whether it is large or small, its franchise will be destroyed if it can't fund its assets anymore.

It is not like a brick and mortar company. It has to have liquidity support to maintain the healthy parts of its franchise. If you are going to provide that type of mechanism, make sure it is under the control of the government which has a public interest mandate.

So I think that does need to be an important part of the debate about bankruptcy versus Title II. But I do think it is a viable strategy, and I think it would have worked a lot better, served the country better and ironically Lehman creditors as well if it had been used in that case, but we didn't have it then.

Mr. GREEN. Thank you.

Now a question for everyone. I would like to ask a really difficult question, but you are all brilliant people, and this should be easy for you, given what you have accomplished in life and what you have studied. If you genuinely thought in your heart of hearts that the failure of a given entity would bring down the American economy as well as the world economy, if you genuinely thought that it would and the only way to prevent it would be the utilization of tax dollars to be repaid, you genuinely believe that we may bring down the American economy if you do not respond, and tax dollars to be repaid is the only methodology by which you can prevent this, would you take the measure of using the method available to you, Mr. Fisher? I am going to ask for a yes or no, given that time is of the essence.

Mr. FISHER. My quick answer, Congressman, and again, you are a personal friend of mine, but my quick answer is this: It is better to create—

Mr. GREEN. I reject your quick answer, and I ask you this.

Mr. FISHER. It is better to create greater and noble—

Mr. GREEN. Here is what I am going to ask. If you would not, if you would not do this, if you would not utilize the only method available, which is tax dollars, and the American economy and the world economy is about to go under, raise your hand, anyone.

Let the record show that there were no hands raised, including my very good friend, Mr. Fisher.

And I would also say this to you, friends, this is what Dodd-Frank attempts to do. It only has the ability or accords the ability if we are about to have a tragedy of economic import comparable to what happened with Lehman, and as a result, it would not allow us to bring down the economy.

Thank you, Mr. Chairman.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the chairman emeritus of our committee, the gentleman from Alabama, Mr. Bachus, for 5 minutes.

Mr. BACHUS. Thank you. Back in May and June of 2010, we were debating this very subject, how do we address the failure of a large financial institution? We basically had two choices, and one was what I call rule of law, and that is enhanced bankruptcy. And the other was what Chairman Bair referred to a minute ago as tools. But that would be tools you give to the government, and those are discretion. So, really, the choice is between rule of law and discretion, government discretion in my mind, and I would just ask each of you to comment on that.

Mr. HOENIG. If I may, Congressman, number one, Title I is bankruptcy, and that is the preferred method. Number two, our odds of being able to implement Title I in bankruptcy increase if we take the subsidy and pull it back and if we split out investment banking activities from commercial banking so that firms can fail and not bring down the economy, as Drexel did. I think that is a much preferable way, and it does require the rule of law in your Title I.

Mr. BACHUS. And as I understand it, you want to really limit it to commercial banking?

Mr. HOENIG. I want commercial banking to be the only sector which has this very explicit subsidy.

Mr. BACHUS. So that is one path, and I acknowledge that.

Mr. FISHER. Congressman, I agree with Mr. Hoenig.

Our proposal that I have outlined in my submission just restricts the Federal safety net, that is deposit insurance and access to the Federal Reserve's discount window, to where it was always intended to be, as Mr. Hoenig said, and that is in traditional commercial banking deposit and lending intermediation and payment systems functions. If that were the law, that is the law.

And then, secondly, all other activities with other parts of a complex bank holding company, I don't want to get rid of the complex bank holding companies, you can't stuff the old rules back into the bottle, Glass-Steagall, but it would be very clear that every transaction, every counterparty, every customer, anybody who does business with them has a clear contract that says there will never, ever be a government bailout. That is much simpler than what is in this legislation here, which is so opaque and so complicated. So when you have discretion, you have room for powerful lobbies to influence decision making. When you have a strict rule of law, as long as it is a good rule of law—I believe it is a simple proposal we have made from the Dallas Fed—then you remove that possibility for folks to work on the regulators, massage the regulators, lobby the regulators and so on, and you have a greater chance of discipline. So this is all about the rule of law, and I agree with you on that front.

Mr. BACHUS. All right. Dr. Lacker?

Mr. LACKER. I think you are right to put your finger on that. I think discretion is at the core of too-big-to-fail. It is why we got here. It began over 40 years ago with the rescue of a $1 billion institution in Michigan where the FDIC went beyond insured depositors. The precedents that kept being set on through Continental Illinois gave rise to the expectation that policymakers might use their discretion with uninsured claimants, but regulators tried to have it both ways. We tried to, with constructive ambiguity, preserve the fiction that we wouldn't intervene, tried to get people to behave as if we wouldn't intervene because that aligns incentives correctly and limits risk-taking, and yet we wanted to preserve the discretion to intervene, and markets saw through that. And as a result, when the time came, when push came to shove in the spring of 2008, markets had built up a tremendous array of arrangements that were predicated on our support, and we were boxed in. Pulling the rug out from under that would have been tremendously disruptive. But the problem isn't that we need to provide the support. The problem is to defeat that expectation at the core.

Mr. BACHUS. Sure. And even on Lehman, when we started talking about whether the government would exercise discretion or not, it unsettled and made the process unpredictable, and I would say this: Discretion is almost antithesis to predictability and certainty. When you have discretion, you take away certainty, and then it is hard to have something orderly.

Mr. HOENIG. And remember, Lehman had been allowed to leverage up, to issue basically a deposit that had the impression of government backing.

Mr. BACHUS. Right.

Mr. HOENIG. And therefore facilitated its size, its vulnerability and then the crisis.

Mr. BACHUS. I am going to write you all a letter about Governor Tarullo wanting to go beyond Basel 3 in some of his increased capital requirements and other things such as that, and I have a real concern that the rest of the world won't follow us in that regard, and—but I will have to write a letter because of the time.

Mr. FISHER. Chairman, can I just point out as a point of fact that Ms. Bair was not at the FDIC when Continental Illinois failed.

Mr. LACKER. Much less Bank of the Commonwealth.

Chairman HENSARLING. For the record, the Chair now recognizes the gentleman from Massachusetts, Mr. Capuano for 5 minutes. Apparently, I don't.

I recognize the gentleman from New York, Mr. Meeks, for 5 minutes.

Mr. MEEKS. Thank you, Mr. Chairman.

My first question goes to Chairwoman Bair. Dodd-Frank created OLA to apply only in the rare situation where it is necessary to avoid the adverse effects of liquidating a systemically important financial company under the Bankruptcy Code. Can you discuss other adverse effects that may result in liquidating a large and complex financial institution under traditional bankruptcy and how OLA helps mitigate some of these dangers?

Ms. BAIR. Right. So I think the two problems, the main problems you have in bankruptcy, which are where you have an advantage with the Dodd-Frank Act, the Title II approach is, one, regulators can do advance planning, and these institutions don't go down overnight, even with Lehman Brothers. This was a slow burn over months of time. So regulators can be inside the institution planning, trying to figure out how it will be resolved if it fails. Regulators can also provide, the FDIC can provide temporary funding support to keep the franchise operational. Take a bank, for instance. So a bank goes down. If there is no process to continue some liquidity support, a small business can't access their credit line anymore to make payroll, you are going to your settlement for your house, there is no funding for your mortgage anymore. These are financial assets.

To maintain any value in the franchise, you need to continue funding the operations, and again that is true with large and small banks. The government can do that under the stewardship of the FDIC. I think you need a government agency if you are going to be temporarily putting government money into that. You just can't do that with bankruptcy. Again, I caution you that some of these bankruptcy advocates, that is what they want. They want the Fed to be lending into a bankruptcy process.

The third thing that we can do under Dodd-Frank and we could always do under banks is require derivatives counterparties to continue to perform on their contracts, so they can't walk away and repudiate their obligations. That created tremendous disruptions for Lehman. So those are the things that are addressed which are advantages of Title II. I think there are Bankruptcy Code changes that could be made which would facilitate very quick debtor-in-possession financing to provide that liquidity that you need, stop giving derivatives to counterparties this privileged status. The planning thing is still going to be a problem, but maybe working with the regulators, that can work better.

But you don't have that now, and so you need something like Title II, and there is serious work going on at the FDIC to make this a viable, operational strategy where the shareholders and creditors will take the losses. There is no doubt in my mind about that. And there are substantial limitations on the discretion of regulators. They can't differentiate among creditors except under two conditions: one, you are going to maximize recoveries; or two, you are going to maintain essential operations. You have to pay your employees. You have to pay your IT people, the people who are mowing your lawn, and that is true in bankruptcy. Those people are paid in full in bankruptcy. Those creditors are differentiated. So, I think there are a lot of constraints.

Prior to Dodd-Frank, we didn't—Congressman, you are absolutely right, it was all over the place: WaMu goes into receivership; Lehman goes into bankruptcy; Bear Stearns gets bailed out. It was bad. But I think Dodd-Frank was trying to say, this is the process going forward, here, the government is going to do this, these are the limits on their discretion. I think there are very meaningful limits there, and I'm sorry if we disagree, but I think it is in the statute.

Mr. MEEKS. Thank you. Let me ask Mr. Lacker a question about living wills, which are important tools and should credibly show how a bank could be resolved under the Bankruptcy Code, but it is not clear to me why the effective use of living wills makes elimination of the FDIC's authority under Title II necessary or even advisable. Can you discuss your views on the Orderly Liquidation Authority in light of the failure of the Bankruptcy Code to mitigate the systemic impact, for example, that Lehman's bankruptcy had on the economy and the financial stability? And can you also discuss how taxpayers and the economy would be more secure if a large systemic firm was liquidated under bankruptcy? Moreover, where would large firms find adequate debtor-in-possession financing in the private sector?

Mr. LACKER. Good question. I think the orderly liquidation process provides that discretion. I think it provides enough discretion that regulators are likely to feel boxed in and forced to use it. I think that Lehman told the world a lot of things, and as Sheila Bair pointed out, I think that meant essentially five different firms had been handled four different ways, and then, after AIG, it was six different firms five different ways. I think the tremendous turmoil in financial markets was due to just confusion about what the government's strategy was about doing that.

Now, as for the bankruptcy of a large financial institution, so, we have come to become accustomed with the bankruptcy of a large airline, for example, and plenty of people are creditors of airlines, they go fly airlines that are bankrupt, and things, life goes on. I am not saying that we could ever get to the point where a large financial firm could fail and go into bankruptcy and it would be as far back in the newspaper as an airline bankruptcy, but we need to get to that point, and the key thing to remember is that everything that makes bankruptcy scary for a large financial firm is under our control now. They don't have to be so dependent on the—

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentlelady from West Virginia, the Chair of the Financial Institutions Subcommittee, Mrs. Capito, for 5 minutes.

Mrs. CAPITO. Thank you, Mr. Chairman.

We obviously have a disagreement on the panel, and I think if the basic disagreement is whether too-big-to-fail exists or not and half the people think it exists, then, in my opinion, it exists because, real or imagined, it is very much a part of the Dodd-Frank bill and also the Orderly Liquidation Authority.

So let's dig down with President Lacker, talking about the living wills and how they may be used to then tweak, as Chairman Bair was saying, or reshape the Bankruptcy Code to be able to address the issues that you all have talked about today. Could you please talk about how a living will could be beneficial in this process?

Mr. LACKER. It is a matter of planning ahead of time so that you have confidence that you can take them to bankruptcy unassisted, and it would not be disruptive. Sheila Bair points out the ongoing franchise value of a company sometimes involves liquidity needs. Those liquidity needs are foreseeable. We can plan for those, we can provide for those.

Congressman Meeks mentioned debtor-in-possession financing that a bankrupt firm gets in bankruptcy. That is something we can entirely foresee and for which we can entirely plan. We can estimate how much liquidity they could need at the outside, what is likely needed, what is the worst-case scenario, and we can make them organize their affairs so that they don't need any more liquidity than they would have on hand themselves in a bankruptcy. So they wouldn't need the Fed or the FDIC or the Orderly Liquidation Authority.

Mrs. CAPITO. Let me ask a further question on this because one of the push-backs on an enhanced bankruptcy initially when we argued this was that it wasn't—the courts weren't agile enough or quick enough to be able to react to this. Does anybody have a comment on that?

President Lacker, go ahead.

Mr. LACKER. I will just say I am familiar with proposals for a new chapter in the Bankruptcy Code, Chapter 14. There are some, I think, meritorious features of those recommendations that are definitely worthy of consideration that would improve, that could improve on the bankruptcy process for large financial firms. I think dedicated judges assigned specifically to this class of bankruptcies could help in that regard.

Mrs. CAPITO. Okay. Another thing I have been concerned about, as the Chair of the Financial Institutions Subcommittee, is the consolidation and mergers that we are seeing, not so much on the largest institutions, but we know they are getting bigger, but some of the other smaller institutions, if they can't meet the cost of compliance, so they are either being acquired or merged or whatever. I don't know if this liquidation or this resolution process will mean more concentration in the financial services industry. Has anybody thought of it like that because it does provide that?

Yes, Mr. Fisher?

Mr. FISHER. What is interesting about this conversation is that we are still talking about institutions that are too-big-to-fail. These different sections are to handle these mega-institutions that present a systemic risk. As long as they exist, as long as they have a comparative funding advantage, they place the smaller institutions at a competitive disadvantage, and if that is your question, what I worry about here is this entire conversation is based on maintaining too-big-to-fail and on institutions that are so-called systemically important, and putting them through a process that, again, is understandable, is earnest, but develops a massive bureaucracy and procedure in order to deal with them should they get into trouble.

Far better I think and we propose to structure the system, incent the system to have institutions that don't put us in this position in the first place. That is the basis of our proposal. But as it is now, we are continuing to allow them to concentrate, and then we have these fire drills we put up in case they get into trouble.

Mrs. CAPITO. Right.

Ms. BAIR. Could I just add, I think—

Mr. HOENIG. Let me just say—

Ms. BAIR. Go ahead.

Mr. HOENIG. Let me just say I agree with what Mr. Fisher is saying, but I think, in bankruptcy, there are still two issues. One is debtor-in-possession financing and the other is cross border, and that is what the living wills are partially designed to address, and what a new Chapter 14 would address as well. But if you rationalize the structure of the firms—if you get them into manageable sizes and you scale back the subsidy—you address the drive toward further consolidation. Although that is always an issue, if you take away the competitive advantage that these largest institutions have over regional and community banks, I think you have a much more rational system in which failure can be addressed through bankruptcy, and Title II becomes less significant under those circumstances.

Ms. BAIR. I would just like to add that Title II really subjects these large financial entities to the same process that community banks have always had, and almost all community banks I know support Title II of Dodd-Frank because they know that process. They know it is a harsh process. It is a harsher process than bankruptcy, frankly, because the management is gone; the boards are gone. They have to—they are required to be fired. They can continue in a bankruptcy process. So I don't think—there is a problem, there is absolutely a problem, Congresswoman, with too many of these other regulations applying to small banks and compliance costs, and that is going to speed further consolidation, but on Title II, I think, if anything, most community banks I know support it because it imposes the same discipline.

Chairman HENSARLING. The time of the gentlelady has expired.

The Chair now recognizes the gentlelady from New York, Mrs. Maloney.

Mrs. MALONEY. Thank you very much, Mr. Chairman.

I would like to ask Sheila Bair, I am sure you remember the bailout of AIG in 2008, and we did this by taking an 80 percent stake, equity stake in the company. Essentially, the government or the American taxpayers became the majority owners of the company. We did not put it through bankruptcy, and we did not liquidate the firm. We kept the old firm alive with government money.

Now, I would like to draw your attention to Section 206 of Title II, which says that the FDIC, "shall not take an equity interest in or become a shareholder of any covered financial company or any covered subsidiary." I understand you wrote a large part of Title II. And in light of this prohibition that is in Section 206, do you think that Title II of Dodd-Frank permits more AIG-type bailouts by the FDIC? Does it permit it?

Ms. BAIR. No, just the opposite. It bans, as you say, capital investments. You just can't do that anymore. Title II is really an

FDIC-controlled bankruptcy process. The claims priority is the same. It is more harsh, as I said, because of the punitive way that the boards and managers are treated. So, no, there could be no more AIGs, and that was a very specific purpose of mine in working with this committee and folks in the Senate in drafting Title II.

Mrs. MALONEY. Also, how would a liquidation under Title II be different from the AIG bailout? How would it be handled? How would it be different?

Ms. BAIR. So, there would be a restructuring. My guess is they would use a good bank-bad bank structure. The bad assets would be left in the receivership, the shareholders and creditors would take the losses, the healthy part of the organization would be spun out probably into—I am sure into smaller, more manageable pieces. It would be recapitalized by converting some portion of the long-term debt at the holding company level into equity positions. These would be by private stakeholders, and the equity positions and the healthy parts of the entity that would be spun out back into the private sector, and I think it would take less than 5 years, 5 years is the outer limit, but it is 5 years since Lehman went through bankruptcy, and the bondholders still haven't been paid, so, in the world of restructurings and traditional bankruptcy processes, 5 years is not a hugely long time.

Mrs. MALONEY. And can you please describe why the bankruptcy option and that process did not work for Lehman?

Ms. BAIR. I think, again, there was a full stop with the financing. The franchise lost value very quickly because there was no liquidity left, and I think the ability of the derivatives counterparties to repudiate their contracts and pull out their collateral also had a disruptive effect, and then, of course, you triggered insolvency proceedings in overseas operations, as Tom Hoenig has mentioned, because the whole thing was going into a receivership process as opposed to the single point of entry strategy, which is also the one that the bankruptcy reform advocates want to use. It is the holding company that goes into the receivership, but the healthy operating subsidiaries underneath, including those in foreign jurisdictions, remain open.

Mrs. MALONEY. And very importantly, why did Lehman's bankruptcy really spur a global economic crisis? Can you explain how that happened?

Ms. BAIR. I think it was a combination of things. It surprised the market, as we said. There were so many different—I think there was a bailout expectation, and when the market didn't get a bailout, the market doesn't like surprises. I think the derivatives, the full stop on the funding was a real problem, I think the derivatives counterparties pulling out and then going back to the market to rehedge, I think that created some significant disruptions as well, and then just general uncertainty. Another important recommendation that I make in my testimony which will help facilitate bankruptcy or Title II is better disclosure, what is inside these firms, their financial statements. The market just doesn't have any confidence in them. When Lehman went down—so who else is out there with bad assets that we don't know about because the financial statements aren't doing a very good job reflecting that.

Mrs. MALONEY. And speaking about disclosure, there has been some testimony about reports which have shown that the markets are more dark or less disclosed since Dodd-Frank, that they are really not going on the exchanges. So this is not—probably the best clearest way is an exchange where you know what is happening. Why is it becoming darker? Why is that trend happening?

Ms. BAIR. I was referencing more the financial statements that publicly traded companies and financial institutions in particular have to make publicly available. I think on market trading, yes, that is another problem, and that accelerates volatility because who is trading what and what the deficit market is becoming quite opaque, and the amount of money sloshing around out there, it is quite volatile. So I do think that does exacerbate the problem as well. It is more of a market structure issue.

Mrs. MALONEY. My time has expired.

Chairman HENSARLING. The time of the gentlelady has expired.

The Chair now recognizes the Chair of the Capital Markets Subcommittee, the gentleman from New Jersey, Mr. Garrett.

Mr. GARRETT. Thank you. And Ms. Bair, just to follow up on those lines, who exactly with regard to being the bailed out in those situations under that title—who exactly is it that is being bailed out? Is it the credit—I will answer the question. Is it creditors actually that are being bailed out or—

Ms. BAIR. Nobody is bailed out in a Title II, and nobody—creditors are—if you say because creditors are paid something, that is because the remaining value of the franchise is enough to give them some of their money back. That is true in bankruptcy, that is true in the FDIC. That is not a bailout. That is just the way the process works.

Mr. GARRETT. But is it the creditors who are receiving the fruits of the payments in that situation? I don't want to get into the weeds with the definition of a bailout or not.

Ms. BAIR. No, I think it is more the customers of the institution. It is the customers of the institution who, if they are relying on the credit functions of the institution, are the ones who are receiving the benefit. The unsecured creditors and shareholders are held in receivership and will take whatever attendant offices there are. If the franchise is so worthless that there is very little recovery left, they won't get anything back.

Mr. GARRETT. Yes. So let me go into an area in which I thought I agreed with you. And generally, I agree with you more now than in your previous capacity, by the way. So you made an interesting point in your written statement that I don't believe got a lot of attention so far here, and that is with regard to FMUs, financial and market utilities, is that right? Specifically to their access to the Fed's discount window, and in that area, I do completely agree with that where you say that new GSEs—this is creating a new GSE and a potential new source of system instability if left in place. Now, you may know that last Congress, I introduced, along with Senator Vitter, legislation that would have eliminated Title VIII, among other things, and I would hope that this will be included, by the way, with any new package that goes forward.

But a couple of points with you on this, right? If the Chairman of the CFTC continues to move forward with regulations that force swaps transactions which take place outside of this country, overseas, between non-U.S. firms, and to comply with the clearing requirements under Dodd-Frank, then those clearinghouses will have to do, what, to clear the trades and then also have access to our discount window, right? So isn't that in short what Mr. Gensler is doing is trying to, not maybe trying to, but actually importing potential systemic risk over in Europe and then looking to the taxpayer here in the United States to bail them out? Isn't that the actual outcome?

Ms. BAIR. Congressman, I have not looked as closely as perhaps I should at the CFTC's proposed regulation. Could I give you a written response to that? I'm sorry; I just don't feel like I have enough information to answer that right now.

Mr. GARRETT. But it is true regardless of where they are, your point is that by having access to the FMUs, to the discount window, you basically have a backstop for the taxpayers?

Ms. BAIR. You absolutely do. That is 1,000 percent. I just have not thought about the interrelationship between that designation and what the CFTC is proposing, but yes, that is a bailout. I don't think Title I is, but Title VIII absolutely is. The too-big-to-fail designation comes with liquidity access, no additional regulation. Yes, if you could get rid of that, that would be great.

Mr. GARRETT. Right, so that is all good, and I agree with you, great, on that. The flip side of that is you have also talked, however, in some of your public comments and saying that you have been critical of the claim that the top tier allows for taxpayer bailouts in this section, right? But then you advocated for a prefunded pot of money, bailout money I will call it, paid for how? By additional levies on the financial institutions themselves, and I would—are you with me?

Ms. BAIR. Yes.

Mr. GARRETT. You say, and I can pull out your statements on it, that this is not a tax on the consumer; this is a tax on the financial institutions. Is that correct, in your assessment?

Ms. BAIR. I don't anticipate—first of all, I think you need to differentiate between propping up an institution, leaving it open, leaving the management in place, and giving them liquidity support, which is what you can do with clearinghouses under Title VIII, and once an institution has been forced into receivership, the managers are gone, the boards are fired, the shareholders and creditors will take whatever losses there are. This is true in bankruptcy or Title II. That is the process you provide the liquidity support. So you get the market discipline—

Mr. GARRETT. But ultimately, indirectly, it first goes onto the financial institutions, and the first one, if it can bear it, with its equity and what have you, but if not then to the other financial institutions in the industry, and ultimately doesn't that get passed through to the consumer?

Ms. BAIR. I would be very surprised if that happens, but I think that is a good reason why other large financial institutions which work closely with the Fed and the FDIC to make sure both Title I and Title II work.

Mr. GARRETT. Right. But wouldn't the simple solution just be to—I am with you 100 percent on the first—eliminate that backstop? Wouldn't the simple solution be just treating both of them in the same way to prevent any possibility because nobody knew about the possibility going into 2008 that this was all going to be feed back on the consumer. So wouldn't that be the most direct way, just to eliminate them both entirely?

Ms. BAIR. I would like to get to a world where for operations outside of insured banks, outside of the safety net, I would love Tom Hoenig's activity differentiation, the rest of that can go into a bankruptcy process without hurting the rest of us. I would love to see that world.

Mr. GARRETT. Thanks.

Ms. BAIR. We are just not there yet.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Massachusetts, Mr. Capuano, for 5 minutes.

Mr. CAPUANO. Thank you, Mr. Chairman. I am still trying to process Ms. Bair and Mr. Garrett agreeing on something. I am going to have to rewind this tape at a later time and try to figure this out.

Mr. Hoenig, in your testimony, your verbal testimony, you used the word "perception." Mr. Fisher used the same word. Mr. Lacker, you used the words, "implicit, artificial, the people believe certain things and expectations." I agree with everything that the three of you said on those issues. I may or may not agree on whether there is a real ability to use too-big-to-fail anymore, but I agree that the perception is out there. Whether I like it or not, whether I agree with it or not, it is there.

I agree with it, and by the way, Chairman Bernanke agrees with it as well. To quote his testimony from an earlier date in this committee, he said that market expectations that the government would bail out these firms if they failed, period, those expectations are incorrect. He went on to further state, obviously, the perception is there, but he thought the reality is not, and at a later time, he also stated that the tools that the Federal Reserve used to implement too-big-to-fail in 2008 were no longer available to the Fed. So I guess a lot of this to me is a lot of wasted time. We can agree or disagree whether the law does it or not, but I don't think there is any argument, regardless of what we think the law does, that the perception is there, so perception in this case may well be reality.

Mr. Fisher, I particularly like, and I will be filing a bill to implement your second proposal, the item that just sign something saying we are not doing it. I like that. I don't think you have to repeal anything to do that. I like belts and suspenders. I am going to be filing a bill, and I hope my colleagues will cosponsor it with me. I think that is a pretty good general proposal.

I also particularly liked your comment earlier that it is the first time I think I have heard it said that a SIFI designation provides a competitive benefit to somebody. I actually believe that, but I congratulate you for saying it.

I want to get back to the too-big-to-fail. Really, in my opinion, it deals with the subsidy, the alleged subsidy which I happen to agree is there but some people disagree that the bigger banks or the bigger entities get. I was very interested to note that in all of your testimonies, you didn't really talk about size too much; you talked mostly about complexity and concentration. Now, size obviously factors into that. You can't be complex if you are not big enough. But I wonder, Mr. Hoenig, how would you feel if you could, if I gave you a magic wand, would you re-implement something along the lines or something equivalent to Glass-Steagall if you had that power?

Mr. HOENIG. Yes, I would.

Mr. CAPUANO. Mr. Fisher?

Mr. HOENIG. Something like it. That is what I propose because you want to change the perception.

Mr. CAPUANO. I know that is what you proposed, that is why I asked you the question.

Mr. Fisher, I don't know what you proposed. Would you implement, not necessarily the same law, but something equivalent to Glass-Steagall if you could?

Mr. FISHER. I think what we proposed is similar. I don't think you can stuff Glass-Steagall back in a bottle.

Mr. CAPUANO. I agree with that.

Mr. FISHER. Thank you for offering to put a bill in. I am now proud to have been educated in Massachusetts. Thank you, Congressman.

Mr. CAPUANO. Thank you. Mr. Lacker, would you again impose something equivalent to Glass-Steagall if you could?

Mr. LACKER. I think the living will process will get us there if we need to go there. I think it will identify what activities we need to push out, separate from banking activities, if that is what is needed to make unassisted bankruptcy palatable.

Mr. CAPUANO. Ms. Bair, would you reimpose something equivalent if you could?

Ms. BAIR. Yes, I agree with it, and I think the regulators have the tools under Title I to get there.

Mr. CAPUANO. Thank you.

Are any of you familiar with an article that was written by Professor Hurley and Mr. Wallison of AEI several months ago? It appeared in Forbes magazine. It proposed something that would impose a market discipline on the larger institutions to actually make themselves smaller. It basically would require a higher capital formation if these institutions were too big, which would put pressure on stockholders to then voluntarily shrink the entity. I am just wondering if any of you are familiar with this? If you could read—maybe I will send you a copy of H.R. 2266, because that is my attempt to put it into legislation. I like the idea of the market rather than the government saying, you are too big, I like the idea of the market doing the same thing, which is a little different than everything else. It kind of lets the entities themselves, actually the stockholders make that decision, and I am just wondering, are any of you familiar with the concept of the proposal?

Mr. HOENIG. I am generally familiar with the concept, and my concern is that given that you have them internally, doing this against a market bench, it probably will be gamed, and it will be very hard to get the capital ratios that you would need.

Mr. CAPUANO. I am convinced that anything that we ever do will be gamed, which is why Congress exists, to play whack-a-mole with everybody else.

Mr. Fisher, are you familiar with the concept?

Chairman HENSARLING. Speaking of whacked, the Chair is going to whack the gavel. The time of the gentleman has expired. The Chair now recognizes the gentleman from California, the Chair of our Monetary Policy and Trade Subcommittee, Mr. Campbell of California.

Mr. CAMPBELL. Thank you, Mr. Chairman.

One thing we haven't talked about yet is capital, and the Brown-Vitter proposal over in the Senate is very much capital-based. I have a proposal on this side that is entirely capital-based. The theory from those of us who believe that SIFI institutions should have more capital is that it is an elegant solution, in that by requiring them to have more capital, it makes the circumstances under which OLA or whatever any sort of government bailout, bankruptcy, whatever, would be reduced, and that it simultaneously reduces those competitive advantages that SIFI institutions have because this capital will be expensive, and it will thereby reduce their returns, which might even encourage some of them to break themselves up, either by region or by business line. But we haven't really talked about any of that today, so I am curious from each of you on the capital thing, and I know you have talked about it, Ms. Bair, at long-term subordinated debt. Good idea, bad idea, should it be a part of a proposal, or not part of a proposal? Is it a complete solution, or not a complete solution? I am just interested in all of your views on that.

Mr. HOENIG. First of all, more capital would be a real plus for the industry. Right now, the largest institutions actually have less capital than the regional and the community banks by a substantial margin, so the largest should increase their capital. Whether they should have more capital, I think if you could get them up to the same level as regional and community banks, you would have accomplished something, but I do think for an equal playing field, they should have the same basic tangible capital levels, and then we need to revise the Basel 3 to simplify it and make it more useful as a risk measure against the tangible capital. I do think some of the largest institutions are woefully undercapitalized overall, and that needs to be addressed.

Mr. CAMPBELL. Mr. Fisher?

Mr. FISHER. I agree with Mr. Hoenig, too-big-to-fail with higher capital requirements but without complementary structural changes, I think falls short of the necessary action. Again, living wills, which we talked about before, have higher capital requirements, are potentially helpful tools, but they are not sufficient to ensure the survival of the company, and they will not eliminate massive losses that can choke off liquidity and disrupt financial markets in the economy, so I would say they are necessary. They are important. By the way, the big banks are going to fight you on that big time.

Mr. CAMPBELL. I have experienced that.

Mr. FISHER. You know that? Put on your body armor? But I would say exactly what Mr. Hoenig said, just reminding you that structural changes are also an important part of this aspect. Thank you.

Mr. CAMPBELL. Thank you.

Mr. Lacker?

Mr. LACKER. I think robust capital requirements are very important, very valuable. We have seen increases in capital. They are very substantial since the crisis, and I hope that process continues. I agree with President Fisher; they are insufficient. I think if you get to the point where you have run out of liquidity, where you have run through capital, the fact that you used to have a lot of capital is cold comfort, and I think that the misalignment of incentives, which is at the core of the too-big-to-fail problem, really has to do with what happens in the end game. When you get to the point where you have run through capital and run through liquidity, and I think we have to pay attention to that, too.

Mr. CAMPBELL. Thank you. Ms. Bair?

Ms. BAIR. You know where I am. Yes, your first strategy is always to try to prevent a failure or reduce the probability of it, and that can only be done with high quality capital. We also need to dramatically simplify the risk weightings. They are just broken, and they are providing incentives for frankly harmful behavior. They really need to be changed.

Mr. CAMPBELL. Do you have a view—Ms. Bair, let me just start here in the last minute here, how much capital, debtor equity or what are your—

Ms. BAIR. I have suggested a minimum 8 percent, as has the Systemic Risk Council, which I chair, an 8 percent leverage ratio, nonrisk-weighted assets, with a denominator that includes a lot of off-balance-sheet risks, so it is what is called the so-called Basel 3 leverage ratio, which is one of the good parts of Basel. Not everything in Basel was good, but I think that part was good. They only wanted 3 percent, I think it should be a minimum of 8 percent.

Mr. CAMPBELL. Mr. Lacker?

Mr. LACKER. I don't have specific numbers for you. We are moving in the right direction, though.

Mr. CAMPBELL. Okay. Mr. Fisher?

Mr. FISHER. I don't have a specific number, although I do note that the community bankers aren't uncomfortable with 8 percent capital ratios, and as Mr. Hoenig said, the big ones are woefully undercapitalized relatively speaking although improving, and there should, of course, as Chairman Bair said earlier, I think we have to be careful that we do have a Basel 3 outcome that doesn't penalize the smaller and regional banks.

Mr. CAMPBELL. Last words, Mr. Hoenig?

Mr. HOENIG. I have suggested a leverage ratio as high as 10 percent because before we had the safety net, that is what the market demanded of the industry. So we ought to at least be at that level, and then simplify the industry so we can in fact apply that systematically.

Mr. CAMPBELL. Thank you.

I yield back, Mr. Chairman.

Chairman HENSARLING. Before proceeding to the next Member, Chairman Bair, I was just informed that you are requesting to be excused at noon. Is that correct?

Ms. BAIR. Yes.

Chairman HENSARLING. We won't keep you here against your will. It was simply the first I had heard of it.

Ms. BAIR. Oh, I'm sorry.

Chairman HENSARLING. So, again, for Members, they should take note that Chairman Bair has to leave soon.

The Chair now recognizes the gentleman from Missouri, Mr. Clay, for 5 minutes.

Mr. CLAY. Thank you, Mr. Chairman.

I want to thank the panel of witnesses for their participation today.

This is a panel-wide question, and it goes back to 2008 and prior to that. What was your position regarding the state of the U.S. economy? Did anyone on the panel see a potential collapse of our economy, and if so, did you warn anyone or say anything about it? I will start with Mr. Hoenig, and we will just go down the line.

Mr. Hoenig, did you see trouble coming?

Mr. HOENIG. I did speak about issues in terms of the imbalances that were developing in the economy in 2003 and 2004. I did not identify exactly where this would all play out, but I certainly had my concerns given the interest rates that were in place.

Chairman HENSARLING. Mr. Hoenig, could you pull the microphone a little closer, please?

Mr. HOENIG. I'm sorry. The answer is yes, I did speak about the imbalances that were caused by some of the interest rate policies that were in place at that time.

Mr. CLAY. Thank you. Mr. Fisher, did you see any trouble coming?

Mr. FISHER. Yes, sir. In fact, I listened to Mr. Hoenig at the table and Mr. Lacker, all three of us did speak of this, and particularly was concerned about the housing market, what was happening in the housing market, the excesses in mortgage-backed securities, and without getting technical here, watching the credit default swap spreads that were occurring particularly among certain firms, Merrill and others, Bear Stearns, one could see a storm coming.

As to how pervasive and how dangerous it would be, one could not foresee that, but one knew that there was a big storm on the horizon, and we spoke about it a great deal at the Federal Reserve.

Mr. CLAY. Go ahead, sir?

Mr. LACKER. In June of 2008, I gave a speech warning that the actions we had taken with Bear Stearns would set precedents that would alter incentives going forward and had the potential to contribute to financial instability.

In all fairness, I was looking forward to the next business cycle, not the one we were in then. I had no idea that it would come so soon and so swiftly and with such ferocity.

Mr. CLAY. Thank you.

And Ms. Bair?

Ms. BAIR. Yes, when I was at Treasury in 2001 and 2002, I spoke about and tried to do something about deteriorating mortgage lending standards. I went into academia. I came back to the FDIC in 2006. The FDIC staff were already on top of this. We started speaking very early about deterioration in lending standards, the underpricing of risks, the need for banks to have more capital, not less, so I think we do have a good track record on that.

Mr. CLAY. When you were at Treasury, did you bring it to the attention of then-Treasury Secretary O'Neill?

Ms. BAIR. We did. We initiated something, Ned Gramlich, the late Ned Gramlich worked with me. We tried to get—the Hill was not going to have mortgage lending standards. I think there were some on this committee who were trying to do it on a bipartisan basis. The Fed had decided they didn't want to write lending standards. They had the legal authority. So we put together a group of industry and consumer groups to develop best practices to try to put some curbs on this, but it was voluntary so it helped little on the margin, but yes, that was all very public.

Mr. CLAY. Thank you for that response.

One more panel-wide question: Do you think that U.S. taxpayers are better off today with the Dodd-Frank law, or are they not better off today in fear of another bailout of large banks by taxpayers?

I will start with Mr. Hoenig.

Mr. HOENIG. Today, we have institutions that are every bit as vulnerable as we had before, and that is a concern. Hopefully, we have the tools in bankruptcy to make sure that we don't repeat the mistakes of the past. But I do worry that if they do get into trouble, we still have a very vulnerable financial system.

Mr. FISHER. I would agree with Mr. Hoenig, Congressman, I don't think we have prevented taxpayer bailouts by Dodd-Frank, and I think the taxpayer is still susceptible, and I would like to have, again, restructuring occur so that this would not be the case.

Mr. CLAY. You don't think Dodd-Frank and certain sections provide enough protection to taxpayers?

Mr. FISHER. No, sir, because I think it still perpetuates too-big-to-fail.

Mr. CLAY. Okay. All right.

Mr. LACKER. I agree that the Dodd-Frank Act did some good things, and also did some things that I don't think are the best approach to these issues. Back in the 1930s, there were several pieces of substantial banking legislation. It wouldn't be uncalled for, for Congress to revisit this issue again.

Mr. CLAY. Thank you.

And Ms. Bair?

Ms. BAIR. I do think Dodd-Frank provides very strong protections against taxpayer bailouts. The shareholders and creditors will be taking the losses. If there should be any shortfalls, there is going to be an industry assessment, the taxpayers aren't going to pay for it, and I am happy to support an amendment to the Tax Code to eliminate the deductibility of those payments if an assessment ever occurs.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Georgia, Mr. Westmoreland.

Mr. WESTMORELAND. Thank you, Mr. Chairman. And I want to thank the witnesses for being here today.

This question is for President Fisher and President Lacker. Can Dodd-Frank's Orderly Liquidation Authority provide the opportunity for more AIG-like bailouts where a hard-working, taxpaying factory worker in my district would end up bailing out the creditors of European banks 100 cents on the dollar?

Mr. FISHER. Mr. Lacker, would you like to go first?

Mr. LACKER. Sure. It has been commented before that there were certain features of the way we structured the intervention into AIG that wouldn't be legal now, purchasing equity, for example. But having said that, the way that the Orderly Liquidation Authority is envisioned to work, with a single point of entry, a parent company, it envisions providing funds from the FDIC that would let creditors of operating subsidiaries escape losses. So I would have to say that your characterization is accurate, that it could happen again.

Mr. FISHER. With regard to your hard-working factory, Congressman—

Mr. WESTMORELAND. Taxpaying. Hard-working, taxpaying.

Mr. FISHER. Hard-working, factory-working taxpayer, I don't believe that it provides adequate protection for that type of individual. I think it, again, enmeshes us in hyperbureaucracy, and it certainly doesn't do anything for, and in fact doesn't improve the situation, the comparative advantage too-big-to-fail institutions have over whom that individual is likely to go to, to secure a loan or finance their car or do the kind of things that they like to do and they need to do at their level, the small community and regional banks.

And as long as that advantage is maintained or, as the gentleman pointed out earlier, perceived to have been maintained, then they are at a funding disadvantage to the operation of these large systemically important financial institutions.

So from the standpoint of that particular constituent it may mitigate the risk for these gigantic institutions, but it doesn't prevent these gigantic institutions in the first place nor the advantage they have in operating compared to the bank with which that institution is likely to work.

Mr. WESTMORELAND. Thank you.

Let me ask, I know that there has been some agreement between most of you on the panel. I know one area that you do agree on, I think all of you support the Brown-Vitter bill that is in the Senate, that we have heard a lot about over here. Do you think that when we are looking at too-big-to-fail, we need to look at some of these things that are in Brown-Vitter? And the thing that I would like for you to comment on is the 15 percent capital requirement for the 8 largest banks. I got in here a little late and heard Mr. Campbell asking some questions about the cash requirements. Do you feel that the 15 percent for these larger banks is an unrealistic number or do you think that is the right number?

Mr. HOENIG. I think that the Brown-Vitter approach does bring the discussion forward in the right way. Whether 15 percent is the right number, I think that may be high given the history in terms of capital. My number is 10 percent with a real leverage number. But that would do much to improve these institutions which are right now sorely undercapitalized.

And to again make the point, this would be even more effective if we had the system rationalized where we were looking at commercial banks as commercial banks and broker-dealers as broker-dealers and where the capital requirements are different for each. They are different types of animals, they have different risk profiles, and the markets should in fact demand the capital that it needs, and it is going to do that if we scale back the subsidy that is right now distorting what the right capital ratio should be.

Mr. FISHER. I would agree with that, Congressman. And I would also add that one of the benefits of Brown-Vitter—and I am not willing to endorse the bill entirely; there are some aspects in terms of the Federal Reserve that are undefined in it—is it does show that there can be a bipartisan approach to dealing with what is a problem and it encourages me enormously.

As to the capital ratios themselves, again, if you were to follow our plan at the Dallas Fed where we would only provide the Federal guarantees to the commercial banking operation of a complex bank holding company, I am not sure we have to be as high as 15 percent, and I am more in the range of Mr. Hoenig. And I think that will be a negotiated rate, again depending on how big the lobbies are and how powerful they are at influencing the Senators who have to vote on that bill.

Mr. WESTMORELAND. One quick comment to that, and then I know my time is up. But there were different levels: the 15; the 10; and the 5. Do you think all those levels need to be adjusted from your standpoint or just the top level?

Mr. HOENIG. I think we need to have an across-the-board number that is applicable to all so that you have a level playing field, but I think that is dependent upon correctly separating out the broker-dealer activities which would then define their own capital needs.

Chairman HENSARLING. The time of the gentleman has expired. And again, for Members, although I just recently learned about this, we will excuse our witness, Chairman Bair, at this time.

I assume, Madam Chair, that if Members have further questions, you would be happy to answer them in writing.

At this time, the Chair will recognize the gentleman from Texas, Mr. Hinojosa, for 5 minutes.

Mr. HINOJOSA. Thank you, Mr. Chairman. I had a question for the Honorable Sheila Bair, but I think I will pass that question on.

Chairman HENSARLING. The gentleman is officially out of luck.

Mr. HINOJOSA. Yes, I am out of luck. I apologize that I had to run to speak to a very large group of students on the Education Committee and I was one of their speakers. So I ran down there and spoke and ran back to take this opportunity to ask a couple of questions.

So I will start with the first one for President Richard Fisher. I want you all to know that he is my fellow Texan, someone that I know very well, and I would like to ask him a question or two, because I read an article in Bloomberg, and I quote, “Fed’s Fisher urges bank breakup amid too-big-to-fail injustice.” And one sentence that I will read, it says, “Fisher reiterated his view that the government should break up the biggest institutions to safeguard the financial system. He is one of the central bank’s most vocal critics of the too-big-to-fail advantage he says large firms have over smaller rivals.”

So my question then, President Fisher, is you have made those statements, and I have to say that I respectfully disagree with you about the tools within Dodd-Frank to end too-big-to-fail, but I am interested to hear your thoughts about the danger of ever-growing megabanks. What danger do they pose and how would you go about splitting them up?

Mr. FISHER. Thank you, Congressman Hinojosa, and I have explained that in my more fulsome statement that I submitted. First, I want to make it clear that I would prefer to have a market-driven solution here, and our first aspect of our proposal, which we have discussed while you were in and out of the room, is that the government guarantees that its deposit insurance access to the Federal Reserve discount window would be applied only to the commercial banking operation of a complex bank holding company. They would be allowed to continue to have those other aspects, but everybody who is a counterparty with those other parts of that big bank holding company, or little bank holding company, whatever it may be, would simply sign an agreement saying that the government will never, ever come to their rescue should that transaction go sour.

I think if you did that, then market forces would begin to focus on who is strong in these areas and who is not and you would have a better rational allocation if it was understood that the entire bank holding company wasn't protected as too-big-to-fail. So I want to make sure that you understand that I prefer a market-driven solution rather than a government-imposed solution, although there may have to be a bridge in a period where the government might, by making clear how we would approach this ultimately, implementing the plan that we have suggested, rather than the hypercomplexity that is embedded in the 9,000 pages of rules that have come out of Dodd-Frank. I don't mean that disrespectfully. I am just stating an observation here that simplicity sometimes trumps complexity.

Mr. HINOJOSA. I am glad you gave us the count, because it is a huge piece of legislation. I want to say to our witnesses that I agree that it is important for us in Congress, both Republicans and Democrats, to read the law and examine the relevant provisions within the Dodd-Frank Act. And I want to ask a question on a portion of the Dodd-Frank Act, specifically Title XI, Section 1101(A)(B)(i), which reads, "As soon as practicable after the date of enactment of this subparagraph the Board shall establish by regulation, in consultation with the Secretary of the Treasury, the policies and procedures governing emergency lending under this paragraph."

So my question I guess will go to our first panelist, the Honorable Thomas Hoenig, if you would like to answer this question. Can you discuss the emergency lending authorities that were used in 2008, as well as how they were used, and whether that type of lending is possible under Title XI of the Dodd-Frank Act?

Mr. HOENIG. In 2008, the primary section that was used was what is called Section 13(3), which allowed for lending under exigent circumstances to institutions, including nonbank institutions. So that would allow for the lending to the money markets and so forth. That provision was used extensively in that crisis.

The law that you are citing is designed to limit the lending ability, as it has to be systemic, it has to be industry-wide, not given on a case-by-case basis to individual institutions. We don't know until you actually have a crisis whether we will be able to implement that authority or whether the Federal Reserve will be able to implement that successfully.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from California, Mr. Royce, for 5 minutes.

Mr. ROYCE. Yes. I think as we go to the written testimony of Mr. Fisher, President Fisher and President Lacker, we have this concept of what we do when we place a name, SIFI, on these institutions. What are the unforeseen consequences of doing that? Are we sending the message to say that they occupy a privileged space in the financial system? What does that mean in terms of their cost of borrowing compared to the costs faced by their smaller competitors? As Mr. Fisher pointed out, it is like saying you bought it at Neiman Marcus when you have this stamp.

And my question is, did the Dodd-Frank legislation further expand, compound the conundrum here by using an arbitrary, or as the General Counsel of the Fed calls it, a somewhat arbitrary threshold number of $50 billion in assets to determine SIFIs, and do we really make the system safer by putting everyone in the pool together in this way, or is there a better way to do this? And if there is a better way to do it, what is that better way? That is my question to the panel.

Mr. LACKER. If I could, Congressman Royce, when I think of the provision of the Dodd-Frank Act about designating SIFIs, it is a natural outgrowth of one of the animating philosophies of Dodd-Frank, which is that rescues are inevitable and we need to do what we can to stiffen and strengthen the constraints on risk taking at these institutions. I think strengthening constraints on risk taking is a valuable thing, but the other animating philosophy which at times competes in Dodd-Frank is that we want to strengthen market incentives and the discipline that a competitive marketplace imposes on institutions and the power of that discipline to limit risk taking. And from that point of view the designation of SIFI cuts in the other direction because of the implication coming out of the first philosophy, the implication that it is there because they are viewed as likely to be rescued.

So there are cross-purposes there in that designation. How we grow out of that, how we transition away from that, I am not sure I have a solution for you, but it is a dilemma in the end.

Mr. ROYCE. Thank you, Mr. Lacker.

Any other observations on that?

Mr. FISHER. Again, I think by designating an institution as systemically important, you give it a special moniker. And by having a procedure which is under the FSOC to deal with these institutions that are considered systemically important or that might present risk by being systemically important, you give a special imprimatur. I just think that places the community and the regional banks at a disadvantage.

And again, Congressman, I would respectfully ask you to take the time to read the proposal that we have made in the Dallas Fed. Under our plan, supervisory agencies would oversee several thousand community banks, as they do now—

Mr. ROYCE. I understand.

Mr. FISHER. —a few hundred moderate size banks, and no megabanks.

Mr. ROYCE. But remember that part of my question was the $50 billion threshold.

Let me ask Mr. Hoenig.

Mr. HOENIG. Let me just say, first of all, that being a SIFI has advantages and disadvantages. The disadvantage from their perspective is they have to do these living wills. I found in the last crisis that no one wanted to be a holding company until they wanted to be a holding company, that is, only when it is to their advantage. So I think there are institutions that will affect the economy which do not want to be designated SIFIs, because of this work, until they need to be, and I think that is a risk.

On the $50 billion, it is not indexed, and there are a lot of institutions that would be pulled into that. If that is the issue, raise the limit, because I don't want it to be discretionary any more than absolutely necessary because then you get different outcomes depending on what the political pull and so forth is of the individual institutions.

Mr. FISHER. And I would agree with that, Congressman Royce.

Mr. ROYCE. And the last question I would ask you is just the factors that should be taken into account if we are going to set a regulatory standard in terms of moving over from the risk-based approach towards an equity capital standard or equity leverage ratios. If we move in that direction, what then are the factors that should be taken into account in setting a regulatory standard?

Mr. Hoenig?

Mr. HOENIG. I think, first of all, we need to make sure the leverage ratio does include off-balance-sheet items, either using international accounting standards or a—

Mr. ROYCE. That is the major issue to you?

Mr. HOENIG. A major issue. Because you have value, you have $1.5 trillion on the largest company off balance sheet in derivatives. That is just the derivatives. That is not the lines of credit. So that needs to be brought into the equation.

And then we should ask, what should be the right number? And I think the Basel discussion should be about what the right number should be based on research that is out there, and what the timeframe should be to get to that number. Then, you have a systematic approach for leverage. Then, simplify the risk base to make sure that they don't get out of bounds just using a pure leverage ratio.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Massachusetts, Mr. Lynch.

Mr. LYNCH. Thank you, Mr. Chairman. I also want to thank the witnesses for coming before this committee and helping us with our work.

Let's pick up right on that point of derivatives. Each of you has expressed concerns about inappropriate use of the government's safety net. Section 716 of Dodd-Frank, commonly referred to as the swaps push-out provision, would force banks to move at least the riskiest swaps out of the insured depository institution.

Do you believe the pricing of swaps in depository institutions receive a benefit from access to the Federal safety net and do you support our efforts in Dodd-Frank to move them out of the depository institution?

Mr. HOENIG. Yes and yes. I do think that they should be outside, and I think being inside does give them a subsidy and does facilitate their ability to use those instruments beyond what they would be able to do without a subsidy.

Mr. FISHER. Yes and yes squared.

Mr. LACKER. Derivatives provide the opportunity to do good things and to take excessive risks, and I am not sure the law as crafted doesn't go too far and limit the ability of banks to use derivatives in legitimate ways.

Mr. LYNCH. One of the problems that remains here is by allowing internal models of these banks to really calculate their risk is in many cases I think discounting the risk that really does lie within these megabanks' derivative exposure, and also the accounting rules here in the United States, I think, allow some of that discounting to occur.

Mr. Hoenig and Mr. Fisher, I believe from your earlier testimony, would you agree that just going to just a capital standard such as in the Brown-Vitter rule, just a 15 percent, instead of getting into whether or not the activity being undertaken is creating the risk, just putting a flat 15 percent—I know 15 percent doesn't have to be the number, but certainly using a total asset-based standard versus an activity standard, is that more appropriate?

Mr. HOENIG. I think you need both. I think you need to have them pushed out to where they are away from the safety net, where they are constantly encouraging increased leverage. But for those institutions you need a strong capital standard in terms of the unexpected. Capital is for good management who make mistakes. It doesn't save everyone from foolish mistakes, but it does help moderate the extremes. But you also have to change the incentive. If the incentive is to lever up because you have a subsidy, you are going to do it. Eventually you are going to push hard, as we have seen over the last 10 to 15 years.

Mr. FISHER. I don't disagree, Congressman. I would like to make a side comment, if I may. The transition in banking that has occurred has been from going from a balance sheet mentality to an income statement mentality. That is, the old banking system used to be where you focus on just preserving the institution, protecting your depositors, and doing what bankers do, intermediating between short-term deposit and long-term risk in terms of commercial loans, et cetera.

The transition that took place post-Travelers and Citigroup, which was quite brilliant, is the transition of mentality to an income statement, how much can we make every single year. And I think what we really need to guard against in the end is the utilization of these derivative transactions to continue to maintain the income statement mentality that seems to be pervasive in these large industrial concentrations, the big megabanks.

So my belief on capital, for what it is worth, and I stress for what it is worth, I believe we should have equity capital as the primary Tier 1 protective capital of the institution, again, especially securing the commercial banking operations of the institution, which is where we provide the government guarantees that we provide or propose be restricted, that they be applied.

Mr. LYNCH. Thank you.

Mr. Lacker?

Mr. LACKER. I think capital quality is very important. I also think we should be humble about the ability of any one group of regulators or supervisors to settle on the single optimal formula for capital. So I think the robust approach would be to use multiple measures.

Mr. LYNCH. I thank the gentlemen.

My time has expired. I yield back.

Chairman HENSARLING. The Chair recognizes the gentleman from Missouri, Mr. Luetkemeyer, for 5 minutes.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

And thank you, gentlemen, for being here today.

I was wanting to talk to Ms. Bair with regards to an article that she wrote April 1, 2013, appeared in the Wall Street Journal, with regards to allowing the banks to basically develop their own internal models with regards to risk basing or to risk weight their capital. And she starts out with the headline of the article, "Regulators Let Big Banks Look Safer Than They Are," with the subtitle, "Capital ratio rules are upside down. Fully collateralized loans are considered riskier than derivative provisions."

As you go through the article, she talks about the difficulties in actually comparing the big banks with the little banks because of the way they model their capital asset ratio and the riskiness of the assets that they are looking at. And she made the comment here that, "And now the London whale episode has shown how capital regulations can create incentives for even legitimate models to be manipulated." And then talks about the latest Fed stress test on Morgan Stanley reported that the risk-based capital ratio was nearly 14 percent. Taking the risk weighting out drops the ratio down to 7. U.S. Bancorp has a risk-based ratio of 9 and virtually the same ratio on a nonrisk-weighted basis.

So we are playing games with the ratios. And I think we have mentioned it a few times and I would just like to get down to the nitty-gritty here, because each one of you have alluded to these same things a couple of times here, in the last two or three folks who have asked questions with regards to how you can play around with the ratios and get right down to the exact real Tier 1 capital.

Can you give me some hard and fast information or an opinion on that, Mr. Hoenig, because you are the one who said a minute ago that we need to simplify the capital—

Mr. HOENIG. Right. I am familiar with her article. I happen to agree with it completely. I think their reporting of 14 percent risk weighted is counting only 50 percent of their total assets as risk. And then when you take out the good will, the intangibles, and you go to equity tangible capital, and you bring on the off balance sheet items, the derivatives and so forth, the risk part is about 3.5 percent to 4 percent. So you have really given the wrong impression, I think, to the market and to the public.

And so what I have suggested is that you have a leverage ratio that is equity capital with the good will and the intangibles out and that you bring onto the balance sheet those off-balance-sheet items that have risk. There are ways to do that systematically, and then report that.

The advanced approach where they are doing internal models is an opportunity to game the system by underreporting risk assets based on advantages that the regulators give by the risk weights themselves. That leads to bad outcomes.

Mr. LUETKEMEYER. Okay. Now you, as a regulator, all three of you gentlemen as regulators, how are you going to get through this little manipulation game that is being done here? Whenever you look at these banks, are you going to say, hey, wait, wait, this is not where you need to be. We are going to take a look at this a little bit differently and force them to raise capital or do something different with their risky assets here?

Mr. HOENIG. Hopefully, through the process of the regulators coming together, we will turn to a leverage ratio that is meaningful. And that is still in process as we look at this Basel agreement. We need to have a full capital program that includes proper risk, simplified where people can at least operate it or understand it from the outside, with a leverage ratio that gives us a standard across all institutions, nationally and internationally, so that you can compare apples to apples and then you can judge risk based upon a useful risk-weighted system. We should do that as one proposal.

Mr. LUETKEMEYER. The reason I bring the question up, and I appreciate your comments, is because a lot of Members and a lot of the public believe that Dodd-Frank solved all these problems. There are still inherent problems with the way they are regulated, with the way some of this information is interpreted. And while Dodd-Frank may have an ability to wind down a particular institution, if you have a meltdown like we had in 2008, it is, "Katy, bar the door." We will throw out the rules and regulations and we will do, as Paul Volcker said, "whatever it takes to get this situation solved."

And with that, Mr. Lacker, I have just 37 seconds left, you mentioned a while ago that you have some 1930s laws and regulations we may need to go back and look at. Would you like to elaborate just a little bit?

Mr. LACKER. I was just pointing out that in the 1930s, there was the Banking Act of 1933. It was a response to just the tremendous turmoil of the banks, the waves of bank failures in 1931, 1932, and 1933. And then Congress revisited banking legislation 2 years later in 1935. They didn't feel as though the Banking Act of 1933 was sufficient. I was just pointing out you might want to take a second bite of the apple.

Mr. LUETKEMEYER. We can use all the good advice that we can get. Thank you very much, and I appreciate all three gentleman being here today.

Mr. Chairman, I yield back.

Chairman HENSARLING. The Chair now recognizes the gentleman from Colorado, Mr. Perlmutter, for 5 minutes.

Mr. PERLMUTTER. Thanks, Mr. Chairman.

Gentleman, I appreciate your testimony today. I have a couple of questions, and I will start with you, Mr. Hoenig. We talked a little bit about Glass-Steagall, and you and I have had conversations about Glass-Steagall. And really, as I remember it, there were three parts to Glass-Steagall: the creation of your organization, the FDIC; the separation of investment banks and commercial banking and insurance companies and that kind of stuff; and the creation of unitary banking. So each bank, big or small, stood on its own capital.

I have had the opportunity as a State senator to vote against branch banking. I lost, because I believed in unitary banking. I had the opportunity here when we were going through Dodd-Frank to, with Mr. Kanjorski, offer an amendment that separated investment banking from commercial banking, and I lost. So I appreciate the things that you are saying, but we are in a political world in this place and you have to have more votes. So we came up with a third approach, Mr. Hoenig, and let's go through it.

So as I understand this, first we try to deal with things in advance. Is that right? The living will—

Mr. HOENIG. Right.

Mr. PERLMUTTER. I know a couple of the very big institutions have 2,000 or 3,000 subsidiaries. Is that right?

Mr. HOENIG. Yes.

Mr. PERLMUTTER. And as regulators, we have put a lot of pressure and a lot of responsibility on your shoulders to look at those living wills, to say, hey, this gives us a good roadmap as to what to do if everything falls apart. Correct?

Mr. HOENIG. Yes.

Mr. PERLMUTTER. So I am going to lead you a little bit here. That is kind of what I do. Then if you see some things that are potentially a problem, you can demand more capital as a regulator. Isn't that right?

Mr. HOENIG. Yes.

Mr. PERLMUTTER. And if that is not sufficient, you can ask for divestiture?

Mr. HOENIG. Yes.

Mr. PERLMUTTER. This is all in advance of getting into bankruptcy, because, Mr. Fisher, Mr. Lacker, I will get to you, too, in a second. You can order a divestiture of some part of the organization, it could be the investment banking, it could be the insurance, it could be the making of engines. We have a big SIFI potentially that is in the manufacturing business. Correct?

Mr. HOENIG. Correct.

Mr. PERLMUTTER. None of that works. Then, I start into the statute. Section 202 allows the Secretary of the Treasury to go to the United States District Court and petition the court to place the whole kit and caboodle into receivership. Isn't that right?

Mr. HOENIG. Yes.

Mr. PERLMUTTER. And this can be done over a weekend in a confidential setting with that United States District Judge.

Mr. HOENIG. Yes.

Mr. PERLMUTTER. And it is very similar to what occurs today, is it not, when the FDIC—they don't go to a judge, but they can place somebody into a liquidation over the course of a weekend.

Mr. HOENIG. That is correct.

Mr. PERLMUTTER. And SIPC does that, but they do go to a judge to place a broker-dealer into liquidation. They do have to get an order of the court.

Mr. HOENIG. Right.

Mr. PERLMUTTER. So now we are in the courtroom, we are in a bankruptcy setting, but it is with the United States District Court, not bankruptcy court, right?

Mr. HOENIG. That is correct.

Mr. PERLMUTTER. All right. So now, we are in court. What is it that you think now allows for the Secretary and the FDIC as its agent, the receiver, to allow too-big-to-fail to continue? We are now in the court. You have the bank potentially being liquidated by the FDIC and you have the rest of the company in court in a bankruptcy. And "bankruptcy" has been used very loosely. There are two kinds of bankruptcy: liquidating; and reorganizing.

So what is it that really bothers you about now we are in court, you have the bank in liquidation and the FDIC in charge, and now you have the rest of the company going under the authority of the United States District Judge and the receiver. And I am already out of time by my leading questions.

Mr. HOENIG. It assumes all your leading questions are correct assumptions.

Mr. PERLMUTTER. That is why I said, do you agree.

Mr. HOENIG. Well, no, I said you can do it. Whether you will do is the question that is unanswered.

Mr. PERLMUTTER. All right. Now, that is really the question. Do the regulators have the guts to do what we have asked of you? That is the real question.

Mr. HOENIG. But, Congressman, the Bank Holding Company Act has had a provision for the last 30 years that if a nonbank affiliate jeopardizes the bank you can force divestiture, and I don't think it has ever been used.

Chairman HENSARLING. The time—

Mr. PERLMUTTER. I am giving you the tools. You have to use them.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from North Carolina, Mr. Pittenger, for 5 minutes.

Mr. PITTENGER. Thank you, Mr. Chairman.

Mr. Fisher, I will direct this to you first, but I welcome comments from any of you. Why is more complex regulation, particularly complex capital regulation, an ineffective way of reining in market expectation of government bailouts?

Mr. FISHER. I'm sorry, Congressman, I didn't hear your question. Excuse me.

Mr. PITTENGER. Why is more complex regulation, particularly more complex capital regulation, an ineffective way of reining in market expectation of government bailouts?

Mr. FISHER. Again, I think if you are simple and straightforward, it is a better solution than complexity. One of the disadvantages of complexity is it places the smaller and regional institutions at a disadvantage. If you talk to community bankers now, they will tell you what they are hiring are lawyers and consultants rather than people who can make loans and affect the business and do the business that they are paid to do.

So it gives an advantage again to those that are big and rich. And the more complex it is, the more you are just giving a comparative advantage to those that have the means to deal with these complexities. And that means the very large institutions. That is the simplest way I can possibly explain it.

Mr. PITTENGER. It makes sense.

Would you all like to respond?

Mr. Hoenig?

Mr. HOENIG. I am not sure that I understood your question completely, but I think the fact is that more capital is helpful. But if you have a subsidy that is driving you towards leveraging and it gives you a cost of capital advantage, as Mr. Fisher is saying, over regional and community banks, it leads to, I think, unintended bad outcomes where you then further consolidate the industry and give the largest firms a competitive advantage that they don't otherwise deserve or would earn in the market.

I hope I understood your question and answered it.

Mr. LACKER. So banking is a complex activity these days, and I think you need to grapple with that complexity. It doesn't mean you fine tune the complexity of your supervisory approach or regulations to it, but you have to be robust against the ways in which firms and markets can adapt to what regime you put in place. So that robustness is what you have to look for, and that is why I think on the capital front, there is a logic to risk-weighted assets, but there is also a sense in which humility ought to lead you to not place all your eggs in the basket of one capital regime. And the value of simplicity, I think, comes forward then.

Mr. PITTENGER. Let me ask you, Mr. Fisher or Mr. Lacker, how can we level the playing field between the smaller and the regional financial institutions compared to too-big-to-fail?

Mr. LACKER. I think leveling the playing field is going to require eliminating the expectation of support for the creditors, the wholesale funding lenders from which they benefit. That wholesale funding source is what I see as the most consequential aspect of the advantage too-big-to-fail gives to larger institutions.

Sure, being too-big-to-fail comes with an outsized burden of compliance, but compliance has hit a lot of small and regional institutions as well. A lot of the compliance burden is a reaction to the risks that have been taken and the riskiness that we see in the banking industry and the exposure of U.S. taxpayers and the government to these institutions, large and small. If we were able to rely more on market incentives, on market discipline, there would be less of a need to continually grow the compliance burden on these institutions and that would help level the playing field as well.

Mr. FISHER. My definition of leveling the playing field, Congressman, is if you are a small or regional bank, or if you are in the 99.8 percent of the 5,500 bank holding companies we have, the FDIC has a saying: "In by Friday, out by Monday." If you screw up, your management is removed, and new ownership is put in place. The playing field will be level when that applies to all financial institutions, including large ones.

Mr. HOENIG. If I can add, number one, you do need to get the capital ratios to be more equal. Right now, the largest institutions have a capital advantage.

Number two, you do need to rationalize and separate out so that commercial banks are commercial banks and the subsidy is confined to that. Then, whether you are a community bank or regional bank or large bank, you are playing on a much more level playing field and I think competition will be well-served.

Mr. FISHER. And leveling the playing field is the purpose of the Dallas Fed's proposal, Congressman.

Mr. PITTENGER. Thank you.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair recognizes the gentleman from Delaware, Mr. Carney, for 5 minutes.

Mr. CARNEY. Thank you, Mr. Chairman, and thank you to the panelists. This has been a very interesting and fascinating discussion today. I don't know that we have shed any light on answering the question of whether too-big-to-fail exists or not, but we have had some really great discussion, I think, about that.

I would like to say with respect to SIFIs being a privileged designation, it is funny, I have not had anybody come to me requesting to be put in the category of being a SIFI. In fact, just the opposite. People have come to us saying, we shouldn't be included in this designation, just as an observation.

But I would like to pick up where Mr. Perlmutter left off in the District Court, and I guess start with you, Mr. Fisher, and ask the question I think he was about to ask, which is what problem do you have with the legislation as it relates to the firm that is brought into the District Court by the U.S. Treasury because it is in big trouble?

Mr. FISHER. I am going to ask Mr. Hoenig to address this question, if I may.

Can you do that, Tom?

Mr. HOENIG. Yes, first of all, if you have these largest institutions in the country at risk of failure, you have to go to the Federal Reserve and the FDIC and get the two-thirds vote to put them in the Orderly Liquidation Process.

Mr. CARNEY. With the potential, as Mr. Fisher said in his testimony, of these eight institutions to take down the rest of the financial system.

Mr. HOENIG. Right. So you are up against this major consequence to the economy. Then, you go to the Secretary of the Treasury, who has a choice: Do I put it in receivership and put that chaos in play or do I do something else? There are options perhaps I can find that would not force it into bankruptcy such as going to the District Court, or going to the President.

So that is a very, very difficult process, which it should be. But I think when you then have the economy going down, you tend to want to step in and intervene in a way that doesn't cause failure.

Mr. CARNEY. Rightly, yes?

Mr. HOENIG. Yes. You are going to be very slow to act.

Mr. CARNEY. So then the District Court Judge determines whether to require orderly liquidation under the Act, correct?

Mr. HOENIG. If the Treasury Secretary does bring it to him, yes.

Mr. CARNEY. If the Treasury Secretary brings it.

Are you familiar with the enhanced bankruptcy proposals that the people out at Stanford have developed?

Mr. HOENIG. Yes.

Mr. CARNEY. What if the District Judge had the option of triggering either the Orderly Liquidation Authority or some sort of structured bankruptcy? The difference, I think, being—I am no expert, as Mr. Perlmutter is, in bankruptcy—that there is no access to the wholesale funding source.

Mr. LACKER. If I could comment on that, it is worth pointing out that in the scenario Congressman Perlmutter laid out, actually they don't spend much time in court. And the sense in which that is true is that there are only limited aspects of the Secretary of the Treasury's decision that are subject to review by the court, and it is just these two fact-finding things out of five determinations that the Secretary makes.

Mr. CARNEY. Okay, don't get too far down in the weeds, we don't have much time. I am interested in whether you think it would be a better process if the judge had that discretion and why?

Mr. LACKER. I think it would be useful if the regulators themselves could initiate bankruptcy. As things stand now, they don't have the option to do anything but orderly liquidation by themselves. They can ask the firm to put itself in Chapter 11, but they can't force that. The Hoover Group proposal would give regulators the ability to do that, and I think that would be valuable, and I think that would be a better way to get to the right outcome.

Mr. HOENIG. May I add that if the Stanford Group is successful with regard to the Chapter 14, which they are working on now—to address the issues of debtor-in-possession financing to provide liquidity and cross-border issues—then bankruptcy will be a natural first choice in every instance.

And those are the two things that the Orderly Liquidation Authority addresses. That is why it is there. So, you have to get a solution to debtor-in-possession and cross-border issues to make sure we can put the largest firms into bankruptcy. That is what Stanford is working on.

Mr. CARNEY. Thank you very much. My time has expired.

Mr. MCHENRY [presiding]. We will now recognize Mr. Hurt of Virginia for 5 minutes.

Mr. HURT. Thank you, Mr. Chairman.

And I want to thank each of you for your testimony here today, and I'm sorry that Ms. Bair is gone because I thought her testimony was very interesting as well.

It occurred to me as I listened to the testimony of each of you that there really can be or should be some opportunity here to amend the Dodd-Frank law in a way that really can get us where I think that we all want to be, and that is something which has eluded us over the 2 years that I have been in this Congress. And so this gives me some hope that maybe there is some possibility that we can do these important, important, important things that we must take the opportunity to do while we can, as Mr. Lacker said, all the things that we can do to keep this from happening again. We control those levers, if we will. And so, I am just very interested in your testimony, and I thank you for it.

I guess my first question—which would have been to Ms. Bair had she been here, she makes it pretty clear; she uses the word "abolish." She says that bailouts are abolished under Dodd-Frank. But I hear something different from this side of the table, that it is really not that clear. And when you look at the numbers—and I was particularly interested in the numbers from the Richmond Fed—that financial sector liabilities today, 27 percent of the financial sector's liabilities today enjoy an implicit government guarantee.

That being the case, and I know that you can't speak for Ms. Bair, but can you help those of us up here who are listening to very intelligent people, can you help us figure out where is the difference between what Ms. Bair is saying and what I think the facts are, and that is, there are tremendous implicit guarantees and there is risk associated with that.

Mr. Lacker?

Mr. LACKER. Sure. In Ms. Bair's defense, the legal authority under which we provided assistance to the merger of Bear Stearns and JPMorgan Chase and assisted AIG was Section 13(3), and the ability to craft a firm-specific 13(3) program has been eliminated. We can craft a program, but it has to be of wide market availability. So in that sort of narrow sense, that is true.

But too-big-to-fail has been around since—it started in the early 1970s, as I said. That was carried out via the FDIC's authority. They had the ability to add extra money and pay off uninsured creditors, uninsured depositors in bank failures. And the Federal Reserve has a role, too, because when we lend to a failing bank before it is closed we can let uninsured creditors get their money out before the closure takes place and the remaining uninsured creditors are forced to take losses.

So, we still have those modalities. We still have those capabilities of keeping short-term creditors—letting them escape without bearing losses. That is why she says, yes, that authority we used, the way we chose to do it has been abolished, but we were doing it other ways before that.

Mr. HURT. Got it.

Anything you want to add to any of that?

Mr. FISHER. I think President Lacker has given a good explanation of what we think she meant by that.

Mr. HURT. One of the things that has been touched on by both sides of the aisle is this idea that the subsidy, the government subsidy that is real, that gives competitive disadvantage to the largest banks, and I think that you see that trend seems to me to be continuing, that trend in favor of those banks, despite the fact that we are told that the bailouts have been abolished, we continue to see that. And so it concerns me from an issue of competitiveness domestically.

But are there other concerns that any of you have as it relates to global competitiveness? Obviously, it goes to the heart of what individual customers and banks, the competitiveness that exists in this country. But does any of this rise to the level of concern as it relates to global competitiveness?

Mr. HOENIG. Congressman, I have been asked that question a lot, and I am convinced that a banking system that competes from a position of strength will be the system that wins. What we have now is a structure that is not a free market structure. It is heavily subsidized. Because of that, we have capital levels that are lower than they otherwise would be.

We are asking, if you will, directly or indirectly, for either other members of the banking industry or the public to underwrite our ability to supposedly compete with the rest of the world. When we rationalized this structure before, when we had broker-dealers separate from commercial banks, we were the most competitive capital market in the world.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from New Mexico, Mr. Pearce, for 5 minutes.

Mr. PEARCE. Thank you, Mr. Chairman.

And I thank each one of you for being here today.

So we started this discussion today on whether or not Dodd-Frank ended too-big-to-fail, and there are a lot of different opinions. I think the first thing that I was curious about, now, under Title II you have the insurance, and are too-big-to-fail firms predominantly banking firms or are those just different financial firms? Because where I am going is, under Title II they are now covered by deposit insurance, which gives them access to funds from firms too small to succeed. And so I wonder what kind of advantage that we are giving too-big-to-fail firms?

So forget whether or not Dodd-Frank did anything. We have different opinions. But what about, Mr. Fisher, do you have an opinion about that ability for too-big-to-fail firms to get into the deposit insurance funds now?

Mr. FISHER. Yes, sir, and I believe I addressed that very specifically in my written submission. But just to summarize, again, the purpose of deposit insurance was the old-fashioned purpose of assisting commercial bankers to take in deposits, assure their depositors, and then intermediate to make the kind of loans on which your constituents depend. I believe that should be the sole purpose of that deposit insurance. In other words, I don't believe that a complex bank holding company should be able to exploit that for other services they may provide.

By the way, I don't want to take away their capacity to provide those other services, but it should be restricted to the original purpose for which it was intended.

Mr. PEARCE. Forget the discussion of whether Dodd-Frank technically ended it. We have given them a conduit to funds that they did not have access to before, which seems to hint that maybe it doesn't have as much effect at killing too-big-to-fail. That is what some of our friends on the other side of the aisle say.

Mr. Hoenig, now, first of all, regulators have discretion, is that correct? I heard that comment.

Mr. HOENIG. Discretion for?

Mr. PEARCE. For making decisions on what to do under circumstances of too-big-to-fail during bankruptcy. You have discretion, is that correct?

Mr. HOENIG. Under bankruptcy, they would go to a bankruptcy court and it would be handled there.

Mr. PEARCE. But as it approaches that, the regulator has the ability to maneuver certain tools, I think is what Ms. Bair said.

Mr. HOENIG. Of course. The regulators will examine the institution or deal with the institution, insist on more capital to keep it from failing, and so forth.

Mr. PEARCE. Does Dodd-Frank have any consequences for regulators if they choose incorrectly or purposely make a mistake?

Mr. HOENIG. Purposely make a mistake?

Mr. PEARCE. Just if they make a mistake. We will just leave it at that.

Mr. HOENIG. Well, look, if it is a mistake, it is a mistake like any other. That is what you have capital for, mistakes by management or otherwise.

Mr. PEARCE. I find the whole discussion that we are having today, we are going to create a regulatory agency that comes in and looks and determines if firms are solvent, if they are qualified, but we are going to turn that over to regulators. Now, keep in mind the regulators had been hearing for 10 years on Bernie Madoff that he was doing stuff, but they turned a blind eye, and the courts found that the regulators could not be held accountable for that. They were shielded by the discretionary function exception. And the court did express regrettable disdain for the actions, but nothing happened.

So we are trying to decide on fairly small nuances here, but there is no nuance in taking segregated customer accounts, and yet Jon Corzine still hasn't had anything done to him. He took $1.5 billion. The regulators were sitting in the room watching him, multiple regulators, and not one thing going.

We are having this protracted discussion here today on should the regulations be tweaked here or tweaked there. If we can't hold the regulators accountable, I will guarantee you it does not matter if too-big-to-fail is in place or it is not in place, because the regulators will have in their discretion, in your terms, their discretion to determine whether or not things should be done, whether or not they should get bailed out, and there is nothing that we as the American people, the taxpayer, can do.

These are the things that are making people furious out there in the streets. They get stuck for people who have wrung every single bit of profit they can out on risky adventures, and then the taxpayer gets stung with it. And I will guarantee you this whole system has many, many problems ahead of us if we don't get this right, if we continue to create a system of too-big-to-fail through law.

Chairman HENSARLING. The time of the gentleman has expired.

The gentleman from Kentucky, Mr. Barr, is recognized for 5 minutes.

Mr. BARR. Thank you, Mr. Chairman.

I think of all of the data available to Members of Congress and observers of this interesting question about too-big-to-fail, there is one piece of data that is most telling about whether or not Dodd-Frank has solved the too-big-to-fail question. It is the statistic that Mr. Fisher points to, that 0.2 percent of institutions control nearly 70 percent of all industry assets. So for those folks out there who say that Dodd-Frank has solved too-big-to-fail, I think that is a statistic that we ought to always keep in mind.

To that point, have we seen a greater concentration of industry assets in these megabanks in the 3 years since Dodd-Frank has been the law of the land?

Mr. FISHER. Congressman, we have seen a greater concentration as we go through time. And certainly from before the financial crisis to now, yes, because of the acquisitions that were made, we have seen a concentration in fewer hands.

Mr. BARR. You have kind of two parts to this. You have the implicit government taxpayer subsidy, the $83 billion subsidy, the cost of funding advantage for the SIFIs, but you also have the regulatory pressures placed on the 99.8 percent, the other banks, the regional banks, the community banks, the consolidation that we have seen in the smaller banks.

I would like for the panelists to comment on not only the taxpayers' subsidy and the funding advantage of the SIFIs, but also the effect of Dodd-Frank and the CFPB and the regulatory pressures and the consolidation and the lack of new charters in the smaller banking sector and whether or not that has exacerbated the problem of too-big-to-fail.

Mr. FISHER. I am going to just quickly comment because my other colleagues will no doubt want to comment in the 2½ minutes left. I travel throughout my district, which is a large district, the Federal Reserve District of Dallas, the 11th District. I meet constantly with bankers. To a person—these are community bankers, these are regional bankers—they are deeply concerned that they are being overwhelmed by regulation and they are having to spend their moneys, as I said earlier, hiring people, lawyers, et cetera, with all due respect to lawyers, to help them comprehend and deal with this, rather than being able to afford, with their limited budgets and with their interest margins being so tight, hiring bankers to make loans to go out and do what bankers are paid to do.

So we are being constantly criticized and concerns are being raised that they are way swamped in terms of all the different things that you mentioned. And it is not just Dodd-Frank, you mentioned other authorities that have been granted under different legislation that was enacted, and they just feel deluged. And that puts them at a disadvantage, because if you are not able to spend your time worrying about how to make a loan, someone else is going to make it for you.

Mr. BARR. And I think it is a good point. I think it just goes to show that we ought not just look at Title II and OLA and the implicit taxpayer subsidy here, but also the consolidation that is happening and the lack of sufficient competition to the SIFIs because of the consolidation—

Mr. FISHER. These are unintended consequences, Congressman, of this process.

Mr. BARR. Right. One final question as my time is expiring, and the question is to all of you. It relates to the regulatory discretion that is conferred under OLA and whether or not we are moving away from a bankruptcy rule of law-based system to a system in which there is excessive discretion and we are moving away from the rule of law.

Many people believe that General Motors, the automobile bailout of recent years was highly politicized, because the Federal Government conditioned its bailout on GM giving preferred treatment to the union claims. President Fisher and President Lacker, under Dodd-Frank's OLA, could the FDIC use its discretion to pick winners and losers, much like we saw in the auto bailout, and picking winners and losers among creditors of a failed firm in a politicized manner, much like we saw in the auto bailout?

Mr. HOENIG. Let me say first that, just to clarify, in terms of the discretion under Title II to the FDIC, it is limited. And besides that, the FDIC's own rule requires that you treat, in terms of order of preference, in the same manner as bankruptcy. And I would point out that even in bankruptcy, a bankruptcy judge can make exceptions in terms of assuring that payments are made and that essential operations continue.

So it is not a broad-based discretion that they can pick whomever they want. It is very clearly identified in terms of the order of preferences that they have to stick with, and the exceptions have to be explained as carefully as in a bankruptcy.

Chairman HENSARLING. Really quick answers from the other gentlemen.

Mr. LACKER. He is right, discretion is constrained at the FDIC. But broadly speaking they have, as I read the statute, more discretion, more authority, more leeway than a judge does in bankruptcy to violate absolute priority.

Chairman HENSARLING. Mr. Fisher nodded in consent. The time of the gentleman has definitely expired.

The Chair now recognizes the gentleman from South Carolina, Mr. Mulvaney, for 5 minutes.

Mr. MULVANEY. Thank you, Mr. Chairman.

And thank you, gentlemen, for making yourselves available and for sticking around.

I want to go all the way back to one of the opening statements. It was made by Mrs. Maloney and it caught my attention; it is the actual language of Section 214. And she read it accurately, the second sentence says that no taxpayer funds shall be used to prevent the liquidation of any financial company under this title. And I think for some people, both in this room and outside of this room, that sort of ends the discussion. But I think it is clear that it doesn't end the discussion. In fact, you heard Mr. Green give a certain set of circumstances under which he would certainly support additional taxpayer funds being spent. So I think it is very much an open question as to whether or not taxpayer funds can still be used.

Walk me through the process under which that might possibly happen. I turn to Section 214(b), and it says that, "all funds expended in a liquidation of a financial company under this title shall be recovered from the disposition of assets of such financial company," but then it obviously immediately contemplates that might not be enough to pay because the next half of the sentence says, "or shall be the responsibility of the financial sector through assessments."

Now, let's skip for a second the impossibility of defining perhaps what the financial sector is, but that is the word that is used.

These assessments, number one, how easy would it be to do that, Mr. Lacker? If we are talking about a situation, the economic situation where a major bank is failing, how easy is it going to be to assess the other banks in the financial sector?

Mr. LACKER. It is going to be really hard to do it in a timely way. And my sense is that what is envisioned, both in the FDIC's plans for implementing the Act and the Act itself, is that is recovered after the fact. After assets are sold off in an orderly way over the course of several years, then you do the calculation that says, oh, we have to go back, we have a hole we have to fill, we go back.

The point I would make about the taxpayer part is the key thing about too-big-to-fail is the incentives, short-circuiting the incentives of creditors, and from that point of view it doesn't matter where you get the money, whether you get it from taxpayers, which is viewed by I think many as terribly unfair, or you get it from the man in the moon. Ultimately, you are short-circuiting incentives, and that is what gives rise to excessive risk-taking, and excessive short-term wholesale funding.

Mr. MULVANEY. I recognize that.

Mr. Fisher, yes, go ahead.

Mr. FISHER. I was just looking, sir, at the remarks made by Martin Gruenberg when he was Acting Chairman of the FDIC at a Federal Reserve Bank of Chicago conference. Just to make your point here, he talks about the Orderly Liquidation Fund located in the Treasury Department. Those are taxpayer moneys. The Orderly Liquidation Fund must either be repaid from recoveries of the assets of the failed firm or from assessments against the larger, more complex financial companies. Taxpayers, as you said, cannot bear any loss from the resolution of a financial company under the Dodd-Frank Act.

As I pointed out in my spoken comments, first of all, these are taxpayer moneys, there is an opportunity cost of setting them aside. I know we don't often talk about that, but that is something to consider.

Secondly, let's say that it is insufficient in liquidation and you need to go back to the industry, as you mentioned, and you assess them. They are given a tax deduction as a business expense for the expenditure of those funds. That is taking money from the taxpayer, as far as I am concerned.

Mr. MULVANEY. And, by the way, if we do get the assessments set up, who ultimately pays for those?

Mr. LACKER. The customer is going to pay for it.

Mr. HOENIG. The customer.

Mr. LACKER. And I would venture to say many of them are going to—

Mr. HOENIG. Let me add one thing, though. Title I, and I think Title II, are designed for an idiosyncratic event, a large institution that gets into trouble. If you have a systemic meltdown as we had last time, I feel pretty confident that the Congress will be asked for another TARP. The market perceives if you have a systemic meltdown, that may be the case. So, you have many issues.

Mr. MULVANEY. I think that is an excellent point. This might work if you have an aberration, if you have one large financial institution going out, but it raises very serious issues about what is going to happen if you end up in a similar situation to where we were in 2008 and 2009.

Mr. Fisher, you wanted to say something?

Mr. FISHER. I completely agree with that, because remember how interconnected all these firms are. I doubt you would just have one alone.

Mr. HOENIG. Bankruptcy will be—

Mr. FISHER. And then you go back to Mr. Fisher's—

Mr. MULVANEY. That goes to Mr. Lacker's point that if you have perverted the market and you have given this sense of safety where there is none, you are going to encourage creditors to lend to these facilities when they shouldn't be doing so.

Mr. HOENIG. Which is why we should, if you will, rationalize or simplify the system so that we don't end up in the same position we did in 2008. We need to pull back the safety net to commercial banking so that we can—

Mr. MULVANEY. I hate to cut you gentlemen off, but I have 20 seconds left. The last section says, "Taxpayers shall bear no losses from the exercise of any authority under this title." I would suggest to you and to the chairman that is simply unenforceable. That is language that made people feel good about voting for the bill, but I think you have already seen, and Mr. Hoenig you just mentioned it, that there are folks in here today who, under the right set of circumstances, would use taxpayer money again, even with Dodd-Frank in place, and I think that tells us a lot about where we are.

Thank you, gentlemen.

Chairman HENSARLING. The time of the gentleman has expired. No other Members are in the queue.

I wish to thank all of our witnesses for their testimony today.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

This hearing stands adjourned.

[Whereupon, at 1:04 p.m., the hearing was adjourned.]

A P P E N D I X

June 26, 2013

Testimony of Sheila C. Bair

Chair of the Systemic Risk Council[1] and

Former Chair of the Federal Deposit Insurance Corporation

Before the House Committee on Financial Services

June 26, 2013

Thank you for the opportunity to appear here today to discuss the Dodd-Frank Act, too-big-to-fail and the resolution of large, complex financial institutions (LCFIs). There remains no single issue more important to the stability of our financial system than the regulatory regime applicable to the entities. Given the unprecedented government assistance required in 2008 and 2009 and all that we have learned since, I think there is a general recognition of the role certain large, mismanaged institutions played in the lead-up to the financial crisis, and the need to take tough policy steps now to ensure that taxpayers are never again forced to choose between standing behind the risky bets of large financial firms or financial collapse. As our economy continues to slowly recover from the financial crisis, we cannot forget the lessons learned, nor can we afford a repeat of the regulatory and market failures which allowed that debacle to occur.

Summary

The Dodd-Frank Act requirements for the regulation and, if necessary, resolution of LCFIs are essential to address the problem of too-big-to-fail and eliminate the need for taxpayer bailouts of failed institutions. I strongly disagree with the notion that orderly liquidation authority (Title

[1] The independent non-partisan Systemic Risk Council (www.systemicriskcouncil.org) was formed by CFA Institute and the Pew Charitable Trusts to monitor and encourage regulatory reform of U.S. capital markets focused on systemic risk. The views expressed here are my own personal views and do not necessarily reflect the views of the Systemic Risk Council, other Council members or the supporting organizations.

II/OLA) enshrines the "bailout" policies that prevailed in 2008 and 2009. Implicit and explicit too big to fail policies were in effect under the legal structure that existed before Dodd-Frank. Dodd-Frank has abolished them. To the extent the problem of too-big-to-fail and risks of taxpayer assistance remain, it is because (1) regulators have more work to do to reduce the risk of a LCFI failure and make sure rules and processes are in place to ensure their orderly liquidation if they do fail; and (2) markets continue to question whether government can and will follow-through on its plan to allow an LCFI to fail without a bailout. I believe we are on the right track for addressing both of these realities, but more can, and should, be done.

The Problem of Too Big To Fail

There is nothing inherently wrong with size in and of itself. In many business areas, large institutions can achieve significant economies and public benefits. However, size should be driven by market forces, not implied government subsidies. Capital allocation should be determined by investors pursuing sound, innovative business models which promise sustainable returns based on acceptable risk tolerances. It should not be based on highly leveraged bets which promise privatization of benefits but socialization of losses if those bets fail. With the implied government support provided to Fannie Mae, Freddie Mac, and so-called too big to fail financial institutions, the smart money fed the beasts and the smart money proved to be right. As failures mounted, the government blinked and opened up the taxpayers' check book. Because creditors and trading partners were made whole and many executives and board members survived, markets (and management) may view these types of institutions as implicitly backstopped by the government. This results in incentives for "heads I win – tails you lose" risk-taking and funding advantages for these firms relative to their smaller competitors. Taken together, this phenomenon would make already large firms even larger and more risky.

Orderly Liquidation Authority is Essential to Helping End Too-Big-To-Fail

In recognition of the harmful effects of too big to fail policies, a central feature of Dodd-Frank is the creation of a resolution framework which will impose losses and accountability on shareholders, creditors, boards, and executives when mismanaged institutions fail. Under Title II, the government can now resolve a potentially destabilizing financial institution using the same time tested tools the FDIC has used to resolve failing banks for decades. Such tools were not available during the 2008 crisis. The FDIC has made real progress implementing these provisions and spelling out the process that will be used under Title II to resolve large financial institutions, including the bankruptcy-like claims priority schedule that will impose losses on shareholders and creditors, not on taxpayers. We cannot end too big to fail unless markets know that shareholders and creditors will take losses if the institution in which they have invested fails.

To this end, the FDIC, working in consultation with the Federal Reserve Board and international regulators, has developed an innovative strategy for the orderly resolution of a large, internationally active bank which involves seizing control of its holding company through a so-called "single point of entry" approach. In the event of an LCFI failure, the FDIC would use its authority as receiver to form a bridge financial company. The holding company's shareholders and creditors would absorb losses associated with the failure, while some of their claims would be converted to equity to recapitalize the new enterprise.

Improving the Orderly Liquidation Process

While the FDIC has a solid plan and has been working diligently to prepare and address key challenges (among them by making significant progress with foreign governments on cross-border issues)[2] important work still needs to be done.

- ***Regulators must ensure that LCFI's have sufficient long-term debt at the holding company level.*** The success of the FDIC's orderly liquidation authority using this "single point of entry" strategy depends on the top level holding company's ability to absorb losses and fund recapitalization of the surviving operating entities. Currently, nothing requires that firms hold sufficient senior debt to meet this need. I and the Systemic Risk Council agree with the increasing number of financial regulators at the Federal Reserve and FDIC and other experts that we need to address this gap.[3]

  The senior, unsecured long-term debt must be issued at the top level holding company to eliminate the banking organization's ability to game the requirement by redirecting its debt issuance to its insured depositories or other operating subsidiaries. The redirection of debt issuance to subsidiaries would impede the effectiveness of single point of entry resolution. The loss absorption and recapitalization capacity must reside at the top-level holding company and should be based on total (non-risk weighted) assets. In addition, to limit the contagion or domino effect of a LCFI insolvency, the debt must not be an

[2] See, e.g. FDIC Memorandum of Understanding with Canada Deposit Insurance Corporation. http://www.fdic.gov/news/news/press/2013/pr13051.html. See also "Resolving Global Active, Systemically Important, Financial Institutions," Joint Paper by the FDIC and the Bank of England, Dec. 10, 2012. http://www.fdic.gov/about/srac/2012/gsifi.pdf

[3] See Letter from Systemic Risk Council to Ben Bernanke, Chairman of the Federal Reserve Board, June 6, 2013. http://www.systemicriskcouncil.org/wp-content/uploads/2013/06/SRC-Ltr-Re-LTD-6-7-2013.pdf

eligible investment for any other LCFI or any other bank, nor should other LCFIs be permitted to write credit protection for, or have other real or synthetic exposure to, that debt.

A properly sized long-term debt cushion that meets these parameters would support the FDIC's single point of entry resolution strategy and help assure the markets that the LCFI is indeed resolvable and not too big to fail.[4] The debt cushion could include a minimum subordinated debt requirement to offer some protection for senior bondholders. This would potentially provide a more stable funding structure and greater market discipline as creditors would have the incentive to closely monitor the riskiness of their respective investments. As investors would likely require these LCFIs to pay somewhat higher premiums for the added debt, this approach could have the added benefit of providing a strong incentive to reduce complexity, interconnectivity and growth of these large, complex financial institutions through market forces.

Even with tougher capital standards – which I also strongly support and discuss more below – there is no guarantee that a large bank failure can be prevented in the future. Thus, it is imperative that losses incurred with the failure of an LCFI be absorbed by the

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[4] Some have proposed a ratio of 30 percent of equity, subordinated debt, and unsecured long-term debt to total consolidated assets. See comment letter on the Federal Reserve Board's Notice of Proposed Rulemaking to implement Sections 165 and 166 of the Dodd-Frank Act, signed by Sheila Bair, Senior Advisor, Pew Charitable Trusts; Simon Johnson, MIT Sloan School of Management and Senior Fellow, Peterson Institute for International Economics; Anat Admati, Graduate School of Business, Stanford University; and Richard Herring, Co-Director of the Wharton Financial Institutions Center, Wharton School, University of Pennsylvania; March 30, 2012. http://www.federalreserve.gov/SECRS/2012/April/20120403/R-1438/R-1438_033012_107166_399897884753_1.pdf

firm's own shareholders and creditors, and not be forced on other firms through special assessments, or worse, on taxpayers.

- ***The Financial Stability Oversight Council (FSOC) must designate potentially systemic nonbank financial firms for heightened oversight.*** Title I of the Dodd Frank Act requires that the FSOC designate firms for heightened supervision by the Federal Reserve. This enhanced supervision is designed to (1) improve regulation over large, potentially systemic firms; (2) provide regulators with important information to assess and plan for a potential failure; and (3) reduce the likelihood that potential systemic risks will simply grow unnoticed outside the traditional regulatory sphere, including at affiliates of otherwise regulated entities as occurred at AIG, Lehman Brothers and other LCFIs prior to the financial crisis.

How Title I Designations Reduce Too-Big-To-Fail. While some have argued that a SIFI designation might be a "positive" for the company – and fuel market perceptions that the company is somehow backstopped by the government, I disagree. The SIFI designation is not a "badge of honor" but a "scarlet letter." It includes no *benefits* from the government, does not reduce any existing regulatory requirements and only *heightens* a firm's required capital and supervision.[5] It does not mean the firm will be resolved under OLA rather than bankruptcy – as a financial company could be resolved under OLA without having been a SIFI (a bad outcome given the need for planning, etc. outlined below) and a SIFI could be made, through effective enhanced prudential standards and resolution planning,

[5] See, e.g., Section 165 which provides that Federal Reserve shall establish prudential standards for these designated firms that "(A) are more stringent than those applicable to other nonbank financial companies and bank holding companies …; and (B) increase in stringency." (emphasis added).

to be resolvable in bankruptcy (a good outcome). In fact the Section 165 requirements for resolutions are aimed at ensuring an orderly resolution ***under the bankruptcy code, not orderly liquidation***.[6] This helps explains why LCFIs have pushed back so strongly to avoid this designation.

To the extent LCFIs continue to enjoy a funding advantage from perceptions of being too big to fail, we need to remember that this perception exists whether or not the firm has been designated under Title I. The bailouts of 2008 and 2009 confirmed this perception and reinforced it. Titles I and II are designed to recognize this potential market perception risk and help address it. Eliminating Titles I and II would only take us back to the types of policies that brought us the large, unchecked financial firms whose risks and failures resulted in the 2008 financial crisis and unprecedented government support.

Importance of Title I Designations to Resolution Planning. Moreover, while the market has understandable questions about ability and willingness of regulators to resolve a LCFI – it is clear that regulators will be much better positioned to resolve a failing LCFI; or even *assess* a failing firm's potential impact on the market to determine if it can go into bankruptcy – if regulators (1) have information about the firm's health, exposures, and complexity, (2) can assess the firm's plan for resolving itself and (3) can plan in advance. Such living will information is triggered by designation. Accordingly, to the extent markets and policymakers questions the FDIC's ability to resolve a firm – those questions are certainly more valid if the firm has not be designated under Title I. Regulators should never again have to try to learn about an LCFI's business, assess the

[6] See e.g., DFA Section 165(d) (4).

firm's risk, determine the potential impact its failure would have on the financial markets *and* determine whether bankruptcy is appropriate over a weekend. That is a recipe for bad decision-making, costly and inefficient resolutions and destabilized markets.

Reducing the Use of Orderly Liquidation

As anticipated in the Dodd-Frank Act, a traditional fair, equal and effective bankruptcy process that protects taxpayers and markets is the optimal and first choice for failure. Orderly liquidation is – and should only be – used as a last resort. There are several steps policymaker can – and should – take to help reduce the need to use orderly liquidation authority.

- ***Regulators must strengthen capital requirements so these firms have a meaningful buffer against losses.*** Our existing capital regime is incredibly complex, riddled with uncertainty and results in a host of perverse incentives that encourages bad risk management and synthetic risk taking (e.g., through derivatives) at the expense of traditional lending. Not only would a stronger and simpler capital regime provide a meaningful buffer that reduces the likelihood of an LCFI failure, it would reduce the artificial funding advantages available to large firms and give regulators and counter-parties a much better sense of a firm's financial health. While current capital regimes continue to over-rely on risk-weighting and internal modeling a better approach is to simplify our capital rules, strengthen the leverage ratio and eliminate regulatory reliance on a firm's internal models.

Stronger Leverage Requirements. The Basel Committee has developed a SIFI capital surcharge for large, internationally-active banking organizations based on risk-based capital levels but not on leverage. However, the Dodd-Frank Act requires that *both* risk-based capital *and* leverage standards should be higher for SIFIs than for non-SIFIs. The new international leverage ratio under Basel III and the proposed rule is only 3 percent (though the 3 percent does apply to certain off-balance sheet assets). The current U.S. leverage well capitalized standard applicable to FDIC insured banks is 5 percent, though this applies only to on-balance sheet assets. Extensive research conducted on banks that became troubled during the crisis demonstrated that an institution's leverage ratio is a much better predictor of financial health than its risk-based ratio. To be true to Dodd-Frank's mandate for higher capital levels for SIFIs, we believe the Federal Reserve should consider a leverage ratio substantially higher than the Basel III standard of 3 percent, for the largest, complex institutions. The SRC and I believe that leverage for such institutions should be no greater than 12 to 1 reflecting a minimum ratio of approximately 8 percent, and indeed the ratio could be set more than double that, based on available research.[7]

Reducing Regulatory Reliance on Internal Models. Not only do models routinely fail in a crisis (precisely when we need loss absorbing shareholder equity most) – their use for regulatory capital purposes can create perverse incentives for risk management and real competitive advantages for larger firms relative to smaller firms doing the same activity. Minimum risk-based capital requirements should be just that: a minimum. If internal models identify additional risks that require higher capital, firms should be required to

[7] See Comment Letter from Systemic Risk Council, October 4, 2012.
http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Fact_Sheets/Systemic_Risk/Final-SRC-Capital-Comment-Letter-10-4-12.pdf

raise more equity. Management, boards, examiners, investors and counter-parties deserve an objective and clear minimum risk-based capital baseline.[8]

- ***Improve public disclosure about LCFIs' activities and risks*** so that investors can make better decisions about these companies – so markets and policymakers can feel comfortable that a firm can fail – in bankruptcy – without destabilizing the financial system. Improved disclosure about the level of a large financial institution's unencumbered assets could increase the chances that debtor-in-possession financing could be seamlessly arranged in a bankruptcy process without disrupting payments processing and credit flows. In addition, greater disclosure about a firm's corporate structure – and profitability by business line could facilitate the market's ability to determine the optimal size and structure for financial institutions. It would also allow investors to see if firms are too big/too complex to manage and would provide better shareholder value if broken up into smaller, simpler pieces.

- ***Consider requiring that LCFIs "subsidiarize" their corporate structure*** to rationalize their legal structures along business lines and significant international operations to reduce the risk of contagion from one part of the firm to another, and to provide better, more specialized management for each of the firm's component parts. Not only would this help improve the transparency and management of their operations, it would make it much easier for investors, firms or bankruptcy courts to value the firm by business line

[8] See Statement by the Systemic Risk Council on Bank Capital Requirements, Nov. 2012. http://www.systemicriskcouncil.org/2012/11/statement-by-the-systemic-risk-council-on-bank-capital-requirements/
See also, Comment Letter to the Securities & Exchange Commission Regarding Internal Risk Models, Jan. 2013. http://www.systemicriskcouncil.org/2013/01/systemic-risk-council-letter-to-sec-about-internal-risk-models/

and international operations and spin-off operations when needed, whether as a going concern or in a bankruptcy or resolution.

Designated Financial Market Utilities

While substantial debate has circulated around Titles I and II of the Dodd-Frank Act, I have been surprised at the lack of concern over the designation of "financial market utilities," and particularly Section 806 which permits the Federal Reserve to provide safety net access to designated financial market utilities. Indeed, I have been struck by the strong arguments against Title I SIFI designations – which brings with it ***no*** government benefits – and the lack of controversy surrounding the designation of financial market utilities – which does. This potential Federal Reserve lifeline not only gives these firms a real advantage over other "non"systemic competitors, it opens up taxpayers to potential losses and creates moral hazard as these firms can weaken their risk-management standards knowing emergency support is potentially available in a crisis. At a minimum, if these clearinghouses are going to enjoy discount window access, they should be subject to the same types of enhanced prudential supervision and resolution planning applicable to large bank holding companies, but an even better approach would be for the regulators to revoke these designations and roll back this unwarranted expansion of the government safety net. Indeed, we saw the results with Fannie Mae and Freddie Mac when lightly regulated, for-profit entities were able to enjoy access to government backing which fueled private profit taking and market share dominance over those which did not enjoy such government largesse. Title VIII FMUs will very likely become the new GSEs and a new source of system instability if left unaddressed.

Conclusion

Thank you again for the opportunity to be here today. This remains an enormously important issue and the Committee is right to keep a very close eye on it. I am hopeful that policymakers will continue to move forward and implement the reforms needed to safeguard our financial system and the economy. Financial reform and system stability are not partisan issues. Both parties want to end too-big-to-fail, and though there may be different perspectives on how to achieve that goal, through open dialogue, discussion, and collaboration, we can achieve it. We must.

Correcting 'Dodd–Frank' to Actually End 'Too Big to Fail'

Statement before the Committee on Financial Services
U.S. House of Representatives

Hearing on "Examining How the Dodd–Frank Act Could Result in More Taxpayer-Funded Bailouts"

Richard W. Fisher
President and CEO
Federal Reserve Bank of Dallas

Washington, D.C.
2128 Rayburn House Office Building
June 26, 2013

The views expressed are my own and do not necessarily reflect official positions of the Federal Reserve System.

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June 26, 2013

Chairman Hensarling, Ranking Member Waters, and Members of the Committee, thank you for the opportunity to testify at this hearing on "Examining How the Dodd–Frank Act Could Result in More Taxpayer-Funded Bailouts."

Before I begin, I want to recognize the common goal that we all share—ending "too big to fail" (TBTF) and taxpayer-funded bailouts. However, as iconic patriot Patrick Henry said in one of his greatest speeches, "Different men often see the same subject in different lights." I recognize and respect a difference of opinion on this critical issue of how to eliminate taxpayer-funded bailouts. But I trust that in the marketplace of ideas and after careful deliberation—such as this hearing—our democratic process will shine through and decisions will be made that are in the best interest of our country.

In the same speech, Patrick Henry also appealed to all perspectives to do right: "This is no time for ceremony," he said, for it "…is one of awful moment to this country."

The great patriot was, of course, addressing the injustice of perpetuating the rule of the British Crown. This morning, I want to address what I consider the injustice of perpetuating financial institutions that are so large, complex and opaque that they are seen as critical to the proper functioning of our economy and are therefore considered TBTF.

I will argue that these institutions operate under a privileged status that exacts an unfair and nontransparent tax upon the American people and represents not only a threat to financial stability, but to the rule of law as well as principles of fair and open competition—hallmarks of the democratic capitalism that makes our country great.

I will argue that the effort crafted by Congress to correct the problems of TBTF—known as the 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank)—is, despite its best intentions, ineffective, burdensome, imposes a prohibitive cost burden on the non-TBTF banking institutions and needs to be amended. It is an example of the triumph of hope over experience.

And, lastly, I will argue that dealing with TBTF is a cause that should be embraced by Republicans, Democrats and Independents alike. For regardless of your ideological bent, there is no escaping the reality that TBTF banks' bad decisions inflicted harm upon the American people in the excessive credit boom through 2007 and particularly during the "awful moment" of the 2008–09 crisis.[1] The American people will be grateful to whoever liberates them from the risk of a recurrence of taxpayer bailouts and the serious threat of another Great Depression.

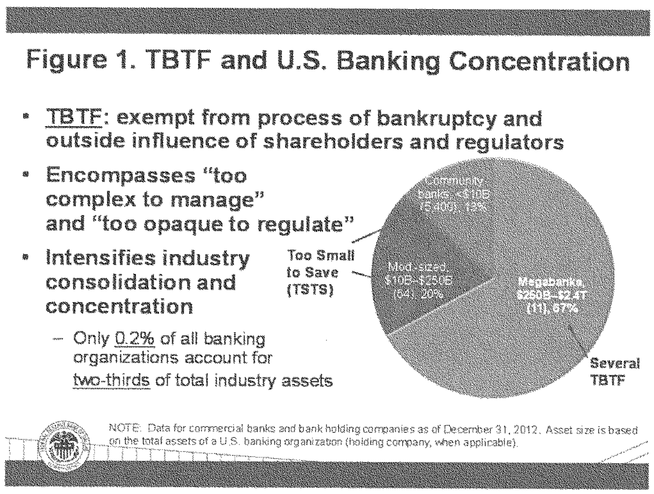
Federal Reserve convention requires that I issue a disclaimer here: As is our practice, I speak only for myself, not for others associated with our nation's central bank. There are different views on this issue even within the Fed; like Patrick Henry's co-patriots, we too "see the same subject in different lights." In addition to Jeff Lacker, President of the Richmond Fed, who is here with us today, the chairman of the Fed, Ben Bernanke, and three other governors, Jeremy Stein, Daniel Tarullo and Jerome Powell, all good friends and men I greatly admire, have expressed different views than ours in Dallas about how to address the problem of TBTF. You should consider their views, as well as those of Mr. Hoenig and Ms. Bair who join Mr. Lacker and me on this panel.[2] Today, I'll simply give you the views that have been thought through over several years by my colleagues and me at the Dallas Fed.

What's the Problem?

Less than a dozen megabanks—a mere 0.2 percent of all banking organizations—control two-thirds of the assets in the U.S. banking industry. The concentration of assets has been ongoing for more than 30 years, but it picked up pace in the 1990s and greatly intensified during the 2008–09 financial crisis, when several failing giants were absorbed, with taxpayers' support, by larger, presumably healthier ones.

The result is a lopsided financial system, and the episode we all experienced in 2008–09 is one we are still in the process of recovering from. None of us ever wish to experience another catastrophe such as occurred in fall 2008. Yet, given the well-intentioned but impracticable reforms forged in the crucible of the crisis, I believe the likelihood and severity of another crisis have risen rather than receded.

Here are the facts: Today, we have about 5,500 banking organizations in the United States. Nearly each and every one of these bank holding companies represents no threat to the survival of our economic system. But less than a dozen of the largest and most complex banks are **each** capable—through a series of missteps by their management—of seriously damaging the vitality, resilience and prosperity that has personified the U.S. economy. Any of these megabanks, given their systemic footprint and interconnectedness with other large financial institutions, could threaten to bring down the economy, again. This 0.2 percent of banks, deemed candidates to be considered "too big to fail," is treated differently from the other 99.8 percent and differently from other businesses (*Figure 1*).



Implicit government policy has made these megabank institutions exempt from the normal processes of bankruptcy and creative destruction. **TBTF** is a euphemism for a financial institution so large, interconnected and/or complex that its functions are seen as critical and policymakers think its demise could substantially damage the financial system and economy *if* it were allowed to fail. Without fear of closure, these banks and their counterparties can take excessive risks. We regularly see this reported in the press: Megabanks are too often driven by a culture directed more toward the generation of revenue growth to inflate their share price, without sufficient regard to prudent risk management. Executives and investors capture the upside; the taxpayers bear the downside risk (although this is not measured in our federal budget).

In our capitalist economic system, when companies that experience difficulties fail, their business models are rationalized, streamlined and reorganized. The highly diverse economic engine of growth that is the United States has become robustly dynamic upon the currents of what the renowned economist Joseph Schumpeter termed "creative destruction"—a "reap what you sow," free-market process of success and failure, innovation and obsolescence. Viable business models should be given the opportunity to compete and prosper on their own merits, while unattractive strategies should be allowed to fail. Subverting the ability to fail, on the taxpayers' dime, is a perversion of American capitalism.

Advantages to being Too Big, Too Complex, Too Opaque

The playing field is tilted to the advantage of the megabanks that can raise capital more cheaply than their smaller competitors due to perceived taxpayer support. Studies, including those published by the International Monetary Fund and the Bank for International Settlements, estimate this advantage to be as much as 1 percentage point, or some $50 billion to $100 billion annually for U.S. TBTF banks, during the period surrounding the financial crisis.[3] In a popular post by editors at Bloomberg, the 10 largest U.S. banks are estimated to enjoy an aggregate longer-term subsidy of $83 billion per year.[4]

Andy Haldane, executive director for financial stability at the Bank of England, estimates the current implicit TBTF subsidy to be roughly $300 billion per year for the 29 *global* institutions identified as "systemically important."[5]

Large banks and their allies have pushed back against these points, producing a flurry of counter-claims in recent months. My staff and I have reviewed these arguments and have found them to be assertions lacking merit.

Given this range of estimates, Sens. Sherrod Brown of Ohio and David Vitter of Louisiana have asked the Government Accountability Office (GAO) to calculate just how much of a cost-of-funds advantage the big banks have over the mid-sized and smaller community banking organizations that make up the 99.8 percent that are *not* implicitly protected from failure.

As pointed out by Simon Johnson, the MIT economist and former chief economist at the International Monetary Fund, all one has to do is ask people in the credit markets if they think lenders to the biggest banks have some degree of protection offered by the government, and you will hear a resounding "yes."[6]

At the Dallas Fed, we believe that whatever the precise subsidy number is, it exists, it is significant and it encourages the biggest banking organizations, along with their many nonbank subsidiaries (investment firms, securities lenders, finance companies), to grow larger and riskier.

This entire arrangement is patently unfair. It makes for an uneven playing field, tilted to the advantage of Wall Street against Main Street, placing the financial system and the economy in constant jeopardy.

The Problem Magnified, Not Solved

The Dodd–Frank Act was a well-intentioned response to the problem. We respect its drafters and those who crafted it in an earnest attempt to address much needed reform in the financial services industry. However, its stated promise to end too big to fail rings hollow. Running 849 pages and with more than 9,000 pages of regulations written so far to implement it, Dodd–Frank is long on process and complexity but short on results. Consequently, nearly three years after Dodd–Frank was signed into law, very little positive reform has been implemented.

Regulators cannot enforce rules that are not easily understood. Nor can they enforce these rules without creating armies of new supervisors. This venerable Committee on Financial Services aggregates information from the Federal Register that estimates the cumulative hours needed for the affected agencies, like the Fed, to fulfill new requirements called for by Dodd–Frank. This Committee presently estimates that it will take 24,180,856 hours each year to comply with new rules already finalized for implementation of the act.[7] And we have yet to complete the rulemaking process!

I work every day with my colleagues at the Fed to craft the monetary conditions to help the economy create jobs. This is not the kind of job creation I would hope for.

I doubt anyone seriously believes that an additional several thousand pages of regulations, on top of the nine thousand already written, will provide clarity, procedural focus and the proper incentives to end TBTF and to "Just Say No" to more government bailouts.

Complex regulations create barriers to entry and encourage firms to morph into even more complex and opaque structures. Further, regulatory supervision, by definition, is always at least one step behind the actions taken by market participants. The more complex the rules, the more difficult it is to bridge the gap due to the complexities of financial markets. None of this is helpful for financial stability.

Bailout Concerns Linger

Briefly, I believe the current legislative solution to ending TBTF has actually exacerbated the issue and potentially codified TBTF, rather than eliminated it.

As soon as a financial institution is designated "systemically important" as required under Title I of Dodd–Frank (and becomes known by the acronym "SIFI"), it is viewed by the market as being the first to be saved by the first responders in a financial crisis. In other words, these "SIFIs" occupy a privileged space in the financial system (one pundit referred to the acronym as meaning "Save If Failure Impending"). As a corollary, a banking customer has a disincentive to do business with smaller competitors, because a non-SIFI does not have an implied government funding lifeline. Even if a SIFI ends up funding itself with more equity capital than a smaller competitor, the choice remains for where you would like to hold important financial relationships: with an institution with a government backstop or one without? Thus, the playing field remains uneven; the advantages of size and perceived subsidy accrue to the behemoth banks that will continue to grow larger and become even more of a systemic risk. Dodd–Frank does not eliminate this perception and in many ways perpetuates it as reality.

Further, some have held out hope that a key provision of Title I requiring banking organizations to submit detailed plans for their orderly resolution in bankruptcy, without government assistance, will provide for a roadmap to avoid bailouts. However, these "living wills" are likely to prove futile in helping navigate a real-time "systemic" failure. Given the complexity and opacity of the TBTF institutions and the ability to move assets and liabilities across subsidiaries and affiliates (as well as off-balance sheet, including through huge and fast-moving derivative positions), a living will would likely be ineffective when it really mattered. I do not have much faith in the living will process to make any material difference in TBTF risks and behaviors—a bank would run out of liquidity (not capital) due to reputational risk quicker than management would work with regulators to execute a living will blueprint.

Adding insult to injury, Title II of Dodd–Frank describes and designates the Orderly Liquidation Authority (OLA) as the resolution mechanism to handle the disposal of a giant, systemically-disruptive financial enterprise. The three letters themselves evoke the deceptive doublespeak of an Orwellian nightmare. The "L," which stands for liquidation, will in practice become a simulated restructuring, as would occur in a Chapter 11 bankruptcy.

In reality, rather than fulfill Dodd–Frank's promise of "no more taxpayer-funded bailouts," the U.S. Treasury will likely provide, through the FDIC, debtor-in-possession financing to the failed companies' artificially-kept-alive operating subsidiaries for up to five years, but perhaps longer. Under the single point of entry method, the operating subsidiaries remain protected as the holding company is restructured. So if a company does business with the operating subsidiaries, say, through derivatives transactions, then this company is even more confident that their counterparty is TBTF. Some officials refer to this procedure as a "liquidity provision" rather than a bailout. Call it whatever you wish, but this is taxpayer funding at far-below-market rates.

At the Dallas Fed, we would call this form of "liquidation" a nationalized financial institution. During the five-year resolution period, this nationalized institution does not have to pay any taxes of any kind to any government entity. To us, this looks, sounds, and tastes like a taxpayer bailout, just hidden behind different language. If it waddles like a duck and quacks like a duck, it's a duck.

Moreover, if the reorganized company cannot repay the Treasury for its debtor-in-possession financing, Title II suggests that the repayment should be clawed back via a special assessment on the company's SIFI competitors. But that assessment is then written off as a tax-deductible business expense, thereby reducing revenue to the Treasury. This is a "rob Peter to pay Paul" chain of events, with the taxpayer playing the role of Peter. Although I have not seen the Congressional Budget Office run the numbers for the plausible scenarios, I suspect that the impact on our federal deficit and debt would be significant, not to mention the potential effects from the concomitant recession that would likely occur. This does not sound like a "no taxpayer-funded bailouts" solution. One form of explicit intervention appears to have been replaced by Title II of Dodd–Frank, a disguised form of taxpayer bailout.

Title II promotes and sustains an unnatural longevity for zombie financial institutions—and this is an acute issue in other financial systems, including parts of Europe today. Title II imposes a competitive disadvantage onto small- and medium-size financial institutions, and it does so for potentially several years at taxpayer expense. It is these smaller financial institutions that, by the way, provide the primary financial lifeline so vital to the small- and medium-size businesses in your Congressional districts that, in turn, provide the bulk of innovation and job creation in the United States.[8]

This Committee's Subcommittee on Oversight and Investigations held a hearing on May 15, 2013, in this very room that focused on Title II in great detail. The four witnesses who testified that day gave a very informative and expert critique of the shortcomings of Title II, and I respectfully refer you to that hearing.[9]

A Simple Proposal

Where does the current reform effort leave us and how should we forge a path forward? Despite the plethora of new rules and regulations created by Dodd–Frank, market discipline is still lacking for the largest financial institutions, as it was during the last crisis. Why should a prospective purchaser of bank debt or other type of counterparty practice due diligence if, in the end, regardless of new layers of regulation and oversight, it is widely perceived that the issuing institution and its subsidiaries will not be allowed to fail? There is a great deal of moral hazard at all levels of decision-making in our current financial system. We must change this status quo.

The return of marketplace discipline and effective due diligence of banking behemoths is long overdue. My colleagues and I at the Dallas Fed offer a modest proposal to that end, with a goal of leveling the playing field for all.

Here is a simple graphic of the basic organizational structure of a typical financial holding company (*Figure 2*). Note that the highlighted commercial bank operation within that structure. To begin with, we would roll back the federal safety net—

deposit insurance and the Federal Reserve's discount window—to where it was always intended to be, that is, to traditional commercial bank deposit and lending intermediation and payment system functions.[10] Thus, the safety net would only be available to traditional commercial banks and not to the nonbank affiliates of bank holding companies or the parent companies themselves. This is how the law needs to be applied, even in times of crisis.[11]

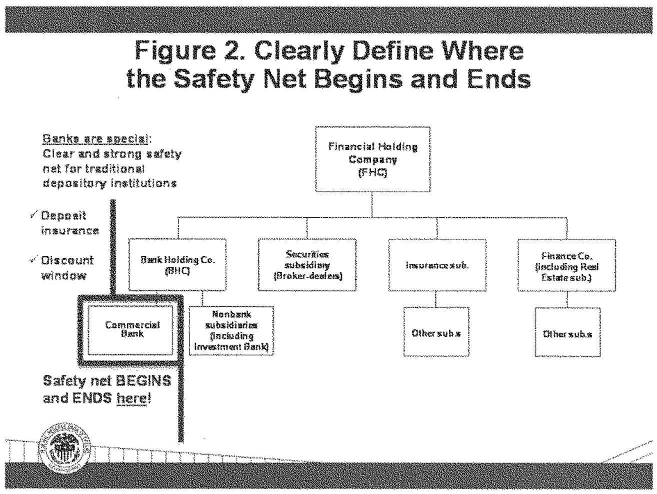


Figure 2. Clearly Define Where the Safety Net Begins and Ends

Second, customers, creditors and counterparties of all nonbank affiliates and the parent holding companies would sign a simple, legally binding, unambiguous disclosure acknowledging and accepting that there is no government guarantee—ever—backstopping their investment (*Figure 3*). They are on their own, and they know it. A similar disclaimer would apply to banks' deposits outside the Federal Deposit Insurance Corp. (FDIC) protection limit and other unsecured debts.

Figure 3. Sample Disclosure

WARNING: Conducting business with this banking affiliate carries NO federal deposit insurance or other federal government protection or guarantees.

I, ___________, fully understand that in conducting business with ___________ banking affiliate, I have NO federal deposit insurance or other federal government protection or guarantees. None.

Knowing where the federal government guarantees begin and end would properly realign incentives and reinvigorate a degree of creditor discipline that has been dormant at large, complex financial institutions for far too long.

Third, we recommend that the largest financial holding companies be restructured so that every one of their corporate entities is subject to a speedy bankruptcy process, and in the case of the banking entities themselves, that they become an appropriate size, complexity and geographic footprint that is "too small to save."[12] Addressing institutional size is vital to maintaining a credible threat of failure, thereby providing a convincing case that policy has truly changed. This step gets both bank incentives and structure right, neither of which is accomplished by Dodd–Frank.

Our third step would provide a more level playing field with reduced regulatory costs for all competitors, encourage greater innovation by all members of the banking industry and minimize the downside consequences to the economy of megabank failures. The downsized, formerly too-big-to-fail banks would then be small and simple enough (just like the other 99.8 percent) that, with adequate planning, the FDIC could close and then reopen the bank in short order with new management and new private-sector ownership. "Closed on Friday and reopened on Monday" is the customary process administered by the FDIC that we would like to see applicable for all depository financial institutions.

No bank would remain so significant and interconnected to the financial system that its demise would spell the unraveling of the financial system. In these new circumstances, all banks that warranted closure would fail the old fashioned way; they would be gone, with their stockholders' equity written down to zero, their bondholders saddled with haircuts and their insured depositors left unharmed.

What's The Way Forward?

The aim of our three-step proposal is simple: All banks would be subject to regulatory oversight that fits its business model—and most important, all banks would be subject to the market discipline exercised by owners and creditors. Given this more explicit treatment of creditors of regulated commercial banks, creditors of unregulated shadow banks should begin to understand that government guarantees don't apply to their transactions with the *affiliates* of regulated commercial banks nor with unregulated financial companies that offer similar products and services. Market discipline could then begin to reinforce and even somewhat replace regulatory discipline.

Some argue that these three steps are already at work within the current regulatory and legal framework. Others cautiously warn that we should wait to see how all of the rules and regulations of Dodd–Frank are implemented before we attempt any improvements. Both perspectives might underappreciate the urgency we feel to correct the current imbalance and perversion of capitalism *before* the next crisis, not after.

Arguments to "give Dodd–Frank a chance" or to simply address TBTF with higher capital requirements (and not complementary structural changes) fall short of necessary action. Living wills and higher capital requirements are potentially very helpful tools but are not sufficient to ensure the survival of a company, and they will not eliminate massive losses that can choke off liquidity and disrupt financial markets and the economy.

Banks are levered institutions and are vulnerable given that they are usually levered with short-term debt like deposits and repo-like funding vehicles. Thus, capital helps to maintain confidence that the institution can sustain some losses and still remain open for business tomorrow. But once investors and creditors begin to fear that losses have been understated or forthcoming at that institution or similar institutions, confidence begins to rapidly diminish, and almost no amount of capital is sufficient to forestall a collapse of confidence and a liquidity crisis. When confidence begins to wane, liquidity dries up quickly. And the plunge in confidence is contagious, often having little to do with the underlying situation of each company. That's where the lender of last resort function of the Federal Reserve comes into play—the central bank lends to solvent companies, those with positive capital and good collateral. But such capital is only a small element in saving a company from extinction. Confidence matters even more.

Within the category of capital, it is loss-absorbing capital that buttresses confidence the most. Equity capital is the first to absorb losses; hence, it is the most expensive capital to raise. Debt doesn't absorb losses except in bankruptcy, at which point the company is dead. Risk-weighted capital is somewhat meaningless—and sometimes deeply misleading—in the context of loss absorbency; any asset that incurs losses must be written off against equity capital, whether the loss was in business loans, mortgage loans, municipal bonds or agency debt. If losses thin out the capital cushion to the point of undermining confidence, the future viability of the company slips. Nobody knows the magic capital ratio that will prevent a loss of confidence, and I do not believe regulators will suddenly become better equipped to set higher magical ratios in the future for the largest, most politically-connected banking institutions. Capital is necessary for viability (nonfailure), and I support higher capital requirements (particularly for any institution that could become of systemic importance), but it is not sufficient.

We concede that our proposal doesn't have all the answers either. It would not eliminate financial crises—that would be an impossible or even foolish goal—but it should reduce their frequency and severity. Nor will it alter the human DNA of those who serve as "first responders" during the next crisis. Our proposal should make the magnitude of the problems regulators face, and the tasks they need to perform, far more manageable. Under our plan, supervisory agencies would oversee several thousand community banks, a few hundred moderate-size banks (by today's standards) and no megabanks. The nonbank and shadow bank components of a large financial holding company would still operate but without subsidy and access to the safety net and with long-overdue market discipline imposed by at-risk creditors.

There will always be some banks that are larger than the rest, and consequently, there will be temptation for regulators to label the "biggest few" as systemically important. The fluctuating nature of human resolve and political fortitude, as well as the problem of "regulatory capture," has been present in U.S. bank policy at least since the intervention/bailout of Continental Illinois and its creditors in 1984. Our proposal may not prohibit regulators from intervening to support the unsecured creditors of a failing banking institution. But our proposal reduces the dimensions of the problem—asset size and systemic interconnectedness—by an order of magnitude and thereby should diminish the tendency to intervene out of fear of unknown systemic risks. Our plan would dramatically reduce the costs of nonintervention.

The elimination of TBTF along the lines we have proposed will not, as the megabanks suggest, diminish our nation's competitive advantage in global financial markets. If anything, our proposal may help drive innovation in our financial system by leveling the playing field.

The former safety net implicitly covered too much of a selective part of the credit intermediation system, promoting perverse risk-taking incentives. We believe that had the Dallas Fed plan I have articulated today been in place a decade ago, it would have altered the insidious behaviors that contributed to the crisis, avoiding the bailouts and their aftermath, the cost of which our nation's citizens will endure for years to come.[13] We believe that had our plan helped guide the restructuring of the banking and financial services industry before the crisis began, neither Citigroup, Bank of America, nor others would have been positioned to receive hundreds of billions of dollars of extraordinary government assistance; the parts of these companies that got into trouble would have been sold off, closed or run through a standard bankruptcy process. The taxpayers would never have been involved.

The same could be said of Bear Stearns; the first shadow bank to require government assistance back in March 2008 would have been governed by market discipline and unable to call upon giant banking institutions to find an over-the-weekend, government-assisted acquisition because there would have been *no* megabanks to invite to the table. Further, the more disciplined financial marketplace that would result from the adoption of our proposal likely would have helped prevent a concentration of risks and imbalances of the magnitude that occurred at AIG. This is the ultimate test and counterfactual thought experiment for any proposal to end TBTF. The GAO and others estimate that the cost of the financial crisis, measured in lost consumption and jobs, could exceed $14 trillion, or roughly one whole year of U.S. output.[14]

We do not think Dodd–Frank would have averted the 2008–09 financial crisis and its horrendous costs and consequences had the act been in place and implemented in the years before the crisis began. Were we to have another crisis today, we believe that the cost would be even greater because, in effect, rather than in theory, Dodd–Frank entrenches and perpetuates TBTF banks that are now even bigger than they were before.

An Appeal for Action

In my introduction, I referred to Patrick Henry. In the speech I quoted, he went on to say, "It is natural to man to indulge in the illusions of hope. We are apt to shut our eyes against a painful truth, and listen to the song of that siren till she transforms us." I implore the members of this important committee and the

Congress to not succumb merely to the illusion of hope. Don't listen to the siren song of the megabanks and their lobbyists. Take action to deal with the unfair advantages that these institutions enjoy. They will spend millions of dollars to try to perpetuate their brand of crony capitalism. Resisting their entreaties is the right thing to do. Leveling the playing field is a just cause for 99.8 percent of American banks and for all Americans.

The potential taxpayer burden of dealing with TBTF institutions might be addressed by a still-growing army of bank supervisory personnel trying to enforce the rigid, complex and probably easy-to-evade rules of Dodd–Frank. However, this would be oversight without the benefit of supplemental reinforcement from market discipline and increased due diligence.

In March of this year, the Dallas Fed released an annual report on "Vanquishing Too Big to Fail." [15] The contents of this report explored the merits of community banks, the adverse effects of current reform efforts and the urgency of reasserting market discipline for all institutions—large and small—to compete on a more level playing field. Accompanying these essays is a series of responses to the questions and criticisms we have received about our proposal, including those raised by proponents for the megabanks. This "Q&A with Richard Fisher on TBTF" can be found at www.dallasfed.org/microsites/fed/annual/2012/ar12c/index.cfm.

Unfortunately, a subsidy once given is nearly impossible to take away. Overcoming entrenched oligopoly forces, in combination with customer inertia, may require government-sanctioned reorganization and restructuring of the TBTF firms in order to accelerate the imposition of effective market discipline.

We advocate using as little government intervention and statutory modification as possible to restructure the largest institutions to a size that is effectively disciplined by both market and regulatory forces—so that every corporate entity is subject to a speedy bankruptcy process and every banking entity is "too small to save."
This would underscore to customers and creditors that a credible regime shift has taken place, that all banking organizations are without subsidy and are governed by the market discipline of creditors at risk of loss, and that the reign of TBTF policies has truly ended.

Notes

[1] The recent recession began in 2007 but cascaded into crisis in fall 2008, the effects of which we still grapple with today.

[2] Some examples of other thoughts on ending TBTF within the Federal Reserve System, include "Regulating Large Financial Institutions," speech by Jeremy C. Stein, Federal Reserve Board of Governors, at the "Rethinking Macro Policy II," a conference sponsored by the International Monetary Fund, Washington, D.C., April 17, 2013, www.federalreserve.gov/newsevents/speech/stein20130417a.htm; "Ending 'Too Big to Fail'," speech by Jerome H. Powell, Federal Reserve Board of Governors, Institute of International Bankers 2013 Washington Conference, Washington, D.C., March 4, 2013, www.federalreserve.gov/newsevents/speech/powell20130304a.htm; "Financial Stability Regulation," speech by Daniel K. Tarullo, Federal Reserve Board of Governors, at the Distinguished Jurist Lecture, University of Pennsylvania Law School, Philadelphia, Oct. 10, 2012, www.federalreserve.gov/newsevents/speech/tarullo20121010a.htm; and "Fostering Financial Stability," speech by Chairman Ben S. Bernanke, Federal Reserve Board of Governors, at the 2012 Federal Reserve Bank of Atlanta Financial Markets Conference, Stone Mountain, Ga., April 9, 2012, www.federalreserve.gov/newsevents/speech/bernanke20120409a.htm.

[3] For one example of the TBTF advantage observed in the spreads paid for longer-term debt, see "BIS Annual Report 2011/12," Bank for International Settlements, June 24, 2012, pp. 75–6, www.bis.org/publ/arpdf/ar2012e.htm.

[4] See "Why Should Taxpayers Give Big Banks $83 Billion a Year?" Bloomberg, Feb. 20, 2013, www.bloomberg.com/news/2013-02-20/why-should-taxpayers-give-big-banks-83-billion-a-year-.html.

[5] See "On Being the Right Size," speech by Andrew Haldane, Bank of England, at the 2012 Beesley Lectures, Institute of Economic Affairs' 22nd Annual Series, London, Oct. 25, 2012, www.bankofengland.co.uk/publications/Documents/speeches/2012/speech615.pdf.

[6] See "Big Banks Have a Big Problem," by Simon Johnson, *New York Times*, March 14, 2013, http://economix.blogs.nytimes.com/2013/03/14/big-banks-have-a-big-problem.

[7] See "Dodd–Frank Burden Tracker," U.S. House Financial Services Committee, http://financialservices.house.gov/burdentracker.

[8] See "Does Size Really Matter?: The Evolving Role of Small Firms in the U.S. Economy," by Nathan Sheets and Robert A. Sockin, Empirical & Thematic Perspectives, Citi Research, Dec. 10, 2012. These international economists noted that "well-established results in the empirical literature have shown a special link between small firms and small banks. As such, this sustained and sizable decline in the role of small banks as providers of credit—reflecting the ongoing consolidation of the U.S. banking system—is very likely a factor contributing to the downtrend in the share of credit provided to small firms." Further, the authors conclude that they "would be inclined to support public policies designed to ensure a level playing field between firms of various sizes and, in addition, measures to incentivize small-business creation and the allocation of credit to young firms." We at the Dallas Fed agree with this conclusion and promote competition across industries, including financial services.

[9] Hearing entitled "Who Is Too Big to Fail: Does Title II of the Dodd–Frank Act Enshrine Taxpayer-Funded Bailouts?" Testimony by Professor David A. Skeel, Professor John B. Taylor, Mr. Joshua Rosner and Mr. Michael Krimminger, May 15, 2013, www.financialservices.house.gov/calendar/eventsingle.aspx?EventID=333122.

[10] The Fed's discount window offers three secured lending programs to depository institutions: primary credit, secondary credit and seasonal credit. Primary credit is a very short-term (usually overnight) loan to depository institutions in generally sound financial condition. Depository institutions not eligible for primary credit may apply for secondary credit to meet short-term liquidity needs. Seasonal credit is extended to relatively small depository institutions that have recurring intrayear fluctuations in funding needs.

[11] This would not prevent the Federal Reserve from serving its lender of last resort function in a liquidity crisis by lending to solvent companies with good collateral at a penalty interest rate on a temporary basis.

[12] This restructuring would be designed and implemented by the companies' top management team within the timeframe established by legislation and/or regulation.

[13] Richard W. Fisher and Harvey Rosenblum, "How to Shrink the 'Too-Big-to-Fail' Banks," *Wall Street Journal*, Mar. 11, 2013, http://online.wsj.com/article/SB10001424127887324128504578344652647097278.html

[14] See "Financial Crisis Losses and Potential Impacts of the Dodd–Frank Act," Government Accountability Office, GAO-13-180, Jan. 16, 2013, www.gao.gov/products/GAO-13-180. Also, "How Bad Was It? The Costs and Consequences of the 2007-09 Financial Crisis," by Tyler Atkinson, David Luttrell, and Harvey Rosenblum, Federal Reserve Bank of Dallas *Staff Papers*, forthcoming, 2013.

[15] The essays included in the Federal Reserve Bank of Dallas *2012 Annual Report*, can be found at www.dallasfed.org/microsites/fed/annual/2012/indexw.cfm

STATEMENT OF

THOMAS M. HOENIG

on

AVOIDING TAXPAYER FUNDED BAILOUTS BY
RETURNING TO FREE ENTERPRISE AND PRO GROWTH
BANK REGULATORY POLICIES

before the

COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

June 26, 2013
2128 Rayburn House Office Building

The views expressed by the author are his own and do not necessarily reflect those of the Federal Deposit Insurance Corporation, its directors, officers or representatives.

Chairman Hensarling, Ranking Member Waters and Members of the Committee, I appreciate the opportunity to testify on issues relating to improving the safety and soundness of our nation's banking system. How policymakers and regulators choose to structure the financial system to allocate the use of the government's facilities and subsidy will define the long-run stability and success of the U.S. economy. My testimony today is based on a paper, titled "Restructuring the Banking System to Improve Safety and Soundness," that I prepared with my colleague Chuck Morris in May 2011. I welcome this opportunity to explain the pro-growth and pro-competition recommendations for the financial system in the paper, which I have attached to this testimony (Attachment 1). Although I am a board member of the FDIC, I speak only for myself today.

Too Important to Fail

Almost three years after passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), an issue that remains critical to the long-run stability of our financial and economic system is the degree to which the government should subsidize and therefore facilitate ever-greater risk taking among our most dominant financial firms. These firms by their very size and complexity affect the broader economy to an overwhelming degree; and since the recent financial crisis, they have only become more influential and the economy more dependent on their performance.

The largest U.S. financial holding company has nearly $2.4 trillion of assets under GAAP accounting, which is equivalent to 15 percent of nominal GDP. If we take into account the gross fair value of its derivative book, it has nearly $4 trillion of assets, equivalent to 25 percent of nominal GDP. The largest eight U.S. global systemically important financial institutions in tandem hold $10 trillion of assets under GAAP accounting, or the equivalent of two-thirds of U.S. GDP, and $16 trillion of assets when including the gross fair value of derivatives, which is the equivalent of 100 percent of GDP.

My concern with the largest financial institutions is not only their size but their complexity and the subsidy that facilitates each. Over time, the government's safety net of deposit insurance, Federal Reserve lending and direct investment has been expanded to an ever-broader array of activities outside the historic role of commercial banks -- transforming short-term deposits into long-term loans and operating the payments system that transfers money around the country and the world. In the U.S., the Gramm-Leach-Bliley Act allowed commercial banks to engage in a host of broker-dealer activities, including proprietary trading, derivatives and swaps activities -- all within the federal safety net. Following passage of this Act, in order to compete with subsidized firms, broker-dealers found it necessary to either merge with commercial banks or change their business model by taking on dramatically greater debt and risk. For example, firms like Bear Stearns began to borrow short to lend long and to engage in other bank-like activities. As they increased in size and complexity, the markets correctly assumed that the safety net would extend to these firms. Therefore, institutions engaged in banking activities significantly contributed to the crisis whether they were called "banks" at the time or not.

Even today, following enactment of the Dodd-Frank Act, government support of these dominant firms, explicit and implied, combined with their outsized impact on the broader economy, gives them important advantages and encourages them to take on ever-greater degrees of risk. Short-term depositors and creditors continue to look to governments to assure repayment rather than to the strength of the firms' balance sheets and capital. As a result, these companies are able to borrow more at lower costs than they otherwise could, and thus they are able increase their leverage far beyond what the market would otherwise permit. Their relative lower cost of capital also enables them to price their products more favorably than firms outside of the safety net can do. For your information, I have included with my testimony a chart (Attachment 2) that shows current leverage ratios for some of the world's largest financial firms. History tells us that without the safety net, the market would have allowed far less leverage.

The Subsidy

The advantages I describe above translate into a subsidy that represents a sizable competitive advantage and which leads to a more concentrated industry. A large and growing body of evidence supports the existence of such a subsidy. A summary of studies is included with my written testimony (Attachment 3). While the estimated size of the subsidy may vary in degree, depending on the methodology, nearly all independent studies calculate the value to be in the billions of dollars. This government subsidy facilitates these firms' growth beyond what economies of size and scope can otherwise justify and subjects the broader economy to the adverse effects of management misjudgments, which in turn entrenches the behavior of repeated financial bailouts within modern economies.

The Dodd-Frank Act was intended to address the build-up of systemic risk and, if necessary, the management of its fallout on the economy. However, there remain systemically important financial firms that are of a size and complexity that would expose the broader economy to overwhelming consequences should they encounter problems. The Dodd-Frank Act unfortunately does not change the fundamental incentive of the safety net's subsidy, which continues to encourage these firms to leverage and take on excessive risk for higher returns. As long as the subsidy exists, we will have highly leveraged, highly vulnerable institutions that will negatively impact our national economy

The Proposal

To improve the chances of achieving long-run financial stability and making the largest financial firms more market driven, we must change the structure and the incentives driving behavior. The safety net should be narrowed and confined to commercial banking activities as intended when it was implemented with the Federal Reserve Act and the Banking Act of 1933. Importantly, such reforms only will be effective if the shadow banking system is also reformed and its activities subjected to the market's discipline.

Commercial banking organizations that are afforded access to the safety net should be limited to conducting the following activities: commercial banking, securities underwriting and advisory services, and asset and wealth management. Most of these latter services are primarily fee-based and do not disproportionately place a firm's capital at risk. They are similar to the trust services that have long been a part of banking.

Extending the safety net to broker-dealer activities is unnecessary and unwise. While trading and investment activities are important parts of the financial system, they operate more efficiently and safely without government protections. Keeping them inside the safety net exposes the FDIC Deposit Insurance Fund and the taxpayer to loss. Therefore, activities that should be placed outside the safety net and thus subject to market forces are: most derivative activities; proprietary trading; and trading for customer accounts, or market making. Allowing customer trading makes it easy to game the system by "concealing" proprietary trading as part of it. Also, prime brokerage services require the ability to trade, and essentially allow companies to finance their activities with highly unstable, uninsured, wholesale "deposits" that come with implied protection. This combination of factors, as we have recently witnessed, leads to unstable markets and government bailouts.

Reforming the Shadow Banking System

These actions alone would provide limited benefits if the newly restricted activities migrate to shadow banks -- broker-dealers, for example -- without that sector also being reformed. We need to change incentives within the shadow banking system through reforms of money market funds and the repo market.

First, we must address potential disruptions coming from money market funding of shadow banks that fund long-term assets. Money market mutual funds and other investments that are currently allowed to maintain a fixed net asset value of $1 should be required to have floating net asset values. Shadow banks' reliance on this source of short-term funding would be greatly reduced by requiring share values to float with their market values.

Second, we must change bankruptcy laws to eliminate the automatic stay exemption for mortgage-related repurchase agreement collateral. This exemption, introduced in 2005, resulted in a proliferation in the use of repos based on mortgage-related collateral. This preferential treatment made it possible for complicated and often risky long-term mortgage securities to be used as collateral when the volume of securities was growing rapidly just prior to the bursting of the housing price bubble. One of the sources of instability during the recent financial crisis was repo runs, particularly on repo borrowers using subprime mortgage-related assets as collateral. Essentially, these borrowers funded long-term assets of relatively low quality with very short-term liabilities.

The reforms specified in the proposal I am describing today would not – and are not intended to – eliminate natural market-driven risk in the financial system. They do address the misaligned incentives causing much of the extreme risks stemming from the safety net's coverage of nonbank activities. The result would be a return to a system of free enterprise where broker-dealer related activities are subject to greater market discipline.

The Industry's Reply

Objections to the proposal I offer suggest that it would undermine the competitive position of U.S. firms internationally. However, under the proposal, the largest financial firms would remain large and would be more competitive. It recognizes that the public should not accept the premise that it must subsidize highly risky financial activities in order to compete for international dominance. It is a serious error to presume that if these activities were not subsidized at U.S. commercial banks, they would cease to be offered by other non-subsidized

U.S. firms. Our dynamic markets would continue to provide these services via independent broker-dealers but in a more competitive manner where the taxpayer is not part of the transaction.

Each country is unique in what banking structure best supports its economic growth. I am not aware of research that suggests the U.S. financial system would be less competitive or that economic growth would suffer with commercial banking separated from broker-dealer activities. It is a fact that the emergence and continued success of the U.S. economy from the end of World War II to the 1990s happened during a period where commercial banking was separate from investment banking. Here's one data point: the growth rate of real GDP averaged 3.3 percent from 1955 to 1990, but only 2.3 percent from 1990 to the present.

The argument for bank deregulation prior to 1999 was that size and diversification of activities reduces risk. While in theory that may have seemed a real possibility, we can surely observe that history – from the 1980s to the most recent crisis – suggests otherwise. In each of these periods of financial crisis, regional and smaller banks failed and didn't bring down the economy. In the recent crisis, some of the largest banks would have failed had they not been bailed out to prevent a total economic collapse. Regardless of TARP repayment at a generously low interest rate, millions of American jobs and trillions of dollars in economic wealth remain lost.[1]

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[1] The GAO reports that estimates of the economic cost in lost output of the 2007 crisis could range from a few trillion dollars to over $10 trillion. http://www.gao.gov/assets/660/651322.pdf

Large banks and large broker-dealers are critical components of the U.S. economy. But I oppose their government-backed ability, when combined as conglomerates, to carry a size and complexity that evidence suggests exceeds what economies of scale would otherwise justify[2] and thus exposes the real economy to levels of risk that are unnecessary.

Benefits of Change

The proposal outlined in my paper would return U.S. financial firms to a more market-driven model. It would reduce the opaqueness of these firms' operations, enabling the market and supervisors to better oversee their actions. It also would improve the pricing of risk, thus enhancing the allocation of resources within our economic system. In addition, it would promote a more competitive financial system with more – not fewer – firms, as it levels the playing field for financial institutions in the U.S.

As a further benefit, the proposal would facilitate the implementation of Titles I and II of the Dodd-Frank Act, allowing the resolution of a failed SIFI by simplifying the structure of these large financial institutions, making the entire system more manageable through a crisis. Finally, it would raise the bar of accountability for actions taken and, to an important degree, give further credibility to the supervisory authorities' commitment to place these firms into bankruptcy or FDIC receivership when they fail, thus reducing the likelihood of future bailouts.

[2] Gambacorta, Leonardo and van Rixtel, Adrian. 2013. "Structural bank initiatives: approaches and implications," BIS Working Paper No. 412, April.

Conclusion

I will close my remarks by recalling that twice within the past century Americans have experienced the tragedy of vast job and wealth losses due to the economy's exposure to financial crisis. Most recently, the Financial Crisis Inquiry Commission identified a series of abuses that opened our economy to crisis. These included using special purpose vehicles and affiliates to engage in and fund speculative off-balance-sheet activity, and participating in and syndicating for sale low-quality assets.

Finally, I want to conclude by mentioning two admonitions of Adam Smith. First, he argued well that specialization most often increases productivity. I suggest that in the financial services industry, specialization would do much to increase productivity, innovation and other overall benefits to our economic system. Second, Adam Smith wisely warned that,

> "The interest of the dealers....is different from, and even opposite to, that of the public. To widen the market and to narrow the competition, is always the interest of the dealers. To widen the market may be agreeable to the public; but to narrow the competition is against it, and enables the dealers, by raising profits above what they naturally would be, to levy an absurd tax upon their fellow-citizens."

In the United States we must reform financial conglomerates so we have a more stable, more innovative, more competitive system that continues to support the largest, most successful economy in the world.

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Attachment 1

Restructuring the Banking System to Improve Safety and Soundness

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Executive Summary

Proposal

- This paper provides a specific proposal to limit the financial activities that are covered and thus subsidized by the government safety net in order to protect the financial system and the economy. The U.S. safety net, which consists of central bank loans to solvent but liquidity strained banks and federal deposit insurance, was developed in the early 1900s to protect commercial banks.
- The safety net originally was limited to commercial banks because they are critical to an economy's overall health and growth. Their core activities of making loans funded by short-term deposits provide essential payment, liquidity, and credit intermediation services. But banks also are inherently unstable because depositors will "run" if they believe their bank is in financial trouble.
- While the safety net solves the instability problem, it also creates incentives to take excessive risk because it subsidizes banks. With safety net protection, depositors and other protected creditors are willing to lend to banks at lower interest rates, given the amount of risk. This cheaper funding and reduced market discipline creates incentives for banks to make riskier investments and increase leverage. The subsidy and associated incentive to take greater risks have grown substantially over the past 30 years because the activities the safety net supports has expanded beyond the core banking activities considered necessary to protect.
- The recommendation in this paper is to limit the safety net – and thus its subsidy – to what the safety net should protect by restricting banking organization activities by business line. Under the proposal, banking organizations would continue to provide the core services of commercial banks – making loans and taking deposits to provide payment and settlement,

liquidity, and credit intermediation services. Other allowable services would be securities underwriting, merger and acquisition advice, trust, and wealth and asset management. Banking companies would not be allowed to conduct broker-dealer activities, make markets in derivatives or securities, trade securities or derivatives for either their own account or customers, or sponsor hedge or private equity funds.

- The difference between what banks would and would not be allowed to do is based on the principle that beyond their core services, they should not conduct activities that create such complexity that their management, the market, and regulators are unable to adequately assess, monitor, and control bank risk taking. Current activities conducted by banks that would be prohibited for them, such as trading and market making, are important to the economy. But they should not be subsidized by the safety net because it causes their overproduction, and therefore imposes unnecessary risks and costs on the financial system and economy. In fact, by removing the safety-net's protection for activities such as securities and derivatives market-making, the market for these services should become more competitive and less dominated by the largest investment banks, which currently are all affiliated with commercial banks.
- The benefits of prohibiting banks from conducting high-risk activities outside of their core business, however, would be limited if those activities continue to threaten stability by migrating to the "shadow" banking system. Shadow banks are financial companies not subject to prudential supervision and regulation that use short-term or near-demandable debt to fund longer-term assets. In other words, shadow banks essentially perform the same critical, core functions as traditional banks, but without an explicit safety net or prudential regulation. As a result, the shadow banking system is susceptible to disruptions that threaten

financial and economic stability and lead to additional implicit government guarantees and the associated incentive to take excessive risks.

- To mitigate the incentive for shadow banks and other financial companies to take excessive risk and the associated potential systemic effects, this paper makes two additional recommendations. First, money market mutual funds and other investment funds that are allowed to maintain a fixed net asset value (NAV) of $1 should be required to have floating net asset values. Second, bankruptcy law for repurchase agreement collateral should be rolled back to the pre-2005 rules, which would eliminate mortgage-related assets from being exempt from the automatic stay in bankruptcy when a borrower defaults on its repurchase obligation.
- The problem with fixed NAVs and current bankruptcy law is they provide special treatment – that is, they essentially subsidize – short-term funding. As with the safety net for banks, the subsidy leads to the overproduction of risky shadow banking activities. By reining in this subsidy, these two recommendations should greatly curtail shadow banking activities by exposing shadow bank creditors to the true costs of their investments.

<u>Why Restricting Activities is the Solution</u>

- The reduced market discipline and incentive to take excessive risk caused by the safety net has long been recognized, which is one of the major reasons for the prudential supervision of banks. The incentive to take *excessive* risk traditionally has been contained through strong on-site examinations and minimum capital requirements that were supplemented as appropriate based on the exam results. This does not mean that banks do not take risks, nor that they do not make mistakes that cause them to fail. Banking is a business of risk taking, and when they do make bad decisions that lead to insolvency or liquidity problems, they should fail and be resolved. Thus, it is the prevention of excessive risk taking arising from the safety net subsidy that prudential supervision is supposed to stop.

- This traditional financial structure and regulatory framework worked well for many years, and it still does for those banks that still operate within the framework, which includes all but the largest universal banks. That framework has three components. First, it limits bank activities to those essential to the economy but inherently unstable. Second, it provides a safety net for banks and their limited activities, which prevents the instability but has undesirable side effects. Third, it includes strong supervision to control the side effects.
- The current financial structure, however, is vastly different. Leading up to the financial crisis, the financial system became dominated by a handful of large *and* complex financial organizations, and these companies have become even more dominant. These complex universal banking companies combine traditional banking activities with a variety of investment banking and insurance activities.
- The problem with this change in structure is not that banks are larger, but that the scope of the safety net and its subsidy -- and therefore their sizes – has expanded beyond the traditional bank activities that provide external social benefits. The subsidy is provided, either explicitly or implicitly, to the organization as a whole and not limited to the specific activities for which it was intended. The riskiness of banks can be reduced by the additional activities, for example, if they increase the diversification of bank assets and revenue streams. However, the riskiness of banks also can be increased by the additional activities because they not only are subsidized by the safety net, but also because they create complexity that makes it more difficult for bank management, the market, and regulators to assess, monitor, and contain the excessive risk taking induced by the safety net. Moreover,

the large size of the universal banks – both individually and collectively given the increased interconnections among them – further endangers the stability of the financial system and the overall economy. Thus, the social costs of extending the safety net to large, complex universal banks that cannot be sufficiently monitored by their own management, the market, or regulators greatly exceeds the private benefits to an individual bank.

Evolution of current financial structure

- Over the past 30 years, the U.S. banking system has changed dramatically from the stylized view of banking that arose from the banking panics of the early 1930s. The structure of the banking industry that emerged from the 1930s separated investment banking and other financial services from "traditional" commercial banking – making loans and taking deposits to provide payment, liquidity, and credit intermediation services. These core banking services are the foundation of the financial infrastructure that is critical for the overall health of an economy and its growth.

Regulation

- The 1930s financial structure that lasted largely until the end of the century was shaped by three major legislative and regulatory changes: the Glass-Steagall Act, creation of federal deposit insurance, and the Federal Reserve's Regulation Q.
- The Glass-Steagall Act refers to four provisions of the Banking Act of 1933 that separated commercial and investment banking. Deposit (i.e., commercial) banks were prohibited from conducting securities activities (underwriting and dealing) or affiliating with companies that conducted securities activities. The rationale was that banks are crucial for a well-functioning economy because they settle payments, provide deposits that are available at par

value on demand, and are the primary source of credit for the vast majority of businesses and individuals. These functions are a critical part of the economy's financial infrastructure.

- Banks are provided access to a public safety net because of their importance and susceptibility to runs from using demand deposits to fund longer-term, illiquid loans. Prior to the 1930s, the Federal Reserve's discount window provided a limited safety net for solvent banks.[1] The public safety net was significantly enhanced in 1933 by passage of the Federal Deposit Insurance Act and the associated provision of limited deposit insurance because it protected depositors of banks that failed.
- Access to a safety net, however, increases the incentive for banks to take excessive risks. Given the importance of a stable banking system, the necessity of a public safety net to provide the stability, and an incentive to take greater risk, a mechanism is needed to prevent banks from taking excessive risks and endangering the safety net. The market cannot be solely relied upon to prevent the risk taking because some deposits are insured and banks are inherently opaque. As a result, prudential supervision and regulation must be used to prevent excessive risk taking.
- One of the key regulations of the Banking Act of 1933 was the prohibition of paying interest on demand deposits and the authority to impose ceilings on savings deposit rates, which was implemented through the Federal Reserve's Regulation Q. The rationale for Regulation Q was to prevent competition for deposits from causing instability in the banking system.
- The combined effect of the Glass-Steagall Act, bank access to a government safety net, prudential supervision and regulation, and deposit rate ceilings was a fairly stable, profitable banking industry with a positive franchise value for many years. The franchise value was

[1] Also, only members of the Federal Reserve could borrow from the discount window until the Monetary Control and Depository Institutions Deregulation Act of 1980.

protected to the extent banks were protected from outside competition and competition among themselves.

Increased competition

- Over time, banks faced increasing competition on both the liability and asset sides of the balance sheet. The increase in competition was spurred by advancements in portfolio theory, investment and money management techniques, and information technology combined with greater volatility of the economic environment.

- On the liability side, banks had to compete with money market mutual funds (MMMFs) and savings association NOW accounts that paid interest on close substitutes for bank demand deposits. They also faced greater competition for household savings from mutual funds, pension funds, and insurance companies.

  - MMMFs started in 1971 as a competitive alternative to bank deposits because they paid a market interest rate and were allowed to maintain a net asset value (NAV) of $1 a share as long as their actual NAV is greater than 99.5 cents (i.e., they do not "break the buck") and not too far above $1, and they met certain investment (quality and maturity) requirements. They allow investors to withdraw funds on demand and have limited check-writing privileges. MMMF shares are held by individuals, institutional investors, and corporate and noncorporate businesses as an alternative to bank deposits for cash management and payments purposes. MMMFs started out investing in highly-rated financial and nonfinancial company commercial paper (CP) and short-term Treasury securities, and then over the years expanded to other money market instruments (MMIs), such as asset-backed commercial paper (ABCP), and short-term repurchase agreements (repos).

- It is important to note that although an MMMF investor technically owns equity shares of the fund – that is, there is *no leverage* – the investor is more like a depositor because the expectation is that funds can be withdrawn at a par value of $1 a share – that is, there is no equity and *leverage is infinite*. As a result, MMMF investors act more like depositors and will run whenever they are concerned about a fund's safety so they can redeem their shares for $1 before the fund "breaks the buck" and reduces the value of the shares.

- NOW accounts were developed by savings and loans in the early 1980s as a competitive alternative to demand deposits that paid interest. NOW accounts essentially were just like demand deposits – funds were available upon demand and had unlimited check-writing privileges – but they could pay interest because the depository institution reserved the right to require notice before allowing funds to be withdrawn or transferred by check.

• On the asset side, banks faced competition in making loans from investment banks (junk bonds, securitization, and nonfinancial commercial paper), mortgage brokers, and specialty lenders such as unaffiliated finance companies (primarily consumer lending), captive lenders (auto financing, retailers), and factors (trade receivable lending).

- Banks have long faced competition in making loans from unaffiliated and captive finance companies and factors. Commercial paper became a competitive alternative to bank operating loans for large, highly-rated nonfinancial companies in the late 1960s and early 1970s.

- Competition for bank loans increased substantially beginning in the 1980s with the growth of junk bonds and an ability to originate and distribute loans through the development of mortgage-backed securities (MBS), followed by other types of asset-backed securities (ABS), which are typically backed by consumer loans (credit cards, auto, student).

Shadow banking

- The combination of alternatives to bank deposits and loans created an alternative system for providing complete end-to-end banking – from gathering funds to making loans – which collectively comprises the so-called shadow banking system.[2]
  - In contrast to a typical bank that conducts the entire process of borrowing funds from savers, making loans to ultimate borrowers, and holding the loans to maturity, credit intermediation through the shadow banking system is a vertical process that takes place through a series of entities – collectively called shadow banks – similar to a supply-chain manufacturing process.
  - Funding for each of the entities takes place in wholesale markets. Money market instruments – specifically CP, ABCP, and short-term repos – are a major source of funds at virtually each step in the process.[3] The major investors in the MMIs are MMMFs and other short-term investment funds that have a fixed NAV of $1.[4] At some steps of the process, major funding sources also include medium-term notes and ABS that are purchased by long-term investors, such as mutual funds, pension funds, and insurance companies.
  - A typical example of the shadow banking intermediation process is as follows:
    1. A loan is made by either a nonbank financial company or a bank. The nonbank companies finance the initial loans with CP or medium-term notes (MTN).

[2] The description of the shadow banking system and the process described below is largely from Pozar, Adrian, Ashcraft, and Boesky.
[3] The one exception is the step that actually securitizes loans into MBS/ABS.
[4] There are also direct investors in these money market instruments, such as securities lenders.

2. The loan is sold to a bank or broker-dealer conduit, which is an intermediate entity that temporarily warehouses the individual loans until it has enough to package together as an MBS or ABS. The conduits are funded with ABCP.
3. The loan warehouse sells the package of loans to a securitization sponsor that sets up a trust to hold the loans, which is financed by selling MBS/ABS backed by the loans. This is the only step in the process not financed by MMIs.
4. The ABS are purchased by a variety of entities that are funded by a variety of sources.
    a. Entities that purchase ABS and tend to fund them with longer-term sources of funds include mutual funds, pension funds, and insurance companies.
    b. BHCs may purchase ABS and hold them on bank balance sheets funded by deposits. However, prior to the financial crisis, they generally held them in off-balance-sheet entities, such as structured investment vehicles (SIVs) or other conduits, that were funded by CP or ABCP. The CP or ABCP, in turn, was typically purchased by MMMFs and other MMI funds with fixed $1 NAVs.
    c. Investment banks and BHCs purchase ABS for a variety of reasons. They may be held by a securities subsidiary as a proprietary trading asset, in inventory for filling customer trades, or warehoused for creating collateralized debt obligations (CDOs). The ABS are typically funded with repos and sometimes ABCP, which again are funded by MMMFs and other MMI funds with fixed $1 NAVs.

Expansion of bank activities

- Increased competition for banks from the shadow banking organizations combined with regulatory capital requirements (stemming from the Basel I Accord) that were higher than for their competitors led to reduced profits and declining franchise values. As a result, banking organizations looked for alternative activities, revenue streams, and business models, which included the originate-to-distribute shadow banking business model. Whereas the traditional banking model of making loans and holding them to maturity earned profits from loan-deposit rate spreads, the shadow banking model earned profits from fees and trading gains.

- Some banks responded to the increased competition by focusing first on being able to engage in traditional investment banking and securities activities and later more broadly on broker-dealer and shadow banking activities.
  - Banks were able to whittle away at the Glass-Steagall Act restriction on investment banking activities in the 1990s by creating Section 20 securities subsidiaries that were supported by Federal Reserve Board approvals of higher thresholds for being "principally engaged" in securities activities.[5]
  - To fully participate, however, banks needed the Glass-Steagall Act prohibition on affiliation with securities companies to be repealed, which was achieved with the passage of the Gramm-Leach-Bliley Act (GLBA) in 1999. The GLBA allowed the formation of financial holding companies (FHCs), which were BHCs engaged in certain nonbanking activities, such as securities underwriting, broker-dealer activities, and insurance underwriting, not permitted for BHCs.

[5] One of the Glass-Steagall Act provisions was Section 20 of the Banking Act of 1933. Section 20 prohibited Federal Reserve member banks from affiliating with organizations that "engaged principally in the issue, floatation, underwriting, public sale, or distribution of stocks, bonds, debentures, notes, or other securities." For many years, the administrative limit for not being "principally engaged" was that underwriting and dealing accounted for 5 percent or less of a subsidiary's gross revenue. As banks became larger, underwriting and dealing became cost effective even with the 5 percent revenue limit. Over time, banking organizations began petitioning for larger limits, which the Federal Reserve agreed to based on assessments of the risks and benefits to the economy, with the limit eventually rising to 25 percent in 1997.

- Significant changes in the investment banking industry also occurred to take full advantage of the opportunities of the shadow banking industry. With the growth of bond markets and the development of MBS securities in the 1980s, investment banks moved from partnership structures to public corporate structures. The corporate structures essentially allowed the investment banks to engage in riskier activities that put the firm's capital at risk, such as proprietary trading, leveraged lending, and hedge fund sponsorship, that the partners were much less willing to do when their own money was at risk. The risks were exacerbated by relying on debt financing, i.e., leverage, much of which was short-term repos. In fact, it became much easier to use debt after 2004 when the SEC allowed broker-dealers to use their internal risk management models to compute the haircuts for calculating their net capital.[6]

Implications for financial structure, stability, and risk

Changes in financial structure and stability

- The sharp line between commercial and investment banks is significantly blurred as each has engaged in shadow banking activities.
  - The larger banking organizations engage in activities that were traditionally limited to investment banks, which exposes them to investment bank risks. Traditional banks that take in deposits and make and hold loans to maturity have to manage credit and interest rate risk. As FHCs have expanded activities to earning fees from trading and ABS underwriting, their risk exposures expanded to include market risk from trading and the risk from having to roll over uninsured wholesale money market funding risks.

[6] Prior to the 2004 SEC ruling, the SEC determined the haircuts used to calculate the leverage ratios of broker-dealers. The 2004 ruling allowed the broker-dealers to use their internal risk management models to compute these haircuts. The ruling followed a similar change to the Basel I Accord from 1996, under which commercial banks could compute their capital requirements for trading positions using their own models.

- Similarly, the larger investment banks now engage in activities that were traditionally limited to commercial banks, which exposes them to commercial bank risks. By switching from partnerships to public corporate structures, taking on leverage, and making direct investments and loans that are held on the balance sheet, investment banks expanded their risk exposures beyond market risk to credit and funding risk.

- With the largest financial companies – both banking and investment banking organizations – being the key players in shadow banking activities, both types of organizations play a special role in the economy that once was limited to commercial banks. Through shadow banking activities, both types of organizations ultimately provide the same credit intermediation function of traditional banks – lending long term using short-term funds available upon demand.

- The expansion of activities by commercial and investment banks has led to a less stable financial system because it is dependent on wholesale, money market funding without an explicit safety net of insurance and access to central bank lender-of-last-resort facilities.
  - Just like banks were subject to depositor runs that created liquidity crises before deposit insurance was available, virtually every step of the shadow banking process is dependent on uninsured investments in MMMFs and other MMI funds with fixed NAVs of $1.
  - Investors in these money market funds have full access to their money as long as the underlying NAV is $1 or more, so once concerns arise about the quality of the underlying assets, i.e., that the underlying NAV will drop below $1, investors have an incentive to withdraw their funds before others. A loss in funding at any step of the process will cause the system to break down just like a loss in funding at a traditional commercial bank.

- The heavy involvement of large banking organizations (in the form of FHCs) and investment banks in shadow banking activities exposes them to similar risks that previously had been eliminated by deposit insurance in retail banking.
  - Bank subsidiaries are still protected from insured depositor runs, but the holding companies and banks are now exposed to money market fund runs.
  - The bank subsidiaries also are exposed to money market runs because the banks often provide credit lines on the ABCP that fund ABS held by affiliated holding company subsidiaries, such as off-balance-sheet conduits and SIVs. The ABCP often needs a credit line or guarantee so that it has the AAA rating needed to make it an eligible investment for MMMFs. So if MMMFs decide not to roll over their ABCP investments in an SIV and the value of the underlying ABS is below par, the SIV would sell the ABS to the bank guarantor at par, which means the bank takes the loss and has to fund the ABS on balance sheet. In other words, the credit and funding risk to the bank from guaranteeing the off-balance-sheet funding of ABS with ABCP is the same as if it held the underlying ABS on its own balance sheet.
  - To make matters worse, even though the risks to the bank of holding assets on balance sheet or guaranteeing them off balance sheet are the same, FHCs had an incentive to move the assets off balance sheet because it can fund those assets with much less capital.[7] Specifically, the risk-based capital requirements of FHCs had a much higher risk weight for holding the loans or ABS on balance sheet than for guaranteeing the ABCP funding

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[7]Acharya, Schnabl, and Suarez provide evidence consistent with regulatory arbitrage being a reason for the use of ABCP programs by banks. They also document changes in regulatory rules that enabled banks to perform this type of regulatory arbitrage. In July 2004, the OCC, Federal Reserve, FDIC, and OTS exempted assets in ABCP programs from the calculation of risk-weighted assets. As a result, assets moved from banks' balance sheets to ABCP programs did not have to be considered when calculating risk-weighted assets for capital requirements. Moreover, under the Basel I and Basel II Accords, assets placed in ABCP programs carried lower capital charges than the same assets carried on balance sheets.

of an off-balance-sheet entity. As a result of this arbitrage of regulatory capital requirements, FHCs became much riskier because they could fund the credit risk with much higher leverage.

- FHCs also are exposed to runs by money market investors even if the MMIs are not fully guaranteed because of reputational risk. Although subsidiary conduits and SIVs that hold ABS are technically bankruptcy remote, FHCs either purchase assets and bring them on balance sheet or provide capital support to avoid the negative reputational effects of defaulting on the securities funding the subsidiaries.
- Finally, the broker-dealer subsidiaries of investment banks and FHCs also are exposed to MMI runs. As already noted, broker-dealers use repos and ABCP to fund ABS held as part of their proprietary trading business, as inventory for filling customer trades, and for creating CDOs.

<u>New activities make it more difficult to manage and monitor risk</u>

- Overall, the largest financial companies conduct a variety of traditional and non-traditional banking activities, many of which have increased the complexity of their operations and portfolios. The potential problem is not that the new activities are risky – all financial activities are inherently risky, even traditional banking activities. These companies may even benefit from additional activities, for example, if they increase the diversification of their assets and revenue streams. However, it is more likely that these benefits are outweighed by the significant complications the activities pose for bank management, the market, and regulators to assess, monitor, and contain risk taking that is ultimately borne by the public safety net and endangers financial stability. Specifically, as explained below, combining banking and nonbanking activities makes it more difficult for bank management to manage risk, for the market to monitor and effectively discipline banks, and for regulatory authorities to supervise and regulate banks and price deposit insurance.

- Complexity makes *risk management* much more difficult.[8]
  - Risk management is particularly difficult when a banking organization has many different operational divisions and activities. Examples include understanding all of the different business lines and their interactions, having appropriate management information systems, and appropriately allocating and pricing capital across activities. Such difficulties and shortcomings in risk management practices and effectiveness at several U.S. and foreign global banking organizations leading up to and during the recent financial crisis are highlighted in two reports by the Senior Supervisors Group (2008, 2009).
  - The risk management of a complex institution can also vary with the background of its senior leadership. For example, trading is risky in the short term, so it attracts people predisposed to taking risks. In contrast, lenders tend to have a longer term perspective. As a result, an organization's risk culture and appetite is likely to be lower if its senior leadership has a commercial banking background rather than a trading background.
  - To the extent that a bank's senior management has difficulty understanding and managing its risks, it is even more difficult for supervisors to scrutinize and monitor a banking organization's risks.
- Reduced transparency reduces *market discipline*. Banking organizations with a variety of nontraditional activities tend to be less transparent than others, which makes it difficult for the market to discipline their risk taking. Relative to nonfinancial companies, it is difficult

[8] All aspects of managing a large, complex financial company is difficult, but given the context of this paper, the focus is on risk management.

for investors to evaluate the condition of traditional banks and their riskiness because their balance sheet assets and activities are opaque and easily changed.[9] Traditional banking is opaque because banks have more information than investors about the quality and risk of their loans. Banks that engage in nontraditional activities, such as trading, hedge funds, private equity, and market making are even less transparent because the success of these strategies depends on the confidentiality of their positions and speed at which their exposures can be changed. Given the lack of transparency, regulators must play a larger role relative to the market in monitoring and disciplining banks, but as discussed below, regulators also are at a disadvantage when dealing with banks that are engaging in nontraditional activities.

- Some activities make *bank supervision* more difficult.
  - The goal of prudential supervision is to control excessive risk taking by banks so that they are safe and sound and do not endanger the safety net. Supervision includes reviewing a bank's operations and risk management policies; monitoring its financial condition, lending, operations, risk management, and other practices; and enforcing regulatory rules. Because of the periodic nature of bank supervision, supervisors get only a snapshot of bank processes, risk exposures, and capital positions at a given time. Even for the largest complex banking organizations, at which supervisory staff work on site and are continuously looking at some part of the organization and its operations, supervisors still only have snapshots of various operations, albeit at higher frequencies. These snapshots are limited in their ability to predict the safety of a bank's processes, its risk exposures, and its capital positions between supervisory examinations. The

[9] Morgan provides evidence on the increased opacity of banks from combining lending and trading activities.

flexibility to adjust risk profiles between exams depends, to some extent, on a banking organization's activities and the nature of the risks.

- Many of the nontraditional activities that the large, complex banking organizations engage in are difficult to supervise effectively because they are very risky in the short term, which can quickly change a bank's risk profile. For example, trading and market-making are high frequency activities that result in thousands of daily transactions. As a result, snapshots of the positions of these activities may have limited predicative value for future positions. Continuous supervision at the largest banking organizations clearly provides a better understanding of their risks than the traditional approach of periodic exams. Nevertheless, understanding and monitoring the risks still can be difficult, especially when management itself has difficulties in understanding and monitoring risk. Thus, while bank supervision is not meant to prevent risk taking, and is subject to errors regardless of a bank's activities, effective supervision of complex organizations that engage in many nontraditional banking activities is even more difficult.

• Banks with a variety of activities require much more *complex regulations*, which can be difficult for management, the market, and regulators to monitor and understand.

  - The history of the Basel capital requirements provides a good example of the difficulty in effectively regulating complex financial companies. The increased variety and complexity of bank activities required much more complex capital standards, which the financial crisis showed were not very effective in adequately aligning bank risks with capital levels.
  - One problem is that the various capital requirements under Basel are essentially relative prices, and they are set either administratively through regulation or using the banks' own

internal models. Administratively setting risk weights generally will misprice risks. In addition, allowing banks to set risk weights with their own risk models can systematically under price risk. In fact, news articles (Braithwaite, Vaughan) cite several examples of U.S. and foreign banks that plan on "managing" risk weights or are engaging in "risk-weighted asset optimization" to lower their risk-weighted assets and increase their risk-based capital ratios. Thus, it should not be surprising that leading up to the financial crisis the regulatory capital requirements did not adequately align bank capital levels with their risk.

- The Basel requirements also created opportunities for regulatory arbitrage that was a major contributor to the risk taking of the large, complex banking companies and the financial crisis. For example, the capital charge for an MBS based on a pool of subprime loans was lower than that for a portfolio of mortgages held on the balance sheet. Capital charges were also lower for an MBS held in off-balance-sheet conduits than on the balance sheet.

- Complexity of activities makes it difficult to *price deposit insurance*. Deposit insurance would not lead to excessive risk taking if the premiums were priced appropriately to reflect a bank's risk. However, pricing deposit premiums correctly is difficult for the same reasons that it is difficult to determine capital requirements.

- To the extent it is possible, *resolving large, complex banks* is much more difficult and costly. Even with the FDIC's new authority under the Dodd-Frank Act to liquidate a failed complex banking organization, doing so in a quick and orderly manner will be difficult.
  - The Lehman Brothers failure in 2008 is a good example of the difficulty in resolving a complex company. The number of transactions and complexity of interconnections made

it very difficult to determine the company's value quickly enough to find a buyer and have it reopened the following Monday morning. Moreover, Lehman Brothers was a relatively simple company compared to some of the largest BHCs. Some of these BHCs have a thousand or more majority-owned subsidiaries, several of which could be as large and complex as Lehman Brothers. It would be much harder to wind down or find enough buyers to transfer the critical operations necessary for an orderly resolution.

- In summary, the financial system has become less stable over the past 30 years as banks and other financial companies have expanded into more complicated activities. The root of the problem is that large, complex financial companies are funding long-term, illiquid assets with liabilities available upon demand. In addition, after the crisis, the concentration of the industry and complexity of activities at the largest banks increased. The industry is dominated by a handful of companies that combined are half as large as annual U.S. economic output, and the failure of any of them could cause financial instability. Finally, because these companies are so large and complex, they and other institutions that are viewed as systemically important receive an implicit government guarantee on their debt and sometimes on their equity, which creates the incentive to take excessive risk, thereby further increasing systemic risk (the too-big-to-fail problem).

Proposal to Reduce Costs and Risks to the Safety Net and Financial System

- This proposal to reduce costs and risks to the safety net and financial system has two parts.
  - The first part proposes to restrict bank activities to the core activities of making loans and taking deposits and to other activities that do not significantly impede bank management, the market, and regulators in assessing, monitoring, and controlling risk. However, prohibiting banks from engaging in activities that do not meet these criteria and that

threaten financial stability would provide limited benefits if those activities migrate to shadow banks.

- The second part proposes changes to the shadow banking system by making recommendations to reform money market funds and the repo market.

<u>Restricting activities of banking organizations</u>

- The financial activities of commercial, investment, and shadow banks can be categorized in the following six groups (Richardson, Smith, and Walter):
  - Commercial banking – deposit taking and lending to individuals and businesses.
  - Investment banking – underwriting securities (stocks and bonds) and providing advisory services.
  - Asset and wealth management services – managing assets for individuals and institutions.
  - Dealing and market making – securities, repos, over-the-counter (OTC) derivatives.
  - Brokerage services – retail, professional, and institutional investors, and hedge funds (prime brokerage).
  - Proprietary trading – trading for own account and owning hedge and private equity funds.
- Using the criterion for permissible activities stated above, banking organizations would be able to conduct the following activities: commercial banking, investment banking, and asset and wealth management services. Investment banking and asset and wealth management services are mostly fee-based services that do not put much of a firm's capital at risk. In addition, asset and wealth management services are similar to the trust services that always have been allowed for banks.
- In contrast, the other three categories of activities – dealing and market making, brokerage, and proprietary trading – have little in common with core banking services and create risks

that are difficult to assess, monitor, and control. Banking organizations would not be allowed to do any trading, either proprietary or for customers, or make markets because it requires the ability to do trading.[10] In addition, allowing customer but not proprietary trading would be difficult to enforce because the securities inventory used to facilitate customer trading cannot be easily distinguished from proprietary assets. Prime brokerage services not only require the ability to conduct trading activities, but also allow companies to finance their activities with "free balances," which can be highly unstable funds.[11]

- Other potential restrictions include limits on bank investments. Historically, bank investments were restricted to loans and investments in investment-grade securities. As demonstrated in the financial crisis, the complexity of many asset-backed securities made it very difficult to determine their credit quality. As a result, consideration should be given to restrictions on investing in "complicated" securities, such as multilayer structured securities (e.g., CDOs) that are difficult to value, and to determine and monitor credit quality.
- Off-balance-sheet holdings and exposures should be supervised and regulated as if they were on-balance-sheet because, as was also demonstrated in the crisis, they ultimately put a bank's capital at risk.
- The recommended activity restrictions would make banks more transparent and would enable better risk management, market discipline, supervision, regulation, and resolution.
- The proposed activity restrictions will improve the risk management of banks by focusing their activities solely on the traditional banking business with exposure only to risks inherent in these activities.

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[10] Banking organizations would be allowed to purchase and sell derivatives to hedge their assets and liabilities.
[11] Hedge funds hold cash balances with their prime brokers to finance and facilitate transactions. "Free balances" is the cash a hedge fund client has a right to demand on short notice.

- The underlying factors that make commercial banking successful are inherently different from those that make securities firms successful. Banking is based on a long-term customer relationship where the interests of the bank and customer are the same. Both the bank and loan customers benefit if borrowers do well and are able to pay off their loans. In contrast, trading is an adversarial zero-sum game – the trader's gains are the customer's losses. Thus, restricting these activities removes a conflict of interest between a bank and its counterparty customers, which could produce a more stable, less risky company.
- The inherent riskiness of securities trading, dealing, and market-making attracts, and in fact requires, people who are predisposed to taking short-term risks rather than lenders with a long-term perspective. The combination of securities with commercial banking activities in a single organization provides opportunities for the senior management and boards of directors to be increasingly influenced by individuals with a short-term perspective. As a result, the increased propensity of these corporate leaders to take risk leads to more of a short-term-returns culture throughout the organization.

- Prohibiting the activities mentioned above would allow capital regulation to be simplified and improved. Capital regulation would be simpler and more effective because there would be less need for complicated risk-based requirements if the balance sheet is largely limited to loans and investment-grade securities. For example, capital regulation could be structured as a relatively high, simple leverage ratio combined with supervision.[12] Moreover, regulatory

[12] Admati, DeMarzo, Hellwig, and Pfleiderer provide an excellent discussion of the reasons for substantially increasing bank capital requirements. Hellwig provides arguments for abandoning risk-sensitive capital requirements.

arbitrage between balance-sheet and off-balance-sheet activities and between banking and trading books is difficult to prevent with regulation.

- Critics of restricting bank activities argue it would reduce the economies of scale and scope that are critical for the largest banks to be successful in global markets and that large corporations want one-stop shopping for their financial services. These arguments, however, are not persuasive.
  - First, there is no strong evidence of economies of scale at the sizes of the largest banking companies. There are many conceptual and empirical problems with studies of economies of scale.[13] Nevertheless, older studies from the 1990s show that there are no economies of scale when banks are larger than about $250 million in assets, although the threshold is likely to be higher in today's economy because of inflation and advancements in information technology. Although a more recent study from the mid-2000s suggests there are economies of scale for the largest banking organizations, the results are highly questionable because there are so few banks at the sizes in question and the study uses data prior to the problems that banks had during the financial crisis.
  - Second, there is even less evidence of economies of scope.[14] In fact, there is evidence that multiple functions of large, complex banks actually increase systemic risk and anecdotal evidence that if bank activities are restricted as suggested here, a more competitive nonbank financial industry would emerge and thrive.

[13] DeYoung comments that it is not really possible to provide empirical evidence for or against existence of economies of scale in large and complex financial institutions because there are too few of them for a meaningful statistical analysis to be conducted.
[14] Richardson, Smith, and Walter provide a survey of empirical studies on economies of scale.

- Third, large corporations would still be able to do one-stop shopping for commercial and traditional investment banking services, although they would have to go to securities dealers to purchase swaps and other derivatives for hedging purposes.
- Finally, even if there are economies of scale or scope, it does not necessarily mean that banks should be allowed to continue to conduct all of their current activities. Whether they should depends on comparing the marginal benefits from the reduced private costs of operation to the social costs associated with financial crises. Given the large costs of the 2007-9 crisis and the continued weakness of the economic recovery five years after the crisis began, the efficiencies and cost benefits of size and scope would need to be extremely large.

• Critics of restricting activities also question how we would go about divesting the prohibited activities. The divestitures that were required by the Glass-Steagall Act and the breakup of AT&T in the 1980s suggest that divestitures can be conducted in an orderly manner in a relatively short period of time.

• Critics of restricting activities also are concerned that it would cause two major problems for U.S. banks because they would face a competitive disadvantage relative to universal banks, mostly from Europe, that are allowed to conduct the full range of activities.
  - One problem is it would drive U.S. banks to move to other countries. However, it seems highly improbable that any other country would be willing or able to expand its safety net to new large and complex banking organizations.
  - Second, the competitive disadvantage of U.S. banks would lower their franchise values, which would provide an incentive to take even greater risks to raise lost revenues and maintain ROEs. However, the virtue of restricting activities is that it is easier for the

supervisors and the market to detect, prevent, and if necessary punish excessive risk taking.

Reforming the shadow banking system

- Restricting the activities of banking organizations alone, however, does not completely address the stability of the financial system. In fact, it could worsen the risk of financial instability by pushing even more activities from the regulated banking sector to large, interconnected securities firms, which would expand the sector that was an integral part of the financial crisis.
- As previously discussed, the source of this instability is the use of short-term funding for longer-term investment in the shadow banking market, i.e., the maturity and liquidity transformation conducted by a lightly regulated/unregulated sector of the financial system. We believe this source of systemic risk can be significantly reduced by making two changes to the money market.
- The first recommendation addresses potential disruptions coming from money market funding of shadow banks – money market mutual funds and other investment funds that are allowed to maintain a fixed $1 NAV should be required to have floating net asset values.
  - The primary MMIs today are MMMFs and repos. Individuals, institutional investors, and nonfinancial companies are the primary holders of MMMF and other MMI funds with a fixed $1 NAV, which in turn are major investors in repos along with other financial companies.
  - Some have suggested that MMMFs should be backed by government guarantees. We see no reason why the safety net should be extended and the taxpayer put at risk when other solutions are feasible. In addition, providing government guarantees would require

prudential supervision to prevent excessive risk taking, but it would not be effective because of the ability of funds to rapidly shift their risk profiles.

- The runs during the crisis on MMMFs occurred because of concerns about the quality of their investments and because of the promise to maintain a $1 NAV. MMMF investment rules have been strengthened by increasing the minimum average quality and decreasing the maximum average maturity of their investments.[15] However, because of the difficulty in calibrating these requirements, it is not clear that the vulnerability of MMMFs to runs in a systemic event would be significantly reduced as long as the fixed $1 NAV is maintained. We believe reliance on this source of short-term funding and the threat of disruptive runs would be greatly reduced by eliminating the fixed $1 NAV and requiring MMMFs to have floating NAVs.

- Critics of eliminating a $1 NAV for MMMFs argue that this limits cash management options for large corporations. However, MMMFs were first introduced to evade interest rate ceilings on deposits, and the only remaining Regulation Q deposit rate ceiling – the prohibition of paying interest on business transactions deposits – was eliminated by the Dodd-Frank Act. Some may be concerned that their deposits will be largely uninsured, but they are uninsured when invested in MMMFs. In addition, European MMMFs historically have mostly used floating NAVs. Although the percentage of fixed NAV European MMMFs has increased in recent years, the majority still have floating NAVs.

- The second recommendation addresses potential disruptions stemming from the repo financing of shadow banks – the bankruptcy law for repurchase agreement collateral should

[15] Some of the new rules for MMMFs are: 30 percent of assets must be liquid within one week, no more than 3 percent of assets can be invested in second-tier securities, the maximum weighted-average maturity of a fund's portfolio is 60 days, and MMMFs have to report their holdings every month.

be rolled back to the pre-2005 rules. By making this change, mortgage-related assets would no longer be exempt from the automatic stay in bankruptcy when a repo borrower defaults on its repurchase obligation.

- One reason for the runs on repos during the crisis was because of the prevalence of repo borrowers using subprime mortgage-related assets as collateral. Essentially, these borrowers funded long-term assets of relatively low quality with very short-term liabilities. The price volatility of subprime MBS rose sharply when subprime defaults started reducing MBS income flows. As a result, haircuts on subprime repos rose sharply or the repos were not rolled over.
- The eligibility of mortgage-related assets as collateral exempt from the automatic stay in bankruptcy in case of default by the borrower is relatively recent. The automatic stay exemption allows the lender to liquidate the collateral upon default as opposed to having to wait for the bankruptcy court to determine payouts to secured creditors.
- Prior to 2005, collateral in repo transactions eligible for the automatic stay exemption was limited to U.S. government and agency securities, bank certificates of deposits, and bankers' acceptances. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 expanded the definition of repurchase agreements to include mortgage loans, mortgage-related securities, and interest from mortgage loans and mortgage-related securities. This meant that repos collateralized by MBS, CMOs, CMBS, and CDOs backed by mortgage-related assets became exempt from the automatic stay.
- We believe the problem of runs by repo lenders would be significantly reduced by rolling back the bankruptcy law for repurchase agreement collateral to the pre-2005 rules. The problem with the current bankruptcy law for repos is it provides special treatment – that

is, it essentially subsidizes – short-term funding with mortgage-related collateral relative to other longer-term repo collateral or securities-based lending. As with the safety net for banks, the subsidy leads to the overuse of short-term repo funding, and therefore the overproduction of risky shadow banking activities.

- Overall, these two changes to the rules for money market funds and repo would increase the stability of the shadow banking system because term lending would be less dependent on "demandable" wholesale funding and more reliant on term funding. Fixed NAVs, like the just-noted problem with current repo bankruptcy law, provide special treatment and therefore subsidize short-term funding. These subsidies lead to an overreliance on short-term funding and excessive risk in shadow banking activities. With the recommended changes, shadow banks would rely less on short-term wholesale funding and more on term funding, which would continue to be provided by institutional investors such as mutual funds, pension funds, and life insurance companies. While this might increase the cost of funds and, therefore, the cost of mortgages and other consumer loans, it would be less risky and more reflective of the true costs.

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Attachment 2

CAPITALIZATION RATIOS FOR GLOBAL SYSTEMICALLY IMPORTANT BANKS (G-SIBs)

Data as of fourth quarter 2012

	Basel Risk-Based Capital			Tangible Capital				Components of Tangible Capital				Price-to-Book	
				GAAP		IFRS ESTIMATE [4]							
Institution[1]	Tier 1 Capital[2] ($Billions)	Risk-Weighted Assets ($Billions)	Tier 1 Capital Ratio[3] (Percent)	Total Assets ($Billions)	Leverage Ratio[5] (Percent)	Total Assets ($Billions)	Leverage Ratio[5] (Percent)	Total Equity[6] ($Billions)	Goodwill ($Billions)	Other Intangibles ($Billions)	Deferred Tax Assets ($Billions)	Price-to-Book Ratio[7] (Percent)	Price-to-Adjusted Tangible Book Ratio[7] (Percent)
U.S. G-SIBs													
Bank of America	155	1,206	12.89	2,212	5.79	3,540	3.55	237	70	13	33	0.57	1.22
Bank of New York Mellon	17	111	15.02	359	4.02	381	3.77	36	18	5	0	0.85	2.40
Citigroup	137	971	14.06	1,865	5.61	2,878	3.57	189	26	8	56	0.64	1.24
Goldman Sachs	67	400	16.75	939	7.07	1,707	3.87	76	4	1	5	0.88	1.03
JPMorgan Chase	160	1,270	12.59	2,359	5.89	3,947	3.48	204	48	10	11	0.86	1.33
Morgan Stanley	54	307	17.72	781	5.79	1,749	2.55	62	7	4	8	0.62	0.89
State Street	14	72	19.13	222	5.78	228	5.64	21	6	3	0	1.06	1.82
Wells Fargo	127	1,077	11.75	1,423	8.13	1,485	7.78	158	26	20	0	1.24	1.82
Average U.S. G-SIBs	730	5,415	13.49	10,160	6.17	15,914	3.88	983	204	63	113	0.85	1.28
Foreign G-SIBs													
Banco Santander (Spain)	80	716	11.17			1,631	2.97	108	32	4	25	0.84	2.35
Bank of China Limited (China)	121	1,149	10.54			2,009	6.53	136	0	2	3	0.94	0.98
Barclays (UK)	82	611	13.35			2,354	3.08	89	8	4	5	0.60	0.75
BBVA (Spain)	46	423	10.77			819	4.04	56	9	3	13	0.91	1.67
BNP Paribas (France)	97	709	13.63			2,451	3.47	111	14	3	10	0.67	0.92
BPCE Group (France)	60	489	12.21			1,474	3.52	65	5	2	7	...	...
Crédit Agricole Group (France)	79	617	12.85			2,580	2.72	98	19	2	7	...	...
Deutsche Bank (Germany)	63	417	15.13			2,517	1.63	68	15	3	10	0.56	0.93
HSBC (UK)	151	1,124	13.44			2,693	5.16	175	21	8	8	1.13	1.44
ING Bank (Netherlands)	51	358	14.35			1,074	4.11	48	2	1	2	...	...
Nordea bank (Sweden)	31	276	11.17			870	3.65	36	3	1	0	1.03	1.18
Royal Bank of Scotland (UK)	90	726	12.43			2,073	3.72	103	0	21	5	0.53	0.71
Société Générale (France)	52	416	12.50			1,607	2.84	61	7	2	7	0.48	0.66
Standard Chartered (UK)	41	302	13.45			637	5.77	44	7	1	1	1.36	1.65
UBS (Switzerland)	44	205	21.29			1,343	2.52	49	6	1	9	1.17	1.71
UniCredit (Italy)	63	549	11.44			1,191	3.83	85	15	5	21	0.34	0.70
Average Foreign IFRS	1,150	9,087	12.65			27,324	3.61	1,334	162	64	132	0.84	0.98
Other Foreign G-SIBs													
Credit Suisse (Switzerland; CHF, U.S. GAAP)	42	229	18.44	969	3.06			45	8	0	8	...	...
Mitsubishi UFJ FG (Japan; JPY, Local GAAP)	136	1,114	12.22	2,672	5.07			151	0	13	4	0.68	0.79
Mizuho FG (Japan; JPY, Local GAAP)	81	633	12.75	2,064	3.66			86	0	6	5	0.85	1.06
Sumitomo Mitsui FG (Japan; JPY, Local GAAP)	84	654	12.81	1,692	4.76			95	0	10	5	0.81	1.06
Average All Foreign G-SIBs	1,492	11,717	12.74	34,720	3.77			1,711	170	93	154	0.83	1.02
Average U.S. BHC by Size Group[8]													
U.S. G-SIBs	730	5,415	13.49	10,160	6.17	15,914	3.88	983	204	63	113	0.85	1.28
Ten Largest Non-G-SIBs[9]	171	1,499	11.41	1,913	8.21	1,927	8.15	226	57	12	6	0.94	1.59
Ten Largest Less Than $50 Billion[10]	24	191	12.85	293	7.91	293	7.91	33	8	1	2	1.07	1.51
Ten Largest Less Than $1 Billion[10]	1	7	13.40	10	8.67	10	8.67	1	0	0	0	...	...

Source: Bankscope (Data updated as of April 19, 2013), Bloomberg LP, Federal Reserve Y-9C Reports, International Monetary Fund, and 10-Q reports.

Notes:

[1] Global systemically important banks (G-SIBs) are defined by the Financial Stability Board and include eight U.S. bank holding companies (BHC). Foreign G-SIBs report in local currencies, which are converted into U.S. dollars using IMF International Financial Statistics exchange rates.

[2] Tier 1 Capital is equity capital less unrealized gains on available-for-sale debt securities, unrealized losses on available-for-sale equity securities, disallowed preferred stock, disallowed goodwill, disallowed servicing assets, disallowed deferred tax assets, and other tier 1 capital components.

[3] Tier 1 capital ratios and underlying data are calculated and reported under Basel I standards for U.S. Banks, under the China Banking Regulation Commission regulations for the Bank of China, under Basel II for Banco Santander, BBVA, ING Bank, Mitsubishi UFJ FG, Mizuho FG, Nordea Bank, Royal Bank of Scotland, Standard Chartered, Sumitomo Mitsui FG, and Unicredit, and under Basel 2.5 for Barclays, BNP Paribas, BPCE Group, Credit Agricole, Credit Suisse, Deutsche Bank, HSBC, Societe Generale and UBS.

[4] Differences in accounting requirements for netting and offsetting of assets and liabilities result in significant differences in banks' total assets. The ability to offset under International Financial Reporting Standards (IFRS) is limited in comparison with Generally Accepted Accounting Principles (GAAP), especially for derivatives traded with the same counterparty under an International Swaps and Derivatives Association (ISDA) Master Netting Agreement. U.S. GAAP permits the netting of derivative receivables and payables, and the related cash collateral received and paid when a legally enforceable master netting agreement exists between a firm and a derivative counterparty. U.S. GAAP discloses gross derivative assets and liabilities and the offset amount applied to derivatives in the notes to the consolidated financial statements rather than in the consolidated balance sheet. To narrow the difference in total assets between IFRS and U.S. GAAP reporting institutions, the U.S. G-SIBs IFRS estimates follow the methodology used by ISDA in its Netting and Offsetting Report (May 2012, http://www2.isda.org/functional-areas/research/studies/) and adds the disclosed offsetting amount applied to derivatives back to total assets in order to calculate total assets. Total assets are as reported in the consolidated balance sheet while the offset applied to derivatives is as reported in the notes to the consolidated financial statements on derivatives in each firm's 10-Q report.

[5] The Leverage Ratio is the ratio of adjusted tangible equity to adjusted tangible assets. Adjusted tangible equity, adjusted tangible assets, and adjusted tangible book subtract goodwill, other intangibles, and deferred tax assets.

[6] Equity Capital is the basic GAAP measure of net worth, defined as total assets minus total liabilities.

[7] Median price-to-book ratios and price-to-adjusted tangible book ratios are used instead of averages for subgroups and for U.S. BHC size groups. Data are not available for six bank holding companies with assets less than $1 billion, as well as for BPCE Group, Credit Agricole Group, and ING Bank.

[8] Bank holding companies that are owned by a foreign parent or reported a net loss in fourth quarter 2012, and thrift holding companies that did not file a full FRY-9C report as of fourth quarter 2012 were excluded.

[9] Six of the ten largest non-G-SIB (American Express, KeyCorp, Northern Trust, PNC, Suntrust and U.S. Bancorp) reported the fair value of their derivative positions in their 10-Q reports. The leverage ratio for these six banks is 8.53 percent under U.S. GAAP and 8.47 percent under the IFRS estimate. The 6 basis point difference is used to adjust the leverage ratio for the entire group from 8.21 percent to 8.15 percent and to estimate total assets under the IFRS estimate. The remaining four bank holding companies reported minimal derivative exposure.

[10] The ten largest U.S. bank holding companies with assets less than $50 billion and the ten largest U.S. bank holding companies with assets less than $1 billion reported de minimis derivative exposures. We assume that total assets and the adjusted tangible equity to adjusted tangible assets ratio are essentially the same under U.S. GAAP and the IFRS estimate.

Attachment 3

TBTF Subsidy for Large Banks--Literature Review

June 2013

Prepared for:

Thomas Hoenig, Vice Chair - Federal Deposit Insurance Corporation

Findings of Studies on the TBTF Subsidy:

Acharya, Anginer and Warburton:

- Funding cost advantage of 28 basis points annually for the period of 1990-2010; the cost advantage peaked at over 120 basis points in 2009. The authors estimate that the 2009 estimate represents a subsidy of $100 billion.

Baker and MacArthur:

- Average funding cost advantage increased to 78 basis points for 2008:4-2009:2 implying a subsidy of $34 billion per year to the 18 BHCs with more than $100B in assets in 2009:1

Brewer and Jagtiani:

- Acquirers paid more than $15 billion in added premiums in 8 merger deals that brought the combined organization to over $100B in assets

Ghandi and Lustig:

- The largest commercial banks receive a subsidy of 3.10 percent of their market capitalization, which amounts to $4.7 billion per bank in 2005 dollars

Haldane:

- The average annual subsidy for the top five U.K. banks from 2007-2009 was over £50 billion.

Jacewitz and Pogash:

- The largest banks pay approximately 45 basis points lower in risk premiums for uninsured deposits.

Kelly et al:

- The value of the government guarantee extended to the financial sector during the crisis peaked at over $150 billion.

Li et al:

- CDS spreads are reduced by 23 basis points pre-crisis and 56 basis points post-crisis due to a TBTF subsidy for the 20 largest institutions.

Noss and Sowerbutts:

- Using three methodologies the authors find TBTF subsidies of approximately £40 billion, £30 billion, and £120 billion for U.K. banks.

Oxera (prepared for RBS):

- The value of state support for a financial system with total assets of approximately £7 trillion and volatility of about 4 percent, the subsidy is about £5.9 billion per year.

Stogin, Steve, Amanda Hindlian, Sandra Lawson, Jorge Murillo, Koby Sadan, and Balakrishna Subramanian (Goldman Sachs Global Markets Institute Report).

- Within a subset of bond-issuing banks, the six largest banks enjoyed a slight funding advantage of 6bps on average from 1999 to 2007.
- The funding advantage increased during the crisis but has since reversed to a funding *disadvantage* of 10 bps on average.

Tsesmelidakis, Zoe and Robert C. Merton:

- Wealth transfers to investors amount to $365 billion ($129 billion to shareholders and $236 billion to bondholders) during the crisis (2007-2010)
- Bondholders realized massive wealth transfers in 2008 and 2009, but no subsidies were recorded for 2010
- Results apply to financial institutions with banks a subset of this

Ueda and Weder di Mauro:

- Banks in major countries enjoyed an estimated funding cost advantage of 60 basis points in 2007, rising to 80 basis points in 2009.

<u>Additional Calculations of a TBTF Subsidy Based on Prior Study Findings:</u>

Bloomberg editorial (based on a study by Ueda and Weder di Mauro cited below):

- The 10 largest U.S. banks receive a subsidy of $83 billion per year

Bloomberg (forthcoming in Bloomberg Markets):

- At the request of Bloomberg Markets, Anginer (of Acharya, Anginer and Warburton) calculated that bondholders of the six biggest U.S. banks are willing to accept lower returns—amounting to $82 billion from 2009 to 2011 ($37.3 billion in 2009 after TARP, $29.9 billion in 2010, and $14.6 billion in 2011)
- When other breaks are added in Bloomberg calculates that the amount of the subsidy jumps to $102 billion since 2009

Bibliography, Findings and Methodological Summaries of TBTF Subsidy Studies and Additional Calculations:

Acharya, Viral V., Deniz Anginer, and A. Joseph Warburton. "The End of Market Discipline? Investor Expectations of Implicit State Guarantees." March 2013.

Findings:

- An annual funding cost advantage of 20 basis points from 1990-2010, representing approximately $20 billion per year.
- The cost advantage peaked at over 120 basis points in 2009, representing a funding advantage of $100 billion.

Methodology:

Using data for the period 1990-2010, the authors find that investors' expectations of government support are embedded in the credit spreads on bonds issued by major U.S. financial institutions. To calculate the amount of the subsidy that results from the assumption of government support, the authors compute the credit spread on each financial institution's bonds as the difference between the yield on its bonds and the corresponding maturity-matched Treasury bond. The authors find a significant negative relationship between spreads and systemic importance. In particular, they find that size—as a measure of systemic importance—has a negative effect on spreads. A test of the effect of size on the relationship between spread and risk shows that for institutions that achieve systemically important status, spreads are less sensitive to risk. The authors quantify the value of the funding subsidy in basis points; this amount is then calculated as a dollar value by multiplying the annual reduction in funding costs by the institution's total uninsured liabilities.

Baker, Dean, and Travis MacArthur. "The Value of the "Too Big to Fail" Big Bank Subsidy." Issue Brief, The Center for Economic Policy Research, September 2009.

Findings:

- An average funding cost advantage of 29 basis points for institutions with more than $100 billion in assets for the period 2000-2007. This advantage increased to 78 basis points for the period from the fourth quarter of 2008 through the second quarter of 2009.
- The increase—of 49 basis points—is estimated to imply a subsidy of $34 billion per year to the 18 bank holding companies with more than $100 billion in assets in the first quarter of 2009.

Methodology:

The authors calculate the difference between the average quarterly cost of funds for institutions with less than $100 billion in assets to the average quarterly cost of funds for institutions with more than $100 billion in assets for the periods 2000-2007 and 2008:4-2009:1. The authors then calculate the difference in the differences between the two time periods to determine if there was a TBTF subsidy. The authors acknowledge that there could be multiple explanations for growth in the difference between the costs of funds for the two groups of banks in the 2008:4 – 2009:2 period, but after adjusting for other possible explanations, the authors find that the spread between large and smaller banks could have increased by 9 basis points following the crisis. For the TBTF banks, this represents an annual subsidy of $6.3 billion. The authors caution that this subsidy may only be temporary and that spreads may return to more normal levels once financial markets settle. The authors use data on U.S. banks provided by the FDIC.

Bloomberg, editors. "Why Should Taxpayers Give Big Banks $83 Billion a Year?" February 20, 2013.

Findings:

- The 10 largest banks in the United States by assets, receive a taxpayer subsidy of $83 billion a year. The top 5 banks account for $64 billion of this total—an amount roughly equal to their typical annual profits.

Methodology:

Using the findings of Ueda and Weder di Mauro (below), Bloomberg multiplies the total liabilities of the 10 largest U.S. banks to calculate a subsidy of $83 billion.

Bloomberg (forthcoming in Bloomberg Markets). Ivry, Bob, "No Lehman Moments as Biggest Banks Deemed Too Big to Fail." May 10, 2013.

Findings:

- Bondholders of the six biggest U.S. banks are willing to accept lower returns, which amounted to $82 billion from 2009 to 2011. ($37.3 billion in 2009 after TARP, $29.9 billion in 2010, and $14.6 billion in 2011.)
- Adding in other breaks, the amount of the subsidy jumps to $102 billion since 2009.

Methodology:

- At the request of Bloomberg Markets, Deniz Anginer (Acharya, Anginer, and Warburton) calculated the subsidy received by six U.S. banks as a result of bondholders accepting lower returns (because bondholders believe these institutions will be bailed out).
- Bloomberg takes the Anginer estimate and adds tax breaks and additional income from the Federal Reserve's mortgage-bond purchases and the interest it pays for bank deposits and calculates that the amount of the subsidy jumps to $102 billion since 2009.

Brewer, Elijah III and Julapa Jagtiani. "How Much Did Banks Pay to Become Too-Big-To-Fail and to Become Systemically Important?" Working paper No. 11-37. Federal Reserve Bank of Philadelphia. 2 September 2011.

Findings:

- Acquirers paid at least $15.3 billion in added premiums in the eight merger deals that brought the combined organizations to over $100 billion in assets (the TBTF threshold).

Methodology:

Using data from the merger boom of 1991-2004, Brewer and Jagtiani analyze the differences in market reactions to bank acquisitions depending on whether the acquisition caused the acquiring organization to cross the threshold from being too small to warrant government support in the event of failure to becoming too big to fail. The authors use OLS regressions to estimate the effect of crossing the TBTF threshold on the cost of the acquisition, the abnormal stock market returns, and the cost of funds measured as bond spreads. They show that when banks cross the TBTF threshold they pay an acquisition premium, that abnormal returns increase, and that banks face a lower cost of funds. The authors use the estimated coefficients from the OLS results to predict the value of the government subsidy. The data sample is restricted to U.S. banks.

Ghandi, Priyank and Hanno Lustig. "Size Anomalies in U.S. Bank Stock Returns: A Fiscal Explanation." April 18, 2011.

Findings:

- The authors find a subsidy of 3.10 percent for the largest commercial banks and a 3.25 percent tax on the smallest banks. This translates into an annual subsidy to the largest commercial banks of $4.71 billion per bank in 2005 dollars.

Methodology:

Ghandi and Lustig show that a long position in the stock portfolio of the largest U.S. banks and a short position in the stock portfolio of the smallest banks underperforms an equally risky portfolio of all non-bank stocks and government and corporate bonds by nearly 8 percent per year over 39 years. The authors interpret this difference as the ex-ante distortion of an implicit government guarantee for the largest financial firms. The authors then build a general equilibrium model of asset prices and calibrate it to match the subsidy. The authors decompose the subsidy into a 3.10 percent subsidy to the largest banks and a 3.25 percent disaster tax on the smallest banks. In the absence of the subsidy, all banks would pay a 3.25 percent disaster tax. The authors multiply the subsidy by the average market cap of the largest banks to calculate the annual subsidy. The data cover U.S. financial institutions.

Haldane, Andrew. "The $100 billion question." Comments by Mr. Andrew G Haldane, Executive Director, Financial Stability, Bank of England, at the Institute of Regulation & Risk, Hong Kong, 30 March 2010.

Findings:

- The average annual subsidy for the top five UK banks from 2007-2009 was over £50 billion.

Methodology:

The author calculates the value of a TBTF subsidy by employing the difference in bank credit ratings that include the credit rating agency's judgment of expected government support and the ratings that exclude that support. He finds the average rating difference is higher for large banks than for small ones. The monetary measure of the subsidy is estimated by "mapping from the ratings to the yields paid on bank's bonds; and then by scaling the yield difference by the value of each bank's ratings-sensitive liabilities." The sample includes banks and building societies in the UK as well as global banks over the period 2007 - 2009.

Haldane, Andrew. "On being the right size." Speech given by Andrew G. Haldane, Institute of Economic Affairs' 22nd Annual Series, The 2012 Beesley Lectures, 25 October 2012.

Findings:

- A subsidy of $70 billion per year for the period 2002-2007. By 2009, the subsidy reached over $700 billion per year.

Methodology:

The author estimates the subsidy with the ratings-based measure used in Haldane (2010). The sample includes the 29 world's largest banks (as defined by the Financial Stability Board).

Jacewitz, Stefan, and Jonathan Pogach. "Deposit rate advantages at the largest banks." FDIC Working Paper, 2012.

Findings:

- The largest banks pay approximately 45 basis points in lower risk premiums for uninsured deposits.

Methodology:

This study makes use of the fact that the difference in interest rates banks pay on insured and uninsured deposits in part reflects the risk of the bank as perceived by the market. The authors use money market deposit accounts with a minimum deposit of $100,000 as their measure of uninsured deposits and money market deposit accounts with $25,000 as their proxy for insured deposits. The authors calculate the difference in the interest rates offered on uninsured and insured money market deposit accounts at all banks for the period 2005-2010. The authors interpret the differences in interest rates across these two accounts as the market perceived risk of the bank.

The authors then calculate the difference-in-difference of these rates between large and small banks. Using this methodology, the authors find that large banks pay a lower risk premium than small banks. Finally, the authors use OLS regressions to explore what part of the lower risk premium paid by larger banks cannot be explained by observable differences in risk across those banks. The authors find an unexplained residual difference in risky deposit rates between large and small banks of approximately 45 bps. They conclude that this unexplained difference in interest rates is consistent with a TBTF subsidy.

Kelly, Bryan, Hanno Lustig, and Stijn van Nieuwerburgh. "Too-Systemic-To-Fail: What Option Markets Imply About Sector-Wide Government Guarantees." Working Paper No. 11-12 Fama-Miller Paper Series University of Chicago Booth School of Business. 2011.

Findings:

- The authors find that the anticipation of future government intervention during a financial sector collapse lowers the market price of financial sector crash insurance (measured by index put options on the sector) in essence creating crash insurance subsidies.

  - Specifically, the authors find that the market was not initially reassured by TARP as the funds would be used to purchase preferred shares that would dilute shareholders. However, once programs were announced for the purchase of toxic assets the collective bailout guarantee became valuable.
- The estimated dollar value of the guarantee extended to the financial sector is calculated to have peaked at over $150 billion.

Methodology:
The authors use the difference between the price of a basket of put options on individual financial firms and the price of a put option on the financial sector index as the basis for measuring the size of a collective bailout guarantee to the financial sector. The authors use an asset pricing model with rare events to study the impact of sector-wide bailout guarantees on option prices. The model is able to explain financial sector joint stock and option moments only when it incorporates a government bailout guarantee of the sector. The authors use the parameters of the model to infer the effect of the bailout guarantee on a firm's expected return and cost of capital as well as the overall dollar size of the government subsidy. The sample period covers January 2003 – June 2009.

Li, Zan, Shisheng Qu, and Jing Zhang. "Quantifying the value of implicit government guarantees for large financial institutions." Modeling Methodology, Moody's Analytics, January 2011.

Findings:
- The authors calculate that CDS spreads were reduced by 23 basis points pre-crisis and 56 basis points post-crisis due to a TBTF subsidy for the 20 largest institutions.

Methodology:

The study explores differences in funding costs between large and all other banks in two stages for the period November 2001 through May 2010. The authors first calculate the difference between an observed CDS spread to an estimated 'fair market' CDS spread using information from the equities market for all institutions in the sample. The authors then compare the observed and estimated fair market CDS spreads between the largest banks and smaller institutions. The data used include information on the 20 largest and 63 other U.S. financial institutions that have CDS spreads and other market information available. (The authors also perform analysis on European data but the estimates in this summary include only U.S. institutions.)

Noss, Joseph and Rhiannon Sowerbutts. "The implicit subsidy of banks." Financial Stability Paper No. 15. Bank of England. May 2012.

Findings:
- The funding advantage, historical-price contingent claims, and options-price contingent claims approaches produce estimates of approximately £40 billion, £30 billion, and £120 billion, respectively, in TBTF subsidies.

Methodology:

The authors use three methodologies to estimate values of a TBTF subsidy—a funding advantage approach, a historical-price contingent claims approach, and an options-price contingent claims approach.

- The funding advantage approach mirrors that of Haldane (2010) and (2012).
- The contingent claims models estimate the subsidy as the expected annual payment from the government to banks needed to prevent their default. This requires estimation of the distribution of banks' future asset values.
  - The options-price contingent claims approach mirrors that of Oxera (2011), except the authors "value the subsidy as a look-back option discounted at a rate of 1.2 percent, calibrated to the distribution of bank equity prices during 2010."
  - The historical-price contingent claims approach estimates the distribution of banks' future asset values based on historical prices of bank equity. To account for rare but large downward movements in asset prices, the authors use statistical techniques to predict extreme asset returns. They use an empirical density function to model the distribution of equity prices, fitted to the center of the distribution. They then add a Generalized Pareto distribution to the lower tail of returns, to capture the rare events for which there are a lower number of observations.

The authors use data from UK banks in 2010 in their study.

Oxera (prepared for The Royal Bank of Scotland). "Assessing state support to the UK banking sector." March 2011.

Findings:

- Estimates show the value of state support for a financial system with total asset values of approximately £7 trillion and volatility of about 4 percent, is about £5.9 billion per year.

Methodology:

The report estimates the value of state support using data from 2010 in three steps: determining the magnitude of systemic shocks that would require the government to provide support, calculating the probability that such a shock would occur, and estimating the expected government payment that would be needed in the event of such shock. The authors use various shares of bank Tier 1 capital as the proxy for the "systemic threshold" - the amount of asset value loss the system could withstand without requiring government intervention. They estimate the risk of such a shock using the variance in the equity prices of banks in the UK and the ratio of equity to assets. Lastly, the authors employ a Black-Scholes model to estimate the value of a European put option on the system's assets as a proxy for the level of state support necessary in the event of a shock. The study focuses on the U.K. banking sector.

Stogin, Steve, Amanda Hindlian, Sandra Lawson, Jorge Murillo, Koby Sadan, and Balakrishna Subramanian. 2013. "Measuring the TBTF effect on bond pricing," Goldman Sachs Global Markets Institute Report, May.

Findings:

- Within a subset of bond-issuing banks, the six largest banks enjoyed a slight funding advantage of 6bps on average from 1999 to 2007.
- The funding advantage increased during the crisis but has since reversed to a funding *disadvantage* of 10 bps on average.

Methodology:

The authors compare bank bond spreads over maturity-matched Treasuries for a subset of U.S. banks. The set of banks are drawn from institutions that are included in the IBOXX Investment Grade Index, which contains daily pricing information for investment grade bonds from January 1999 to March 2013. Banks are defined as all firms that have at least one FDIC-insured affiliate. The average number of banks included in the index over all years is 24. The authors calculate the median spread of the bank bond on a daily basis. Next, the authors rank the bank by assets and compare the average spread of the six largest banks to the average spread of the remaining banks in their data.

Tsesmelidakis, Zoe and Robert C. Merton, "The Value of Implicit Guarantees." Working Paper, September 2012.

Findings:

- Wealth transfers to shareholders and debt holders amount to $129 billion and $236 billion, respectively.
- Debt holders realized massive wealth transfers in 2008 and 2009, but no subsidies were recorded for 2010.
- Most subsidies accrue to the banking subsector; the period from October 2008 to June 2009 accounts for most of the subsidies.
- The determinants of the subsidies are highly related to proxy variables for company size, default correlation, and systemic risk.

Methodology:

Calculates how firms considered too-big-to-fail benefit from access to cheaper funding during crises by combining a structural-model-based methodology for estimating a TBTF premium with a comprehensive data set of bond characteristics and prices in the primary and secondary markets for a sample of 74 U.S. financial institutions. Data are for the years 2007-2010. Separate benefits are calculated for shareholders and debt holders. Shareholder benefits are calculated as of time of issuance while debt holder benefits are calculated over the life of the bond.

Authors estimate that actual subsidies could be twice as high as other forms of debt financing are ignored.

Ueda, Kenichi and Beatrice Weder di Mauro. "Quantifying structural subsidy values for systemically important financial institutions." IMF Working Paper WP/12/128, May 2012.

Findings:

- Banks in major countries enjoyed an estimated funding cost advantage of 60 basis points in 2007 and 80 basis points in 2009.

Methodology:

In calculating the credit default ratings of financial institutions, Fitch Ratings estimates a measure of external support that reflects both the probability of parent company and government support. The authors use this information as a proxy for the likelihood of government intervention on behalf of a financial institution. The authors then estimate the effect of the government support on the long-term rating of the financial institution. The data include information on 895 banks rated by Fitch in 2007 and 2009.

As a point of reference when considering the magnitude of the TBTF subsidy calculations, the following table reports the net income of the top 10 BHCs for 2008-2012.

Net income of top 10 BHCs, 2008-2012	
Year	Net Income ($Bs)
2008	-$19.5
2009	$37.5
2010	$56.4
2011	$69.0
2012	$68.9

EMBARGOED UNTIL 10 A.M. ET, JUNE 26, 2013

Statement by

Jeffrey M. Lacker
President
Federal Reserve Bank of Richmond

before the

Committee on Financial Services
U.S. House of Representatives
Washington, D.C.

June 26, 2013

Good morning. I am honored to speak to the Committee about the Dodd-Frank Act and the persistence of "too big to fail."

At the outset, I should point out that within the Federal Reserve System, the Board of Governors has sole authority to write rules implementing the requirements of the Dodd-Frank Act. Federal Reserve Banks supervise financial institutions under authority delegated to them by the Board of Governors. In keeping with Board of Governors guidance, I will not discuss any current or potential Federal Reserve rule-making. I also should say that my comments today are my own views and do not necessarily reflect those of the Board of Governors of the Federal Reserve or my colleagues at other Federal Reserve Banks.[1] My views have been informed by both my leadership of the Fifth Federal Reserve District over the last seven years and my experience as a research economist studying banking policy for the prior 25 years.

The problem known as "too big to fail" consists of two mutually reinforcing expectations. First, some financial institution creditors feel protected by an implicit government commitment of support should the institution face financial distress. This belief dampens creditors' attention to risk and makes debt financing artificially cheap for borrowing firms, leading to excessive leverage and the overuse of forms of debt — such as short-term wholesale funding — that are most likely to enjoy such protection. Second, policymakers at times believe that the failure of a large financial firm with a high reliance on short-term funding would result in undesirable disruptions to financial markets and economic activity. This expectation induces policymakers to intervene in ways that let short-term creditors escape losses, thus reinforcing creditors' expectations of support and firms' incentives to rely on short-term funding. The result is more financial fragility and more rescues.

The Orderly Liquidation Authority of Title II of the Dodd-Frank Act gives the Federal Deposit Insurance Corporation the ability, with the agreement of other financial regulators, to take a firm into receivership if it believes the firm's failure poses a threat to financial stability.[2] Title II gives the FDIC the ability to borrow funds from the Treasury (specifically, the Orderly Liquidation Fund at the Treasury) to make payments to creditors of the failed firm. The funds are to be repaid from recoveries on the assets of the failed firm or from assessments against the largest, most complex financial companies. While the FDIC is to pay creditors no more than they would have received in a liquidation of the firm, the Act provides the FDIC with broad discretion to pay more.[3] This encourages short-term creditors to believe they would benefit from such treatment and therefore continue to pay insufficient attention to risk and invest in fragile funding arrangements. Given widespread expectations of support for financially distressed institutions in orderly liquidations, regulators will likely feel forced to provide support simply to avoid the turbulence of disappointing expectations. We appear to have replicated the two mutually reinforcing expectations that define "too big to fail."

Expectations of creditor rescues have arisen over the last four decades through the gradual accretion of precedents. Research at the Richmond Fed has estimated that one-third of the financial sector's liabilities are perceived to benefit from implicit protection, based on actual government actions and policy statements.[4] Adding implicit protection to explicit protection programs such as deposit insurance, we found that 57 percent of financial sector liabilities were expected to benefit from government guarantees as of the end of 2011. This figure was about 45 percent at the end of 1999.

A financial system without the broad expectation of government rescues for creditors would likely look different — potentially quite different — from the financial system we currently have. Without the expectation of implicit government guarantees, the incentives of market participants would be better aligned with our public policy goal of a financial system that effectively allocates capital and risks. Large financial firms themselves would want to be less leveraged and less reliant on unstable short-term funding. Institutions and markets would, accordingly, be more resilient in response to financial stress, and policymakers could credibly commit to forgo incentive-corroding rescues.

The alternative, accepting the inevitability of an implicit federal backstop and trying to correct the resulting distortions through the regulation of firm size, structure and capital, would lead to far less desirable results, I believe. It would tilt financial innovation toward bypassing regulatory constraints and relying on fragile funding methods that are most likely to elicit government protection. The result would be ever-increasing regulatory costs and repeated bouts of financial instability.

Reducing the probability that a large financial firm becomes financially distressed — through enhanced standards for capital and liquidity, for example — is useful, but will never be enough. The path toward a stable financial system requires that the unassisted failure of financial firms does not put the financial system at risk. The resolution planning process prescribed by Section 165(d) in Title I of the Dodd-Frank Act provides the road map for this journey.

A resolution plan, or "living will," is a description of a firm's strategy for rapid and orderly resolution under the U.S. Bankruptcy Code, without government assistance, in the event of material financial distress or failure. It spells out the firm's organizational structure, key management information systems, critical operations and a mapping of the relationship between core business lines and legal entities. The heart of the plan is the specification of the actions the firm would take to facilitate rapid and orderly resolution and prevent adverse effects of failure, including the firm's strategy to maintain the operations of and funding for their critical operations and material entities.

The Federal Reserve and the FDIC can jointly determine that a plan is "not credible" or would not facilitate an orderly resolution under the Bankruptcy Code, in which case the firm would be required to submit a revised plan to address identified deficiencies. A resubmission could include plans to change the business operations and corporate structure in order to eliminate deficiencies. If the Fed and the FDIC jointly determine that the revised plan does not remedy identified deficiencies, they can require tighter capital, leverage liquidity requirements or restrict the growth, activities or operations of the firm. In essence, regulators can order changes in the structure and operations of a firm to make it resolvable in bankruptcy without government assistance.

The living will process can address the frequently heard objections to ending government rescues. Cooperation between international regulators in a crisis is often cited as an impediment to orderly resolution. Forming distinct legal entities for the material overseas operations of globally active firms, with separate capital and liquidity holdings, can solve this problem by facilitating the expeditious sale of material foreign operations and obviating dependence on cross-national negotiations about interaffiliate movements in capital and funding.

The so-called "liquidity needs" of failing institutions is often cited as a stumbling block to resolving financial firms in bankruptcy. The U.S. Bankruptcy Code allows the bankrupt firm to obtain, subject to court approval, "debtor-in-possession," or DIP, financing that is generally senior to pre-existing creditors. Such financing can be useful to fund ongoing operations. Other creditors often find it advantageous to approve DIP funding, despite the dilution of their own claims, because it ensures continued access to trade credit. The FDIC's authority to lend to distressed institutions under its Orderly Liquidation Authority amounts to government-provided DIP financing. The beneficial feature of privately provided DIP financing is the presumption that, because it's provided by market participants but also approved by creditors and the court, it's fairly priced and thus unsubsidized and does not unduly disadvantage any particular class of creditors. Indeed, this is why unassisted bankruptcy is so critical to ending "too big to fail" and why firms were instructed not to assume extraordinary government support in their resolution plans. A financial firm's liquidity requirements in bankruptcy, however, are a direct function of decisions made prior to entering bankruptcy. A credible living will would include plans for funding critical operations, without government support, throughout the resolution process.

Some recent proposals to address the "too big to fail" problem would make structural changes to financial firms — imposing quantitative limits on their size or prohibiting certain risky activities. I am open to the notion that such restrictions may ultimately be necessary to achieve a more stable financial system, but I do not believe we have a strong basis yet for determining exactly what activity and size limits should be adopted. The living will process, however, will provide an objective basis for decisions about how the structure or activities of large financial firms need to be altered in order to assure orderly unassisted resolution. In addition, the process of writing credible living wills would illuminate efforts to identify ways in which the bankruptcy code could be improved to make the resolution of financial firms more orderly.[5]

Resolution planning will require a great deal of hard work.[6] But I see no other way to ensure that policymakers have confidence in unassisted bankruptcy and that investors are convinced unassisted bankruptcy is the norm. Resolution planning provides the framework for identifying the actions we need to take now to ensure that the next financial crisis is handled appropriately, in a way that is fair to taxpayers and establishes the right incentives.

Once robust and credible resolution plans are in place, we would be in a position to responsibly wind down the Orderly Liquidation Authority and other financing mechanisms, such as the Federal Reserve's remaining 13(3) powers to lend in "unusual and exigent circumstances." By allowing creditors to escape losses, such lending distorts incentives and exacerbates moral hazard. Eliminating the ability to provide ad hoc support to firms in financial distress would cement our commitment to orderly unassisted resolutions.

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[1] I am grateful to John Weinberg for assistance in preparing this statement.
[2] For a comparison of the Orderly Liquidation Authority provisions with the U.S. bankruptcy process, see Sabrina R. Pellerin and John R. Walter, "Orderly Liquidation Authority as an Alternative to Bankruptcy," Federal Reserve Bank of Richmond Economic Quarterly, First Quarter 2012, vol. 98, no. 1, pp. 1-31.
[3] See Pellerin and Walter, pp. 16-19.
[4] The Richmond Fed's estimates of the size of the federal financial safety net are available at https://www.richmondfed.org/publications/research/special_reports/safety_net.
[5] See Kenneth E. Scott and John B. Taylor (eds.), "Bankruptcy Not Bailout: A Special Chapter 14," Stanford, CA: Hoover Institution Press, 2012.
[6] For more on resolution planning, see Jeffrey Lacker, "Ending 'Too Big To Fail' Is Going to Be Hard Work," Speech at the University of Richmond, Richmond, Va., April 9, 2013.

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Supplemental Materials

1. 2013 Estimates of the Safety Net, Federal Reserve Bank of Richmond.

2. Orderly Liquidation Authority as an Alternative to Bankruptcy, Sabrina R. Pellerin and John R. Walter, Federal Reserve Bank of Richmond *Economic Quarterly*, First Quarter 2012.

3. "Too Big to Fail," Our Perspective, Federal Reserve Bank of Richmond, February 2013.

2013 Estimates of the Safety Net (Using Data as of Dec. 31, 2011)

As used by Walter and Weinberg (2002) and Malysheva and Walter (2010), the phrase government guarantee means a federal government commitment to protect lenders from losses due to a private borrower's default. Following this definition, our estimate of the safety net includes insured bank and thrift deposits, certain other banking company liabilities, some government-sponsored enterprise (GSE) liabilities, selected private-employer pension liabilities, the dollar value of money market mutual fund shares, as well as a subset of the liabilities of other financial firms.

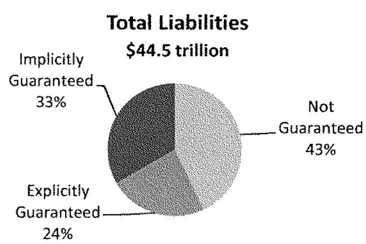
Our estimate (using data as of Dec. 31, 2011) includes a mixture of elements. Some of the liabilities, such as insured deposits, are *explicitly* guaranteed. Others, such as short-term liabilities of the largest banking companies, some deposit balances not explicitly covered by deposit insurance, and the liabilities of certain government-sponsored enterprises, are *believed* by many market participants to be *implicitly* guaranteed by the federal government. Our approach to implicit guarantees is to ask, "Based on past government actions, what might market participants reasonably expect future government actions to be?" Of course, identifying exact market expectations is largely impossible. We therefore provide two estimates—found in our "Most Inclusive" and "Least Inclusive" tables below—that can be thought of as the bounds within which market perceptions are likely to be found.

See the Methodology and Sources section for greater detail on what we have included in our explicit and implicit categories for each liability type contained in our two estimates.

Most Inclusive Estimate

Financial Firms (in billions)	Explicitly Guaranteed Liabilities (A)	Implicitly Guaranteed Liabilities (B)	A+B	Total Liabilities
Banking & Saving Firms (includes BHCs & SLHCs)	$7,146	$5,571	$12,718	$17,369
	41.1%	32.1%	73.2%	
Credit Unions	$795		$795	$883
	90.1%		90.1%	
GSEs				
Fannie Mae		$3,278	$3,278	$3,278
Freddie Mac		$2,204	$2,204	$2,204
Farm Credit System		$196	$196	$196
Federal Home Loan Banks		$726	$726	$726
Total		$6,405	$6,405	$6,405
		100.0%	100.0%	
Private Employer Pension Funds	$2,630		$2,630	$2,994
	87.8%		87.8%	
Money Market Mutual Funds		$2,691	$2,691	$2,691
Other Financial Firms		$170	$170	$14,126
Total for Financial Firms	**$10,572**	**$14,838**	**$25,409**	**$44,468**
Percentage of Total Liabilities	**23.8%**	**33.4%**	**57.1%**	**100.0%**

Note: Total guaranteed liabilities ($25,409 B) as a share of GDP ($14,991 B) equals 169%, using this table's estimate.

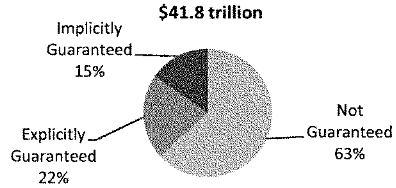


Least Inclusive Estimate

Financial Firms (in billions)	Explicitly Guaranteed Liabilities (A)	Implicitly Guaranteed Liabilities (B)	A+B	Total Liabilities
Banking & Saving Firms (includes BHCs & SLHCs)	$5,577		$5,577	$17,369
	32.1%		32.1%	
Credit Unions	$795		$795	$883
	90.1%		90.1%	
GSEs				
Fannie Mae		$3,278	$3,278	$3,278
Freddie Mac		$2,204	$2,204	$2,204
Farm Credit System		$196	$196	$196
Federal Home Loan Banks		$726	$726	$726
Total		$6,405	$6,405	$6,405
		100.0%	100.0%	
Private Employer Pension Funds	$2,630		$2,630	$2,994
	87.8%		87.8%	
Money Market Mutual Funds*				
Other Financial Firms				$14,126
Total for Financial Firms	**$9,003**	**$6,405**	**$15,407**	**$41,777**
Percentage of Total Liabilities	**21.5%**	**15.3%**	**36.9%**	**100.0%**

*Money market mutual fund shares are not treated as liabilities in this estimate.

Note: Total guaranteed liabilities ($15,407 B) as a share of GDP ($14,991 B) equals 103%, using this table's estimate.



Methodology and Sources

Banking and Savings Firms

Explicitly Guaranteed Liabilities – FDIC-insured deposits of all commercial banks and savings institutions (up to the $250,000 insurance limit), which includes transaction accounts covered by the FDIC's Transaction Account Guarantee (TAG) program[1] plus debt guaranteed by the FDIC's Debt Guarantee Program (DGP).[2] (Both of these FDIC programs expired Dec. 31, 2012.)

Implicitly Guaranteed Liabilities – In our most inclusive estimate of the safety net, we include total liabilities of the four largest banking institutions (those larger than $1 trillion in assets)[3] minus insured deposits (included in explicit column); plus short-term liabilities (federal funds, repurchase agreements, commercial paper, and other short-term liabilities as reported in financial reports)[4] and uninsured deposits[5] of the 34 bank and savings and loan holding companies (beyond the four largest) with assets greater than $50 billion.

Four largest banking institutions – During the financial turmoil of 2008 and 2009, the government promised to provide capital if needed by any of the largest 19 bank holding companies (BHCs) such that their operations could continue uninterrupted, encouraging the view that all liability-holders of these firms would be protected. However, the Orderly Liquidation Authority (OLA) provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) may reduce the likelihood that these companies would receive capital injections to allow their uninterrupted operation. Nevertheless, one can imagine that many market participants will remain skeptical that the government would allow operations of the very largest and most systemically important institutions to be disrupted, even if the interruption might be minimized and carefully managed by the OLA process.[6] As a result, our most inclusive estimate includes all of the liabilities of the four largest companies.

Short-term liabilities – Market participants might expect that the short-term liabilities of large financial firms would be protected if the firms are resolved under the OLA. All bank and savings and loan holding companies (SLHCs) with assets greater than $50 billion have been designated as systemically important financial institutions (SIFIs). While a SIFI designation does not necessarily imply OLA treatment in resolution, market participants are likely to expect that these institutions would not be allowed to enter bankruptcy because it seems ill-suited to handle the failure of SIFIs (Pellerin and Walter 2012, p. 14–16). The OLA provisions of Dodd-Frank permit the FDIC to pay some creditors more than bankruptcy might allow (Pellerin and Walter 2012, p. 16), and the FDIC's OLA implementing rule suggests that this treatment could apply to short-term creditors (FDIC final rule, July 15, 2011, 12 CFR 380, p. 41644). Therefore, we include short-term liabilities of the SIFI-designated banking institutions in our most inclusive estimate.

Uninsured deposits – Historically, uninsured depositors in the largest institutions have been protected (Walter and Weinberg, 2002, p. 380). Additionally, most uninsured depositors were protected during the bank failures that occurred following the financial crisis that began in 2008. Given these facts, market participants are likely to expect uninsured depositors at the largest banking companies (those with more than $50 billion in assets) to be protected from losses in future financial crises.

Least Inclusive Estimate

Explicitly guaranteed liabilities – Drops (compared to Most Inclusive Estimate) liabilities covered by TAG and DGP given that such deposits and debt lost their FDIC coverage as of Dec. 31, 2012. In future failures, such programs may not be in place.

Implicitly guaranteed liabilities – Drops all liabilities of the four largest banking companies based on an assumption that these four BHCs will be handled through the OLA process and liability holders will suffer losses. Drops short-term liabilities of banking companies with assets greater than $50 billion, based on an assumption that OLA treatment may not provide any special protection for such liabilities. Uninsured deposits at banking companies larger than $50 billion are dropped under the assumption that the FDIC might not protect such depositors in future bank failures.

Total Liabilities – Includes total liabilities of BHCs[7] and SLHCs,[8] plus total liabilities of banks and thrifts not owned by BHCs or SLHCs,[9] plus total liabilities of U.S insured branches of foreign head offices.[10]

Credit Unions

Explicitly Guaranteed Liabilities – Total credit union shares at or below the $250,000 National Credit Union Administration coverage limit.[11]

Total Liabilities – Total credit union liabilities.[12]

GSEs

Implicitly Guaranteed Liabilities of:

Fannie Mae – Total liabilities, unconsolidated Fannie Mae mortgage-backed securities held by third parties and other Fannie Mae guarantees.[13]

Freddie Mac – Total liabilities, non-consolidated Freddie Mac securities and other guarantee commitments.[14]

Farm Credit System – Total liabilities and Farmer Mac guarantees.[15]

Federal Home Loan Banks – Total liabilities.[16]

Pension Funds

Explicitly Guaranteed Liabilities – Liabilities of all pension funds insured by the Pension Benefit Guaranty Corporation (PBGC), which insures only defined-benefit plans, were $2,570 billion in 2009, the latest date for which data are estimated.[17] This figure is inflated by twice the average annual growth rate (because 2009–2011 involves two years of growth) of PBGC-insured pension liabilities from 1999–2009 to obtain our estimate of all liabilities in pension funds insured by the PBGC as of Dec. 31, 2011 ($2,769 billion). Since the PBGC covers pensions only up to a specified maximum payment per year, a portion of beneficiaries' pensions in guaranteed plans—those with pensions paying above this maximum—are not insured. According to the PBGC, this portion is estimated to be 4 percent to 5 percent.[18] To arrive at the guaranteed portion of PBGC guaranteed pension fund liabilities, we multiplied total 2011 fund liabilities ($2,769 billion) by 0.95 to yield $2,630 billion.

Total Liabilities – There appears to be no published data estimating total liabilities of all private-employer defined-benefit pension funds. Therefore, we develop our own estimate of total liabilities based on PBGC data. The PBGC insures a portion of private sector single-employer defined-benefit plans, but almost all multi-employer plans.[19] The PBGC does not insure certain single-employer plans, importantly those offered by religious organizations and professional service employers (for example, those employing doctors and lawyers) with fewer than 26 employees. In the following, we refer to this uninsured group as Group U.

In order to calculate the dollar amount of all insured and uninsured pension funds in the United States, we inflate the amount of pensions insured by the PBGC (estimated above at $2,769 billion) to account for the Group U pensions. As a starting point for our calculation, we use the Bureau of Labor Statistics' (BLS) Quarterly Census of Employment and Wages to determine Group U's total wages as a percent of total private wages in the United States. The BLS provides data on the number of employees who work for professional service employers and for religious organizations and their wages. We use these data to calculate the proportion of wages earned by workers in these sectors relative to all U.S. workers (10 percent). We then inflate our total liability figure by this proportion.[20]

To derive our figure for total pension fund liabilities, we divide the single-employer portion of all PBGC-guaranteed pensions ($2,029 billion) by 0.9, which is 1 minus the percent of United States wages earned by Group U, thereby inflating it to account for the Group U employees. That results in a total of $2,254 billion in liabilities for single-employer programs. We then add the multi-employer portion ($740 billion) to arrive at $2,994 billion in total liabilities for all insured and uninsured pension funds in the United States.[21]

Money Market Mutual Funds

Implicitly Guaranteed Liabilities – Total net assets of money market mutual funds (MMFs).[22] Included because the federal government protection that was granted to MMFs in 2008 implies that market participants could view MMFs as being likely to receive government protection in future financial crises.

Least Inclusive Estimate – Walter and Weinberg (2002) and Malysheva and Walter (2010) excluded MMF balances because the principal value of mutual fund investments, including MMF investments, can decline, without the mutual fund defaulting, if the entity in which the funds are invested defaults. As a result, these investments are akin to equity and unlike private liabilities—the focus of our estimates—which typically must pay back full principal (or else be in default). For example, an investor in an MMF, which in turn invested in financial firm commercial paper, could lose principal if the commercial paper were not repaid, but the MMF can continue to operate (i.e., not default). We drop MMF balances in our least inclusive table for this reason and based on the idea that they might not be protected by the government in future crises.

Other Financial Firms

Implicitly Guaranteed Liabilities – Short-term liabilities (repurchase agreements, commercial paper, and other short-term liabilities with original maturities less than or equal to one year) of those non-banking financial companies that could be deemed to be SIFIs by the Financial Stability Oversight Council (FSOC)—meaning those firms that appear likely to move past FSOC's stage-one designation rule analysis announced on April 3, 2012. (See FSOC's final rule, April 11, 2012, 12 CFR Part 1310, p. 21643.) To move past the stage-one test, the firm must have assets exceeding $50 billion <u>and</u> also exhibit at least <u>one</u> of the following features:

- Have more than $30 billion in outstanding credit default swaps;
- Have more than $3.5 billion in derivative liabilities;
- Have more than $20 billion in outstanding loans or bonds;
- Have a leverage ratio (assets to equity) of greater than 15-to-1;
- Have a short-term debt-to-total assets ratio of greater than 10 percent.

Market participants might expect that the short-term liabilities of large financial firms that are designated as SIFIs would be protected if the firm is resolved under the OLA. While a SIFI designation does not necessarily imply OLA treatment in resolution, market participants are likely to expect that these institutions will not be allowed to enter bankruptcy because it seems ill-suited to handle the failure of SIFIs (Pellerin and Walter 2012, p. 14-16). The OLA provisions of Dodd-Frank permit the FDIC to pay some creditors more than bankruptcy might allow (Pellerin and Walter 2012, p. 16), and the FDIC's OLA implementing rule suggests that this treatment could apply to short-term creditors (FDIC final rule, July 15, 2011, 12 CFR Part 380, p. 41644). Therefore, in our most inclusive estimate, we include short-term liabilities of these firms that may be designated as SIFIs.

Least Inclusive Estimate – Excludes short-term liabilities of financial firms that may be designated as SIFIs, based on the possibility that OLA might not provide any special protection for such liabilities.

Total Liabilities – Includes the aggregate amount of liabilities outstanding as of Dec. 31, 2011, from each nonbank financial sector as reported in the Board of Governor's Flow of Funds Statistical Release. Those financial sectors include:

- Property-Casualty Insurance Companies
- Life Insurance Companies
- Issuers of Asset-Backed Securities
- Finance Companies
- Real Estate Investment Trusts
- Security Brokers and Dealers
- Funding Corporations

[1] Federal Deposit Insurance Corporation. *FDIC Quarterly*, 2012, vol. 6, no. 1, pp. 18. "Table III-B: Estimated FDIC-Insured Deposits by Type of Institution." http://www2.fdic.gov/qbp/2011dec/qbp.pdf.

[2] Federal Deposit Insurance Corporation. "Monthly Reports Related to the Temporary Liquidity Guarantee Program, Debt Issuance under Guarantee Program." Dec. 31, 2011. http://www.fdic.gov/regulations/resources/tlgp/total_issuance12-11.html

[3] Consolidated Statements for Bank Holding Companies (FR Y9C)

[4] Our primary source is corporate annual reports because they report short-term liabilities with original maturities of less than one year. FR Y9C uses a broader definition of "other short-term liabilities," one that includes liabilities that may have had original maturities greater than one year. When the top tier was a foreign holding company, we gathered data on specific short-term liabilities (federal funds, repurchase agreements, and commercial paper, almost all of which have original maturities of less than one year) from FR Y9C because FR Y9C contains data only on the U.S. subsidiaries, so it excludes liabilities of foreign subsidiaries. To capture as many liabilities as possible that would likely fall into the FR Y9C's "other short-term liabilities" category, we then reviewed the call reports to find any additional U.S. subsidiary short-term borrowings (e.g. FHLB advances with original maturities of less than one year) that the FR Y9C does not separately report. When available, we used average figures. We also added "securities loaned" when it was included as a separate line item from repos.

[5] "Deposits held in domestic offices" minus "estimated insured deposits" from the FDIC's report that collects data from individual call and thrift financial reports (TFRs) of the insured subsidiaries of a BHC or SLHC.

[6] See, for example: http://www.bloomberg.com/news/2012-04-16/obama-bid-to-end-too-big-to-fail-undercut-as-banks-grow.html; http://www.nypost.com/p/news/opinion/opedcolumnists/too_big_to_fail_grows_cVFocOFPEAJyQ4LgCR2ilO; http://www.reuters.com/article/2011/07/12/financial-regulation-research-idUSN1E76B1II20110712; and https://www.law.upenn.edu/blogs/regblog/2012/09/11-lipson-orderly-liquidation-authority.html.

[7] From FR Y9C and FR Y9SP.

[8] From a memorandum item on the TFRs that provides total liabilities consolidated across the holding company.

[9] Bank data from Consolidated Reports of Condition and Income for a Bank, FFIEC 031 and FFIEC 041, and thrift data from TFRs.

[10] FFIEC 002 Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks.

[11] *National Credit Union Administration 2011 Annual Report*. Page 76.

[12] Board of Governors of the Federal Reserve System. "Credit Unions, Table L.115." Federal Reserve Statistical Release Z.1, March 8, 2012. "Flow of Funds Accounts of the United States." http://www.federalreserve.gov/releases/z1/20120308/z1.pdf.

[13] Fannie Mae Form 10-K. Dec. 31, 2011. Page 83. http://www.sec.gov/Archives/edgar/data/310522/000119312512087297/d282546d10k.htm

[14] Freddie Mac Form 10-K. Dec. 31, 2011. Page 203 and page 209. http://www.sec.gov/Archives/edgar/data/1026214/000102621412000039/f71787e10vk.htm

[15] Federal Farm Credit Banks Funding Corporation. "2011 Annual Information Statement of the Farm Credit System." Page 3 and page 12, Feb. 29, 2012.
http://www.farmcreditfunding.com/farmcredit/serve/public/pressre/finin/report.pdf?assetId=199279

[16]Federal Home Loan Banks. "2011 Combined Financial Report." Page F-4, March 29, 2012. http://www.fhlb-of.com/ofweb_userWeb/resources/11yrend.pdf

[17] Pension Benefit Guaranty Corporation. 2010 Pension Insurance Data Tables. "Table S-44: Funding of PBGC-Insured Plans (1980–2009) Single-Employer Program" and "Table M-9: Funding of PBGC-Insured Plans (1980–2009) Multiemployer Program." http://www.pbgc.gov/Documents/pension-insurance-data-tables-2010.pdf

[18] Pension Benefit Guaranty Corporation. *Pension Insurance Data Book 2006*. Page 20, footnote 11. http://www.pbgc.gov/documents/2006databook.pdf. And,
Pension Benefit Guaranty Corporation. *Pension Insurance Data Book 1996*. Footnote to Table B-5. http://www.pbgc.gov/documents/1996databook.pdf

[19] Pension Benefit Guaranty Corporation. *Pension Insurance Data Book 2008*. Page 5.
http://www.pbgc.gov/docs/2008databook.pdf

[20] Note that our estimate could slightly overstate or understate the amount of total liabilities from private pension funds because the PBGC does not insure pensions provided by employers in these sectors with fewer than 26 employees, while the BLS's closest comparable category breakdown is fewer than 20 employees.

[21] Bureau of Labor Statistics. "Quarterly Census of Employment and Wages." Annual and quarterly data from 2011. http://www.bls.gov/cew/

[22] Investment Company Institute. *2012 Investment Company Fact Book*. Page 170. "Table 37: Total Net Assets and Number of Shareholder Accounts of Money Market Funds by Type of Fund."
http://www.ici.org/pdf/2012_factbook.pdf

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Orderly Liquidation Authority as an Alternative to Bankruptcy

Sabrina R. Pellerin and John R. Walter

When a large nonbank financial firm becomes troubled and in danger of default, government policymakers traditionally have had two options: they could 1) allow the firm to enter bankruptcy, or 2) if policymakers believed bankruptcy is likely to produce widespread (system-wide or "systemic") financial difficulties, the government could provide aid (i.e., a bailout) to forestall failure. In 2010, a third option was made available by the Orderly Liquidation Authority (OLA) provisions, contained in the Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). This legislation authorizes the Federal Deposit Insurance Corporation (FDIC) to pursue an agency-administered wind down for certain troubled financial firms. The OLA provisions are modeled, in part, after the process long followed by the FDIC for handling troubled banks.

The OLA provisions are a reaction to policymakers' and legislators' dissatisfaction with the two options previously available for handling failing nonbanks. For example, Ben Bernanke, chairman of the Board of Governors of the Federal Reserve System, argued, in 2009 testimony before the House Committee on Financial Services, that bankruptcy was not an effective option for certain failing financial firms (Bernanke 2009):

> In most cases, the federal bankruptcy laws provide an appropriate framework for the resolution of nonbank financial institutions. However, the bankruptcy code does not sufficiently protect the public's strong interest in ensuring the orderly resolution of a nonbank financial firm

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> whose failure would pose substantial risks to the financial system and to the economy. Indeed, after Lehman Brothers and AIG's experiences, there is little doubt that we need a third option between the choices of bankruptcy and bailout for such firms.

In a 2010 speech, Chairman Bernanke expanded on his testimony and noted two goals for this "third option," or "orderly resolution" authority (Bernanke 2010):

> The government instead must have the tools to resolve a failing firm in a manner that preserves market discipline—by ensuring that shareholders and creditors incur losses and that culpable managers are replaced—while at the same time cushioning the broader financial system from the possibly destabilizing effects of the firm's collapse.

Legislators focused on these two goals in the language of the Dodd-Frank Act itself when explaining the purposes of the OLA provisions (or the OLA "title"):

> It is the purpose of this title to provide the necessary authority to liquidate failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard.

In this article we review the features of bankruptcy and the OLA. We identify some problem areas when large nonbank financial firm failures are resolved through bankruptcy. We then describe two important features of the OLA that are meant to improve on bankruptcy as a means of handling these types of failures, and discuss how they attempt to achieve the goals of mitigating risk to financial stability while also minimizing moral hazard—goals that are not easily achieved simultaneously.

1. FAILURE RESOLUTION

Goals of any Failure Resolution Regime

Any resolution regime, whether bankruptcy, bailout, or OLA, must address two fundamental problems that arise when a firm faces financial troubles and becomes unable to repay creditors. These three regimes each take different approaches to solving these problems, and these differing approaches are at the core of each regime. The first problem (detailed below) is preserving "asset complementarities" and "going-concern value" in the face of detrimental creditor incentives to rush in and grab the firm's assets immediately upon a firm's default. Resolution methods must take these incentives into account and prevent the detrimental actions. The second problem is determining whether to "liquidate" or "reorganize" the troubled firm. Beyond addressing these two problems, an additional concern arises when the troubled firm is a large financial firm or one with many interconnections with other financial firms: What so called *systemic effects* might the liquidation or reorganization have? Will there be a significant negative effect on other financial firms or on the macro economy in response to actions taken to resolve the troubled firm? As noted in the introduction, policymakers are likely to have a strong interest in any systemic effects when deciding on the appropriate resolution method.

Preserving Complementarities and Going-Concern Value

Following a firm's default on a debt, creditors are likely to rush to seize, and separately sell, assets that, if sold together with other assets, could produce a higher sale price (assets that are "complementary"). For example, one can imagine that with numerous creditors vying for a manufacturer's assets, individual components of an assembly line might be sold off separately, when, if sold as a complete assembly line, these components would be of greater value and produce a higher price. Therefore, this incentive can reduce the total amount that creditors, as a group, receive and can also undercut productivity and economic efficiency. Creditors who manage to be the first to seize assets are likely to recover a higher proportion of their debts than creditors who are slower to react. As a result, creditors have a strong individual incentive to move quickly to undertake such seizures. Preserving complementarities can be important whether the firm is liquidated or is preserved via a reorganization process.

If creditors are allowed to rush in and seize assets, they are also likely to grab those assets that are fundamental to the firm's continued operations, so called "going-concern assets." Such assets might include, for example, necessary operating equipment for a manufacturing firm, or buildings for a financial firm. For a firm that is going to be closed and liquidated, protecting going-concern assets is unimportant, but for firms that might be successful if reorganized, creditors will be made better off, as a group, if their removal is prevented. Indeed, if creditors are allowed to seize going-concern assets, a troubled firm that might otherwise become quite productive in reorganization could be doomed to fail by the asset seizures.

In bankruptcy, the automatic stay (discussed in detail below) prevents immediate asset seizures, and creates a court-overseen process for allocating assets in a way that preserves complementarities and going-concern value.[1,2] The OLA process also involves a stay, but grants the FDIC this preservation role. Bailouts, by (typically) preventing the troubled firm's default on debts, remove the ability of creditors to seize the troubled firm's assets.[3]

Determining Whether to Liquidate or Reorganize

When a firm becomes unable to meets its debt payments, one of two outcomes are possible. First, as already mentioned, the firm might be closed and its assets liquidated. Alternatively, if the firm can be returned to profitability by restructuring (typically reducing) its debts, then, in many cases, it should be reorganized, allowing it to continue operating after a debt restructuring process. If the firm is unlikely to return to profitability, even with a lowered debt burden, because the firm's assets are unlikely to produce a market rate of return, then the firm should be liquidated: The firm should be shut down and its assets sold to the highest bidders. In this case, liquidation will distribute assets to firms that can make more productive use of them, enhancing economic

[1] According to Boul (2006): "Traditionally, the automatic stay has served to 'prevent dismemberment of the [bankruptcy] estate and insure its orderly distribution.' *SEC v. First Financial Group*, 645 F.2d 429, 439 (5th Cir.1981), *citing* S. Rep. No. 95-989, 95th Cong., 2d Sess. 50 (1978); H.R.Rep. No. 95-595, 95th Cong., 2d Sess. 341 (1977), U.S.Code Cong. & Admin. News 1978, pp. 5787, 5836, 5963, 6297, 6298. In that capacity, the automatic stay serves the interests of both the debtor and the creditors of the bankruptcy estate. For the debtor, it provides a 'breathing spell' by 'stopping all collection efforts, all harassment, and all foreclosure actions.' S. Rep. No 95-989, 95th Cong., 2d Sess. 54-55 (1978); H.R. Rep. No 95-595, 95th Cong., 1st Sess. 340 (1977), U.S.Code Cong. & Admin. News 1978, pp. 5787, 5840, 5841, 5963, 6296, 6297. However, the stay also serves the interest of creditors, insofar as it 'eliminate[s] the impetus for a race of diligence by fast-acting creditors.' *SEC v. First Financial Group*, at 439. The stay ensures that assets are distributed according to the order of priorities established by Congress. *Id. at 341*."

[2] Note that if the troubled firm had only one creditor, there would be no need for bankruptcy since that one creditor would always take actions that maximize complementarities and going-concern value. Only in the case where there are many creditors, who, because of their large number, cannot easily coordinate with one another, is bankruptcy necessary.

[3] One might imagine that an ideal solution—when a firm has suffered losses such that its capital level is low and default seems likely, but it could be profitable with a lower debt load—one that requires no intervention by bankruptcy courts or government agencies, is for the firm to gather new funding by issuing new equity shares. The new funding could be used to purchase new, profitable assets that will increase revenues available to service debt (lowering the ratio of debt to assets) and reduce significantly the chance of default. This course may be impossible, however, because of the so-called "debt overhang problem" and, as a result, bankruptcy and the reorganization of debt may be the only course available. Because of the overhang problem, existing equityholders will not vote in favor of a new equity issuance. They will not do so, at least in many cases, because most or all of the benefit flows to the debtholders by improving the market value of their debt, and the existing equityholders will suffer dilution because future earnings must be shared with the new equityholders (Duffie 2011, 43–4). The likelihood that new issues of equity might offer a solution is further reduced by an "adverse selection problem." Weak firms issuing new equity, and especially those firms whose assets are opaque, i.e., financial firms, will have to offer to sell shares at a very low price, because equity investors are likely to conclude, based on the fact that the firm wishes to issue new shares, that the firm is in exceptionally poor health (even worse health than it really is). As a result, existing shareholders will suffer a great deal of dilution and vote against new issues.

productivity and efficiency. Any resolution regime is faced with a decision between liquidation and resolution, and, ideally, will choose the one that produces the most economically efficient outcome.

Addressing Systemic Risk[4] and Moral Hazard

When faced with the failure of a large financial firm, or one with many connections with other financial firms, government decisionmakers will not only wish to ensure that complementarities and any going-concern value are preserved, and that the choice between liquidation or reorganization is optimally made, but they will also care greatly about systemic effects. Simply bailing out the troubled firm will prevent its failure, preserve complementarities and going-concern value, as well as avoid systemic effects. But any bailouts will create a "moral hazard" problem: the view, among investors, that large financial firms are likely to be protected, such that in the future, creditors of such firms will reduce their risk-monitoring efforts and these firms will be willing to undertake an inefficiently large amount of risk-taking. Therefore, any method employed to resolve a large or interconnected financial firm must balance systemic dangers against the danger of excessive risk-taking. Bailouts prevent current systemic problems but are likely to lead to less efficient resource allocation choices in the future. Relying on bankruptcy can avoid future moral hazard because, as discussed later, bankruptcy provides no source of funds for bailouts, but the bankruptcy of a large financial firm carries the risk of heavy current systemic problems. As such, when Congress crafted the OLA, addressing systemic risk was a priority, but so was resolving firms in a manner that does not simultaneously increase moral hazard. The OLA aims to address systemic risks that may otherwise be present when resolving systemically important financial institutions (SIFIs) through bankruptcy, in part, by 1) giving the FDIC broad discretion in how it funds the resolution process and pays out creditors, as well as by 2) changing the way derivatives and repurchase agreements (repos)—known as qualified financial contracts ("QFCs")—are treated.

Overview of Bankruptcy and OLA

When comparing bankruptcy and OLA, understanding their overarching goals is important. The goal of a bankruptcy proceeding is to maximize recoveries for creditors, through liquidation or the rehabilitation of the debtor. The goal of the OLA, on the other hand, is to resolve "failing financial companies that

[4] There is no clear consensus about the definition of "systemic risk" (See Taylor 2010). For purposes of this article, we will define systemic risk as "the risk that the failure of one large institution would cause other institutions to fail or that a market event could broadly affect the financial system rather than just one or a few institutions" (Government Accountability Office 2011).

pose a significant risk to the financial stability of the U.S. in a manner that mitigates such risk and minimizes moral hazard."

Bankruptcy achieves its goals through a court-overseen process that relies largely on the troubled firm's creditors and other investors to decide how best, and most profitably, to resolve the firm's troubles. Funding for a bankruptcy resolution typically comes only from the assets of the troubled company and from any funds that might be provided by private investors. See Table 1 for an outline of the bankruptcy process.

OLA borrows several important ideas from bankruptcy, but moves beyond bankruptcy because of policymakers' dissatisfaction with possible outcomes under bankruptcy. The OLA attempts to capture the firms whose resolution through bankruptcy could be detrimental to the broader financial system. Therefore, the OLA can be differentiated from bankruptcy based on several notable features that are designed specifically with SIFI, or covered financial company (CFC), resolution in mind. See Table 2 for a review of OLA's main features.

During the 2007–2008 financial crisis, an unwillingness to trust large firm failures to bankruptcy often resulted in government assistance to firms popularly described as "too big to fail," such as Bear Stearns and AIG. Yet the grant of government assistance sent strong signals to the market that other, similar firms would receive assistance as well if they were to experience trouble, thereby expanding credit subsidies for certain firms and moral hazard. For example, bond prices for the largest financial institutions remained relatively high during the crisis and prices for Lehman credit default swaps (CDS) may not have accurately reflected default risk (Skeel 2010). In contrast, allowing Lehman to fail can be seen as an attempt to mitigate moral hazard; however, some argue this was done at the cost of creating systemic risk.[5] These objectives are inextricably linked, and focusing on the reduction of one has the likely result of increasing the other. Therefore, the OLA, which charges the FDIC with administering these provisions, was an attempt to address this conflict. How does the FDIC meet this challenge?

[5] The apparent worsening of the 2008 financial crisis following Lehman's entrance into bankruptcy provides, for many observers, an illustrative example of the deleterious effect of resolution by bankruptcy for large financial firms. Yet there is some debate about the conclusions one should draw from the Lehman experience. Some observers maintain that the cascading losses following Lehman's bankruptcy filing were not a result of troubles or anticipated troubles related to the bankruptcy process itself, but were instead the result of a shock to market expectations and therefore to the risk assessments of those who had previously anticipated that Lehman, and firms like Lehman, would certainly be bailed out (see Testimony from Skeel before the Subcommittee on Commercial and Administrative Law, Committee on the Judiciary, U.S. House of Reps., October 22, 2009). Available at http://judiciary.house.gov/hearings/pdf/Skeel091022.pdf.

Table 1 Corporate Bankruptcy

Types of Bankruptcy	
Chapter 7	Chapter 7 bankruptcy (liquidation), the troubled firm is closed down, with the longer-run outcome being the sale of all the company's assets (liquidation) because creditors or management do not believe it can be successfully reorganized. Assets of the troubled firm are assembled by the *bankruptcy trustee* and then sold in a manner that maximizes the sum of the payouts to the creditors. The trustee typically must sell all of the bankrupt firm before distributing funds to creditors [11 U.S.C. 704(a)1].
Chapter 11	Under Chapter 11 bankruptcy (reorganization), the troubled firm's debts are reorganized: debt maturities are lengthened, or interest rates or principal amounts are reduced. Creditors will only agree to a reorganization if they believe that preserving the firm as a *going concern* will produce larger payments than if the firm is liquidated.
Corporate Bankruptcies are Overseen by Federal Courts	
	The operating arm of the bankruptcy courts is the Justice Department's Trustee program, so that most bankruptcies are largely handled by trustees.
Circumstances Under which a Firm Enters Bankruptcy	
Voluntary Bankruptcy	When a firm's management petitions the court to place the firm in bankruptcy because it is unable to pay all its creditors in full. A firm will file for bankruptcy when unpaid creditors will otherwise seize complimentary or going-concern assets.
Involuntary Bankruptcy	When a firm's creditors petition for bankruptcy. Creditors have incentive to seek a firm's bankruptcy when they believe that other creditors might seize complementary or going-concern assets or that the firm might dissipate assets.

Table 1 (Continued) Corporate Bankruptcy

Automatic Stay

- Immediately, upon the filing of a bankruptcy petition with the clerk of the bankruptcy court, creditors' are prohibited ("stayed") from attempting to collect on their claims.
- The stay allows a government-appointed trustee to ensure that assets of the bankrupt firm are liquidated in a manner that maximizes the total pool of funds available for creditor repayment.
- As a result, the stay allows the trustee to produce a better result for creditors in aggregate than if creditors were simply acting in their own self interest. The trustee can be thought of as solving a joint action problem. Similarly, the stay is also the means in bankruptcy by which creditors are prevented from seizing going-concern assets.
- Qualified financial contract (QFC) holders are typically exempt from the automatic stay: They can retrieve their collateral in the event of bankruptcy.
  - Under bankruptcy law a number of financial instruments are QFCs, including repurchase agreements (repos), commodity contracts, forward contracts, swap agreements, and securities contracts.
  - Reasons for the QFCs exemption:
    - Observers worry that preventing QFC holders from retrieving their collateral could create systemic financial problems.
    - Some observers believe that QFCs are not complementary with one another or with other assets, and can be removed without undercutting the troubled firm's going-concern value.

Table 1 (Continued) Corporate Bankruptcy

Priority Rules	
In Liquidation	Payouts coming from asset sales are divided among creditors based upon the creditor's location in the priority order, which is established in the Bankruptcy Code.
	Secured creditors are repaid from the assets that secure their debts prior to payments to unsecured creditors.
	A secured creditor will be fully repaid if the value of his security exceeds the amount he is owed. If not, he joins unsecured creditors and must depend on the sale of other assets for repayment.
	Unsecured claimants are paid based on the following priority list (White 1998, 1):
	First to be repaid are those owed any administrative expenses produced by the bankruptcy process.
	Second, claims are given statutory priority, such as taxes owed, rent, and unpaid wages and benefits.
	Third are unsecured creditors' claims, including trade creditors' claims, long-term bondholders, and holders of damage claims against the bankrupt firm.
	Last, equityholders receive any remaining funds.
In Reorganization	Payments to creditors and equityholders will often differ from those that would arise based simply on priority rules, because reorganization payments typically arise from negotiation between creditors and equityholders (White 1998, 8).
	Reorganization negotiations are driven by two rules: 1) each class of creditors and equityholders must consent to the bankruptcy plan adopted in the negotiation, and 2) if the negotiation produces no plan that is acceptable to all classes, then the firm is liquidated and payments are determined by the priority rules listed above.
	Because of the mutual consent requirement, some classes can be expected to receive more than would be expected if the priorities rules were strictly followed. For example, if assets are insufficient to repay all creditors, abiding by the priority rule would mean equityholders could expect to receive nothing. But creditors are likely to allow equityholders to receive payments in exchange for the investors' agreement to a plan that allows reorganization rather than liquidation, because the reorganization preserves some going-concern value for all classes. In other words, an equityholder agreement is achieved by paying them more than they would get if they held up the plan.
Debtor-in-Possesion (DIP) Loans	
	Loans made to a firm in reorganization, post-bankruptcy filing.
	Such loans are often senior to all pre-bankruptcy debts.

When the FDIC is appointed as the receiver of a failing financial firm designated as a CFC, it assumes complete financial and operational control of the institution. The FDIC has the authority to manage, sell, transfer, or merge all the assets of the failing firm, as well as provide the funds needed for an orderly liquidation, giving it broad discretion.[6] The FDIC's guiding principles in carrying out these responsibilities include using its best efforts to maximize returns, minimize losses, and, unique to this regime, mitigate the potential for serious adverse effects to the financial system and minimize moral hazard.[7] Moreover, the language of the OLA forces the FDIC to balance two competing interests. On one hand, it is to pay creditors no more than what they would receive in bankruptcy[8] and ensure that creditors bear losses in order to promote market discipline. On the other hand, it is to minimize adverse effects on financial stability. In bankruptcy, creditors only inject additional funds when the firm seems viable. The FDIC, on the other hand, may find it necessary to prop up a firm or perhaps protect certain creditors, at least for a time, to prevent any potential systemic consequences even though the firm may not be viable. The Dodd-Frank Act granted the FDIC a line of credit from the Treasury to fund these efforts. Because the FDIC has broad discretion over the way in which it balances these competing objectives, market participants may find it difficult to predict which objective might receive more weight in any given failure.

2. KEY FEATURES OF BANKRUPTCY, ITS WEAKNESSES, AND OLA AS AN ALTERNATIVE

In the United States, the failure of a business firm typically results in that firm entering *bankruptcy*, and actions taken by the firm shift from being determined by management to being guided by rules established under federal law, specifically under the U.S. Bankruptcy Code. What are the core features of bankruptcy? What features lead observers to conclude that bankruptcy is not an appropriate way to handle a SIFI whose failure could pose substantial risk to the financial system? What are the alternative resolution arrangements created by Dodd-Frank's OLA provisions?

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[6] The OLA gives the FDIC authority to operate the company "with all of the powers of the company's shareholders, directors and officers, and may conduct all aspects of the company's business." Dodd-Frank Act § 210(a)(1)(B).

[7] Dodd-Frank Act § 204(a) and § 210(a)(9)(E).

[8] Dodd-Frank Act § 210(d)(2). Under § 210(d)(4)(A) additional payments (in excess of what would be received in bankruptcy) are authorized only with approval of the Treasury Secretary and only if determined to be necessary or appropriate to minimize losses to the receiver.

Table 2 OLA

Who Qualifies as a "Covered Financial Company" (CFC)?
A "financial company" whose failure would have serious adverse effects on financial stability.
Process for Designating a Firm as a CFC
1. Recommendation by Federal Reserve and either FDIC, Securities and Exchange Commission, or Federal Insurance Office, based on their findings that the following is true for the financial company:
   - It is in default or in danger of default
   - A resolution under the Bankruptcy Code would produce serious adverse consequences
   - There is no viable private-sector alternative
2. Determination made by the Treasury Secretary in consultation with the President
3. Appointment of FDIC as receiver of CFC

The FDIC's Powers and Duties
- They can 1) sell the CFC, or any portion of the assets or liabilities to a third party; 2) establish a temporary bridge financial company to preserve the company's value prior to being sold to a third party; or 3) liquidate the company.
- Use their best efforts to maximize returns, minimize losses, and mitigate the potential for serious adverse effects to the financial system.
- Must ensure unsecured creditors bear losses and ensure the directors and management team responsible for the company's condition are removed.
- Has authority to make additional payments to certain creditors (over what their priority would demand and possibly more than similarly situated creditors) if determined to maximize value or limit losses (excess may be "clawed back"), see below.

FDIC's Access to Funding
- Treasury: FDIC may immediately borrow funds from the Treasury (up to 10 percent of the CFC's pre-resolution book-value assets within first 30 days; 90 percent once fair-value is determined and liquidation and repayment plan is in place and approved by Treasury)
- If funds from disposition of failed firm's assets are insufficient to repay Treasury:
   - Creditors (who were paid more than they would in bankruptcy) would have to return excess funds ("claw backs")
   - Large financial institutions can be assessed

Notes: "Financial Company" includes bank holding companies, nonbank financial firms, and securities broker-dealers. Nonbank financial firms are characterized as firms that are supervised by the Fed (because of SIFI designation) or that derive at least 85 percent of their revenues from activities that are financial in nature.

Key Bankruptcy Feature: The Automatic Stay

The "automatic stay" is a primary component of bankruptcy and one that underlies many of the complaints raised against bankruptcy as a means of handling SIFI failures. The stay works as follows. Immediately upon the filing of a bankruptcy petition with the clerk of the bankruptcy court, creditors are enjoined from attempting to collect on their claims.[9] This feature of bankruptcy allows a government-appointed trustee to ensure that assets of the bankrupt firm are liquidated in a manner that maximizes the total pool of funds available for creditor repayment. Without the stay, as discussed earlier, creditors can be expected to rush in, grab, and then sell the bankrupt firm's assets. In so doing, creditors could destroy asset complementarities. The stay typically lasts for the length of the bankruptcy process, though the courts may grant exceptions.

In a Chapter 7 bankruptcy (liquidation),[10] the type of corporate bankruptcy in which the troubled firm is closed down (liquidated), the court-appointed trustee typically must sell all of the assets of the bankrupt firm before distributing funds to creditors.[11] The goal of the trustee is to sell the assets in a manner that maximizes the sum of payouts to creditors. Achieving this maximization goal can result in a lengthy process, so that creditors' funds may be inaccessible for an extended period. Based on a study of all corporate bankruptcies from two federal bankruptcy court districts between 1995 and 2001, the average liquidation lasts 709 days (Bris, Welch, and Zhu 2006; 1,270). It seems likely that for the largest, most complex financial firms the process will take at least as long as average or perhaps longer.

Compared to liquidation, a corporate Chapter 11 bankruptcy (reorganization) process tends to last longer still, 828 days on average according to Bris, Welch, and Zhu (2006), though in reorganization creditors will often be repaid well before this process ends. In reorganization, the troubled firm's debts are rescheduled or cut—but it continues to operate.[12] A corporation that finds itself unable to repay all creditors in full can seek protection from creditors' claims by petitioning the bankruptcy court to enter reorganization. This protection from creditors, which includes a stay of claims, is important when a firm is being reorganized because the stay prevents creditors from seizing "going-concern" assets (assets that might be necessary to keep the firm running). The stay can mean that, in aggregate, creditors receive more than

[9] 11 U.S.C. § 362

[10] In the remainder of the article, for the sake of simplicity, we will typically replace the phrase Chapter 7 bankruptcy with "liquidation" and the phrase Chapter 11 bankruptcy with "reorganization." We will use the phrase "orderly liquidation" or the acronym OLA when referring to a Dodd-Frank Orderly Liquidation Authority process.

[11] 11 U.S.C. 704(a)1

[12] The airline industry provides many well-known examples of reorganization, in which planes continue to fly and contracts are renegotiated with creditors and employees.

they would if individual creditors had been allowed to seize assets to protect themselves. Because creditors must agree to the troubled firm's proposed reorganization plan—if not, the firm is likely to proceed to a liquidation—firms receiving reorganization treatment are those for which creditors, as a group, believe going-concern value exceeds the value of firm assets if such assets are sold, i.e., if the firm is liquidated (White 1998, 2–3).

While reorganization can last longer than liquidation, payouts to creditors will often be made well before the end of the reorganization process. As part of the reorganization, creditors may agree to lower repayments and some may receive these repayments quickly. Further, additional funding can flow into the troubled firm fairly quickly to help keep it afloat.

A source of funding often available to a firm in reorganization is "debtor-in-possession" (DIP) funding. In reorganization, the troubled corporation, the debtor, continues to operate, or "possess," the troubled entity. Any loans to the troubled corporation are therefore loans to the DIP. Such loans are often senior to all former—prior to the bankruptcy filing—debts of the bankrupt firm. The prospect of being senior to other creditors allows funding to flow as long as creditors can be convinced that the firm is likely to survive and therefore repay.

Key Bankruptcy Feature: Limited Sources of Funding

Repayment of a bankrupt firm's creditors and funds to sustain a firm reorganized under bankruptcy can only derive from two sources: the assets of the troubled firm, and, in the case of reorganization, added (DIP) loans that might flow to the troubled firm. While bankruptcy law and practice do not prohibit government aid to troubled firms, such funding is not typically available. As a result, creditors have an incentive to carefully evaluate the riskiness of any firm prior to providing funding and to monitor its activities once funding has been provided. Such monitoring will tend to ensure that the firm undertakes only those risks with a positive expected return. Yet, the government has often provided aid to troubled firms because of the sluggishness with which creditors are often repaid following failure and because of the apparent difficulty of lining up DIP funding. In some cases this aid has been provided prior to bankruptcy, in others during bankruptcy.[13] Therefore, the

[13] Bear Stearns and AIG provide examples of financial firms that received government aid prior to bankruptcy. In 2009, both General Motors and Chrysler received aid from the federal government during their reorganizations. Earlier cases of government aid include Penn Central Railroad in 1970, Lockheed Aircraft in 1971, and Chrysler in 1980.

monitoring advantage offered by bankruptcy can be diminished by the expectation of government aid for certain (especially large) financial firms.[14]

There is no DIP financing in a liquidation. In liquidation, a "bankruptcy estate" is created, including all of the assets of the bankrupt firm. One of the responsibilities of the trustee is to locate all assets and gather them into the estate. The estate assets are sold by the bankruptcy trustee and the proceeds of the sale provide the funds from which creditors are repaid. Funds from no source beyond the assets of the failed firm are available to the trustee and therefore to the creditors.

In a reorganization proceeding, debts are restructured in a manner such that the firm can continue operating. For example, the creditors of a firm might come together and all agree to reduce the amounts the bankrupt firm owes each of them by 30 percent, and extend the maturity of all debts by two years. As a result, the bankrupt firm faces lower monthly debt payments, payments that it might successfully manage. The creditors will only agree to such a plan if they believe that sustaining the operations of the firm is likely to mean larger payments than if the firm descends into liquidation. The debt restructuring and the mode of future operation is called the "reorganization plan" and is subject to court review and creditor appeal to the bankruptcy court. Typically the current management of the troubled firm operates the reorganized firm. If the firm's liabilities exceed its assets, owners are wiped out and the creditors inherit the decisionmaking rights formerly enjoyed by owners. The debtor can acquire funding for the reorganized firm because it can offer very favorable terms to the lenders who provide DIP funding because the new lenders have a claim that is senior to all other creditors. Thus, lenders will have an incentive to provide DIP funding if they believe that the reorganized firm is likely to be able to repay their loans from future earnings—that the reorganized firm will be profitable.

Weaknesses of Bankruptcy

A Weakness of Bankruptcy for Financial Firms: The Stay Threatens Short-Term Debtholders

While the automatic stay, in liquidation or reorganization, may cause no spread of losses when the creditors of the troubled firm are typically long-term debtholders (who are not counting on quick receipt of their funds), in the

[14] One might argue that there could be times in which government aid is appropriate, for example if credit standards have become inefficiently (or irrationally) strict, as in a financial panic. If market participants believe that government aid will only be forthcoming at such times, and will only provide the amount of funding that private lenders would provide if they had not become irrationally strict, then the expectation of government aid will not diminish private investors' risk-monitoring efforts.

case of a failing financial firm, creditors are likely to include a large contingent of those with very short-term claims. Funds invested in financial firms (such as investment banks) often have maturities of one or a few days. Creditors with such short maturity claims are likely to be dependent on the immediate access to their funds in order to pay their own creditors. If funds are tied up for an extended period, as assets are gathered and sold in a liquidation process or as a reorganization agreement is negotiated, the bankrupt firm's creditors may find themselves unable to make payments to their own creditors. As a result, the bankruptcy of one firm may result in the failure of some of its creditors, especially if some of these creditors are also financial firms with their own very short-term debts to repay. Therefore, while the automatic stay may have significant value in preventing creditors from separating complementary assets in liquidation and preserving going-concern value in reorganization, the stay, if it continues more than a very short time, may cause financial distress to spread. The importance of short-term funding, which is often present for non-bank financial firms, may make policymakers unwilling to rely on bankruptcy when such firms become troubled.

A Weakness of Bankruptcy for Financial Firms: Opacity Reduces Availability of DIP Financing

New funding, quickly available, will often be necessary in order for a troubled firm to be successfully reorganized. After all, funds from former sources may have dried up because of the losses these creditors suffered on former loans to the troubled firm. But, financial firms may find it to be relatively difficult, compared to nonfinancial firms, to quickly obtain DIP funding. Such firms often have quite opaque assets: assets that are difficult for outsiders, such as lenders, to value. For example, assets of financial firms often include a heavy concentration of loans to other firms. The value of such loans may depend importantly on information that can be gathered only by performing detailed analyses of the financial condition of the borrowing firms.[15] As a result, DIP loans may be available only after lenders spend a great deal of time reviewing the troubled firm's assets. Further, DIP loans made to financial firms are likely to involve unusually high interest rates to compensate for time spent in asset review and for the potential risk of lending to a firm with highly opaque assets.

[15] Using statistical analysis to measure firm opacity, by comparing the frequency of bond rating disagreements, Morgan (2002, 876) finds that banks and insurance firms are the most opaque of major industry groups. Large nonbank SIFIs are likely to have a portfolio of assets that are fairly similar to bank asset portfolios so can be expected to be similarly opaque. Interestingly, Morgan notes that the industry grouping "Other Finance and Real Estate" seems to be among the least opaque, though, according to Morgan, this is likely because the securities being analyzed for this group are "asset-backed bonds backed by a pool of specific, homogeneous assets 'locked' up in special purpose vehicles. This structure, which reduces the risk of asset substitution, seems to make the securities relatively safe and certain to outsiders" (2002, 877).

The opacity of financial firm assets contributes to the desire to employ some method (i.e., bailouts or OLA) for their resolution instead of bankruptcy.[16]

Key Features of OLA and OLA's Weaknesses

As in bankruptcy, when a troubled financial firm enters the OLA process, creditors—with the exception of holders of QFCs, discussed below—are stayed (prevented) from collecting their debts. The stay lasts the duration of the period in which the financial firm is in the OLA process. During the stay, the FDIC will typically establish a receivership estate into which most assets and liabilities will be placed. Assets placed in the receivership will be sold by the FDIC in the manner that results in the largest returns to creditors—so that the receivership may last, and creditors wait, an extended period while the FDIC lines up buyers. In addition, some of the bankrupt firm's assets and liabilities can be moved into a "bridge entity," a separate company formed by the FDIC, which might be sold off as a whole entity to a private buyer or might even be capitalized by some of the creditors of the bankrupt firm, and continue as a going concern.[17] One purpose of a bridge can be to preserve going-concern value of portions of the troubled firm.[18]

The Dodd-Frank OLA process also abides by a priority schedule similar to the one defined in bankruptcy law (see Table 1 for an overview of bankruptcy priorities). But Dodd-Frank authorizes the FDIC to violate the priority list established in OLA under certain circumstances. Specifically, section 210(d)(4) of the Dodd-Frank Act permits the FDIC to pay a creditor more than priority rules might otherwise allow "if the Corporation determines that such payments or credits are necessary or appropriate to minimize losses to the Corporation as receiver from the orderly liquidation of the covered financial company." According to the FDIC's discussion of its proposed rules related to this section of the Dodd-Frank Act, such additional payments may be made if they are necessary to "continue key operations, services, and transactions that will

[16] An alternative to bailouts or OLA that would address the problem of a lack of DIP funding as a result of SIFI opacity is to allow a troubled SIFI to enter reorganization, and permit the government to make DIP loans to the bankrupt firm. The government could quickly provide DIP funds to keep the firm operating but the bankruptcy process could handle all other aspects of the resolution.

[17] See Acting Chairman Martin J. Gruenberg's (2012) presentation before the Federal Reserve Bank of Chicago Bank Structure Conference for a discussion of how a bridge bank might be capitalized and continue operations as a private entity.

[18] Acting FDIC Chairman Gruenberg (2012) discussed the formation of a bridge, and noted its advantages for protecting going-concern (franchise) value: "... the most promising resolution strategy from our point of view will be to place the parent company into receivership and to pass its assets, principally investments in its subsidiaries, to a newly created bridge holding company. This will allow subsidiaries that are equity solvent and contribute to the franchise value of the firm to remain open and avoid the disruption that would likely accompany their closings... In short, we believe that this resolution strategy will preserve the franchise value of the firm and mitigate systemic consequences."

maximize the value of the firm's assets and avoid a disorderly collapse in the marketplace."[19]

Beyond the authority to, in some cases, make greater payments to creditors than their priority might allow, the Dodd-Frank Act also provides the FDIC with Treasury funding that might be used to make payments to creditors. The Act provides that the FDIC can borrow, within certain limits, from the Treasury. Immediately upon their appointment as receiver of a firm, the FDIC can borrow 10 percent of the value of the firm's pre-resolution assets. For a large financial firm, this initial amount can be significant. In the Lehman failure, for example, 10 percent of assets would have amounted to $63.9 billion. Once the fair value of the failing firm's assets is determined and a liquidation and repayment plan is in place, the FDIC may borrow an additional 90 percent of the value of the firm's assets (with approval from the Treasury). The Act provides that these funds are to be repaid to the Treasury from the sale of the liquidated firm's assets. But, importantly, the Act also specifies a means of repayment if such assets are not sufficient for repayment, first by attempting to "claw back" any "additional payments" (payments beyond what would have been received in a liquidation) made to creditors, and, if that is insufficient, by taxing all large bank holding companies and other SIFIs (Dodd-Frank Act § 210(o)(1)(A)).[20,21,22] The fact that assets might not be sufficient to repay the Treasury in full, and that the legislation authorizes taxes (on large financial

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[19] http://edocket.access.gpo.gov/2011/pdf/2011-1379.pdf; 4,211

[20] The Dodd-Frank Act § 210(o) specifies that assessments (taxes) to repay the Treasury are to be imposed on bank holding companies with assets greater or equal to $50 billion and on nonbank financial companies supervised by the Board of Governors of the Federal Reserve (meaning nonbank SIFIs). Assessments are to be sufficient to repay the Treasury within 60 months, with the opportunity for extension if repaying in 60 months would have a "serious adverse effect on the financial system." Assessments are to be graduated based on company size and riskiness. When determining assessment amounts, the FDIC, in consultation with the Financial Stability Oversight Council, should take account of "economic conditions generally affecting financial companies so as to allow assessments to increase during more favorable economic conditions and to decrease during less favorable economic conditions...the risks presented by the financial company [being assessed] to the financial system and the extent to which the financial company has benefitted, or likely would benefit, from the orderly liquidation of a financial company under this title," and any government assessments already imposed on the firm under such government programs as deposit insurance or securities investor protection insurance.

[21] The Dodd-Frank Act § 210(o)(1)(D)(i) prohibits the FDIC from imposing claw backs on creditors who receive "additional payments" if such payments are "necessary to initiate and continue operations essential to implementation of the receivership or any bridge financial company." The FDIC's implementing regulation, at 12 CFR 380.27, seems to imply that a good portion of any additional payments made by the FDIC will be for such essential purposes so will be protected from claw back. Note that if all additional funds could be clawed back, there might be little reason to be concerned about the potential moral hazard problem created by FDIC payments. But, given that the FDIC is likely to be prohibited from imposing claw backs on some significant portion of payment recipients, the moral hazard concern seems to be in play.

[22] Analysts (Acharya et al. 2009, 31–2; Acharya et al. 2011, 10–1) have noted that it would be more appropriate to impose this tax prior to any failure, and base the tax rate on a firm's riskiness. Such a tax would discourage risk-taking. The current tax does not discourage risk-taking, since the failing firm does not pay it. In fact, because it is paid by survivors, it punishes, and therefore discourages, caution.

firms) to repay the Treasury, implies that creditors may be repaid more than the sum of funds generated by asset sales—more than they would have been repaid in liquidation.

It seems likely that Congress intended to provide the FDIC with a good bit of discretion to bypass strict priority as well as discretion over whether to borrow Treasury funds in order to mitigate systemic risk. For example, given the FDIC's ability to pay some creditors more than they would receive in bankruptcy, these creditors may be less likely to pass on losses to other firms, lowering the risk of a systemic problem.

One might argue that legislators' intention for providing the FDIC with the authority to borrow from the Treasury was simply to allow the FDIC the ability to move quicker than bankruptcy courts. By providing an immediate source of funds, the FDIC could gather funds, which it could then use to make payments equivalent to what would be paid in bankruptcy. In this way creditors would not be denied access to their funds for months or years (as in liquidation), and the FDIC could slowly sell the assets of the failing firm such that fire sales are avoided. Under such an arrangement, legislators could have required the FDIC to immediately estimate the value of the failing firm's assets (similar to the type of analysis currently performed by the FDIC when it determines—and announces in a press release—the cost to the FDIC of a bank's failure), and then limit itself to paying creditors no more than their pro-rata share (given priorities) of this estimated amount. Yet, Congress did not choose this course, i.e., it did not require the FDIC to limit the sum of its payments to be no more than the estimated value of the failing firm's assets. Instead it left the FDIC to determine payments to creditors and authorized taxes on large financial firms if payments exceed the liquidation value of assets. Therefore, it seems clear that Congress intended for some creditors of a failing firm to receive larger payments than bankruptcy allowed, as a means of mitigating systemic risk.

Investors certainly realize that the OLA provisions provide the FDIC with the authority to make larger-than-bankruptcy payments to creditors. As a result, they will tend to under price risk-taking by nonbank firms that might get OLA treatment and such firms will engage in more risk-taking than if they did not enjoy the potential benefits of receiving government aid.[23] Congress was aware that larger payments would have this moral-hazard-exacerbating impact on firm risk-taking and took steps to mitigate the impact in the OLA provisions of the Dodd-Frank Act. Broadly, the legislation requires that the FDIC attempt to liquidate SIFIs "in a manner that ... minimizes moral

[23] Some authors, such as Jackson (2011), argue that a modified bankruptcy procedure can address this excessive risk-taking weakness and better resolve SIFIs. According to them, a system of established rules, judicial oversight, and full public disclosure has a better chance of both reducing bailouts and making the costs of them known than does a non-bankruptcy resolution authority.

hazard."[24] More specifically, the law calls on the FDIC to ensure that any member of the management or the board of directors of the failed firm who is deemed responsible for the failure is fired. Similarly, the OLA provisions require the FDIC to "ensure that the shareholders of a covered financial company do not receive payment until after all other claims and the Fund are fully paid and ensure that unsecured creditors bear losses..."[25,26] The provisions requiring the removal of management and directors are likely to encourage these corporate leaders to limit risk-taking. However, the OLA contains provisions for certain creditors to receive better treatment than they might in bankruptcy, even if some creditors suffer losses, so that creditor oversight is likely diminished by the prospect of OLA treatment.

Dealing With Systemic Risk in Failure Resolution: Exceptions to the Automatic Stay

The class of financial contracts, which are exempt from the automatic stay, are commonly referred to as "qualified financial contracts" (QFCs).[27] Therefore, investors who are holding QFCs have the ability to immediately terminate and net-out their contracts or liquidate the collateral on their claims once a party has defaulted or filed for bankruptcy. Today, under bankruptcy law, a number of financial instruments are QFCs, including repos, commodity contracts, forward contracts, swap agreements, and securities contracts.[28] The treatment of QFCs in bankruptcy (and under OLA provisions) has been the focus of a great deal of public debate.

A possible explanation for exempting QFCs is that the collateral that typically backs QFCs is not directly tied to the defaulting firm's going concern value. A primary objective of the automatic stay in bankruptcy is to prevent

[24] Dodd-Frank Act § 204(a)

[25] Dodd-Frank Act § 206(1-5)

[26] The Dodd-Frank Act includes other provisions intended to minimize moral hazard including 1) a requirement that SIFIs create resolution plans ("living wills") to increase the likelihood that they would be resolved through bankruptcy [Dodd-Frank Act § 165(d)]; and 2) a requirement that the FDIC have a plan in place, before borrowing greater than 10 percent of the failing firm's asset, for repaying the Treasury [Dodd-Frank Act § 210(n)(9)(B)].

[27] In the Bankruptcy Code, contracts exempt from the automatic stay are referred to as "safe harbor contracts." The Federal Depository Institution Act and the Dodd-Frank Act refer to the safe harbor contracts as QFCs. Since safe harbor contracts and QFCs generally refer to the same types of contract, we will use the term "QFC" to refer to both, which is consistent with industry practice.

[28] The types of contracts exempt from the stay are listed in the following sections of the Bankruptcy Code: 11 U.S.C. § 362(b)(6), (b)(7), (b)(17), 546, 556, 559, 560. All terms are defined in 11 U.S.C. § 101 with the exception of a "securities contract," which is defined as "the purchase, sale, or loan of a security, including an option for the purchase or sale of a security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any option entered into on a national securities exchange relating to foreign currencies, or the guarantee of any settlement of cash or securities by or to a securities clearing agency" (11 U.S.C. § 741).

the separation of complementary assets (an important goal of the trustee in liquidation) or to preserve the going-concern value of a firm (typically a goal in reorganization). QFCs can be immediately closed out because the collateral backing them will typically not be complementary to other assets of the firm, nor will QFC collateral be important to the firm's going-concern value. For instance, collateral consisting of highly marketable or cash-like securities (for example Treasury bills or mortgage-backed securities) can be removed from the firm without necessarily undercutting the firm's ability to produce loans or other financial products, since the production of these products depends on such resources as the skill of lending staff, staff contacts with possible borrowers, IT assets, office space and equipment, and funding (liabilities) from which to make loans. However, some argue that the collateral backing certain QFCs can be firm-specific (e.g., a pool of mortgage cash flows used as repo collateral) and therefore not all QFCs should be treated equally (Jackson 2011).

Another possible explanation for exempting QFCs is that the markets in which QFCs trade are special, such that delaying creditor recovery attempts in these markets (by imposing a stay on QFC counterparties) is especially destructive, compared to staying creditors operating in other markets. More specifically, proponents who hold this view seem to be arguing that staying QFCs is more likely to create systemic problems than staying the collection of other debts. This explanation for special treatment—what we will call the "systemic risk" rationale—appears to stand out as the argument used by policymakers supporting the expansion of the list of QFCs that took place over several decades through numerous reforms to the Bankruptcy Code. The rationale offered by those supporting the exemption is that in a fast-paced, highly interconnected market, a counterparty to a QFC may need the proceeds from the contract to pay off other debts in a timely manner. If this counterparty is unable to meet other obligations as a result of having its contracts held up in bankruptcy, other firms relying on that counterparty may become exposed and experience financial distress, which could bleed to other counterparties, and so on, causing a ripple effect and possibly "destabilizing" markets (Edwards and Morrison 2005).[29]

Today, the transactions and agreements covered under the definition of a QFC include a wide range of instruments. However, when the automatic stay

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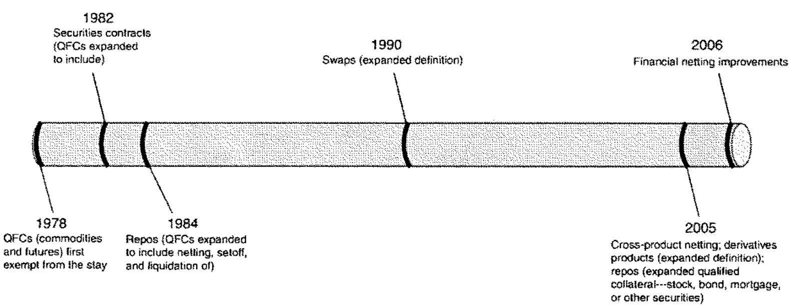
[29] In a letter dated September 30, 1998, to Hon. George W. Gekas, Chairman, Subcommittee on Commercial and Administrative Law, Committee on the Judiciary, Robert Rubin, former Treasury Secretary, argued that applying traditional insolvency laws, such as the stay, to QFCs could cause a "possible domino effect that could turn the failure of one market participant into a failure of the market." See www.wilmerhale.com/files/Publication/eacecfbd-0400-4cb1-80a0-cf3a2c3f1637/Presentation/PublicationAttachment/29b1ce6d-1ce1-4544-a3ec-63ecd65d11e1/Bankruptcy%20%20Derivatives%20outline%20-%20_final_.pdf.

Figure 1 History of QFC Exemptions from the Stay



was first created as part of the new Bankruptcy Code in 1978,[30] only commodities and futures contracts were exempt.[31] At the time, these protections were intended to "prevent the insolvency of one commodity firm from spreading to other brokers or clearing agencies and possibly threatening the collapse of the market."[32] In the decades to follow, various reforms to the Bankruptcy Code expanded the types of contracts classified as QFCs, as well as expanding the types of collateral that could be used to back them (see Figure 1 timeline).

Legislation enacted in 2005 and 2006[33] expanded the safe harbor treatment significantly by broadening the definition of a QFC to such an extent that it would capture any newly created derivatives product that may otherwise not be explicitly included.[34] Moreover, the most recent reforms also expanded contractual netting rights to allow for "cross-product netting" of QFCs (Figure 1). Netting occurs when a non-defaulting counterparty of a defaulting bankrupt firm is allowed to offset debts it owes to the defaulting firm against debts owed it by the defaulting firm.[35] Cross-product netting allows contracts

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30 The *stay* existed as a fundamental feature of bankruptcy before 1978. The Bankruptcy Reform Act of 1978, however, created the "automatic stay," which takes effect immediately upon the filing of a bankruptcy petition. Prior to the Bankruptcy Reform Act of 1978, the stay typically took effect only after the grant of an injunction by a court. Such grants were typical, but were often not immediate, and certainly not automatic (Jessup 1995).

31 U.S.C. §362(b)(6)

32 See H.R. Rep. No. 97-420, at 2 (1982).

33 The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (Pub. L. 109-8, 119 Stat. 23) and the Financial Netting Improvements Act of 2006 (Pub. L. 109-390, 120 Stat. 2692).

34 The following language was added to the definition of commodities, forward, repo, and securities contracts: "any other agreement or transactions referred to" in the definition and "any combination of the agreements or transactions referred to" in the definition.

35 For example, in the simplest case of two contracts, the non-defaulting firm is owed $1,000 by the bankrupt firm on, say, an interest rate swap (derivative) contract, and owes the defaulting

of differing types to be netted against one another, for example a debt owed on a swap to be netted against a debt owed on an option contract. Netting, whether the netting of like product contracts or cross-product contracts, can reduce the credit exposure of firms that use financial contracts. In turn, the chance that the bankruptcy of one firm might lead to large losses for its financial contract counterparties is reduced, which some observers argue could reduce systemic risk (Jones 1999).[36]

Observers explain that the expansion of special treatment for QFCs occurred in order to account for the considerable growth in the number and diversity of complex financial products over the previous decade (Jones 1999, Skadden 2010). These instruments grew in popularity as they served as mechanisms for financial firms to insure and hedge against risk, helping to reduce uncertainty and stabilize earnings. This increasingly expansive protection for derivatives and repos was intended to achieve the goal of "minimizing the systemic risks potentially arising from certain interrelated financial activities and markets."[37,38]

Some Possible Weaknesses of Bankruptcy's QFC Exemption

The onset of the financial crisis led many observers to reexamine whether this systemic risk rationale was consistent with the events that occurred when financial markets became severely stressed during the recent financial crisis. Therefore, the idea that QFCs should be exempt from the stay was revisited in the lead up to Dodd-Frank and ultimately addressed in the OLA. The systemic risk argument is the prominent justification given by those supporting the expansion of the special treatment given to QFCs. However, there is another cohort, which argues that any reduction in systemic risk, because of QFC exemptions, may be offset by another form of systemic risk

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firm \$800 on a different interest rate swap contract. Under bankruptcy law, the creditor firm may net the two contract debts such that the \$800 it owes the defaulting firm is cancelled (netted against the \$1,000) and the defaulting firm ends up owing only \$200 to the non-defaulting firm. The non-defaulting firm will have to wait for the bankruptcy process to proceed before being repaid any portion of the remaining \$200 it is owed. This outcome is superior for the non-defaulting party compared to the case in which netting were not allowed. Here the non-defaulting party would be required to pay the defaulting party the \$800 it owed, but wait for the bankruptcy process to be completed before getting any of the \$1,000 defaulting party owes it. Of course, in reality, the defaulting firm and the non-defaulting firm are likely to have many contracts outstanding with one another at the time of default, all of which might be netted (Mengle 2010).

[36] This may have magnified the concentration of the derivatives industry according to Bliss and Kaufman (2006, 67–8), who argue that "by explicitly protecting these netting agreements, the 2005 bankruptcy changes reinforced the competitive advantage of the biggest counterparties."

[37] See Jones 1999.

[38] "Immediate termination of outstanding contracts and liquidation of collateral facilitates the acquisition of replacement contracts, reduces uncertainty and uncontrollable risk, improves liquidity and reduces the risk of rapid devaluation of collateral in volatile markets" (Yim and Perlstein 2001, 3).

involving runs on repos[39] and fire sales[40] of the collateral underlying closed-out derivatives contracts (Edwards and Morrison 2005, Taylor 2010, Acharya et al. 2011). The simultaneous termination and liquidation of numerous QFCs (which is allowed by the exemption of QFCs from the stay) may lead to fire sales and possibly further insolvencies. In Lehman's case, of their 930,000 derivatives counterparties, 733,000 sought to terminate their contracts upon their bankruptcy filing on September 15, 2008 (Miller 2009).

Additionally, some observers note that the 2005 bankruptcy laws, which, among other things, extended QFC protections to repos backed by all types of collateral, including all mortgage-related securities, may have encouraged use of mortgage-backed securities as repo collateral (Lubben 2010), and thereby contributed to losses during the financial crisis (Skeel 2010, Government Accountability Office 2011). As Skeel (2010) points out, mortgage values could have spiraled down even more had AIG's counterparties been forced to sell a significant amount of the mortgage-related securities they had posted as collateral on their QFCs (which was avoided when AIG was bailed out).

The idea that QFC fire sales might result from their exemption is not new. In fact, it appears to be what led the Federal Reserve to step in and encourage private firms to come to the aid of Long-Term Capital Management L.P. (LTCM), preventing it from entering bankruptcy (Edwards and Morrison 2005).[41]

As discussed, the bankruptcy process can be long, but among other things, this is intended to give the troubled financial firm and its creditors the time to develop plans to salvage the value of the firm. However, with the exemption from the stay, a large financial firm facing possible default (because of a number of factors, such as a recent credit downgrading or an overall crisis of confidence) has a strong incentive not to file for bankruptcy since doing so would likely trigger simultaneous termination of all QFCs (Skeel and Jackson 2012). Thus, a troubled firm may put it off until the last moment and be forced into a rapid liquidation that significantly depresses values to the detriment of other market participants. These arguments suggest that bankruptcy's current treatment of QFCs may not be optimal.

Observers also find that the special treatment given to QFCs—in order to prevent the perceived systemic risks that arise when these instruments are

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[39] By "runs on repos" we mean when counterparties, en masse, seize the collateral underlying these deposit-like instruments.

[40] The phrase "fire sale" typically refers to the possibility that the sale of an asset might yield a lower-than-typical price if holders of one type of asset attempt to sell en masse. In comparison, the "typical" (non-fire sale) price will result if sales are distributed over time.

[41] Krimminger (1999, 1) notes that, "[i]n the case of LTCM, the absence of any mechanism under the Bankruptcy Code to 'slow' the liquidation of assets and collateral, [a power granted to the FDIC under the Federal Deposit Insurance Act] and the resulting 'dump' upon the markets, was a key motivation for the pre-insolvency facilitation provided by the Federal Reserve Bank of New York."

subjected to the automatic stay—not only create a different form of systemic risk, but weaken market discipline (Edwards and Morrison 2005, Scott 2011). The special treatment awarded to QFC counterparties in bankruptcy essentially places them ahead of all other creditors in the bankruptcy repayment line, allowing QFC counterparties to get out of their contracts when all other creditors cannot. As a result, their incentive to monitor the debtor prior to bankruptcy and base their pricing and investment decisions on the perceived risk of the counterparty may be significantly reduced, increasing moral hazard (Edwards and Morrison 2005, Roe 2011). It is argued that this leads to market distortions whereby debtors favor short-term repo financing over traditional sources of funding, encouraging a more fragile liability structure (Edwards and Morrison 2005, Skeel and Jackson 2012). For example, at the time of Bear Stearns' failure, a quarter of its assets (approximately $100 billion) were funded by repos (Roe 2011). Roe (2011) suggests that, without the priority given to these instruments in bankruptcy, it is plausible that Bear would have financed a much larger proportion of its assets with longer-term debt, which would have allowed for a more stable funding structure during the financial turmoil.

Some observers who support these arguments maintain that QFCs should be subject to the automatic stay provisions in the Bankruptcy Code, although there are a range of views concerning the length of the stay and whether all QFCs should be treated equally. According to Harvey Miller (2009), lead bankruptcy attorney for the Lehman bankruptcy, the automatic stay, as originally contemplated, is intended to provide a firm with the "breathing space" to find a third party source of liquidity or to carry out an "orderly, supervised wind down of its business assets." Miller argues that, had the special treatment given to QFCs not applied, Lehman's failure may have been avoided and certainly would not have been as "systemically challenging." For instance, Lehman suffered a significant loss of value when nearly 80 percent of their derivatives counterparties terminated their contracts upon their filing of bankruptcy (Miller 2009).

The OLA's One-Day Automatic Stay for QFCs

Given the controversy—with some experts arguing the exemption from the stay is necessary to prevent systemic risk and others arguing that the exemption creates systemic risk—it is natural that Congress chose a solution that leaves the FDIC with discretion to determine the treatment of QFCs for covered financial companies. Under Congress's solution, QFCs are subject to a one-day automatic stay upon appointment of the FDIC as receiver, whereas QFCs are subject to no stay in bankruptcy.[42]

During the one-day stay under the OLA, the FDIC, as receiver of the failing financial company, must quickly identify how to manage the SIFI's QFC portfolio. The one-day stay is aimed at addressing fears associated with a failing firm's QFC counterparties cancelling their contracts all at once and driving asset prices down. Instead, counterparties' rights to cancel their contracts are put on hold for one day while the FDIC determines how to treat these contracts. The FDIC has this same type of authority when dealing with bank failures. Under the OLA, during this short period, the FDIC has the option to retain the QFCs in receivership, transfer QFCs to another financial institution (to an outside acquirer or to a bridge company created by the FDIC), or reject the QFCs.[43] However, in all instances, the FDIC must retain, reject,[44] or transfer *all* of the QFCs with a particular counterparty and its affiliates.[45,46]

Each action taken by the FDIC has different implications for QFC counterparties of the debtor, as well as the failing firm. Retaining the QFCs in receivership is most similar to bankruptcy in that after the one-day stay expires, QFC counterparties may terminate or net-out their contracts.[47] What differs significantly from bankruptcy, but is very similar to the FDIC's resolution process for depository institutions, is the FDIC's ability to transfer or reject QFCs. If the FDIC chooses to transfer all of the QFCs with a particular counterparty and its affiliates to a third party (including a bridge company), the counterparty is not permitted to exercise its rights to terminate or close out the contract.[48] This awards the FDIC an opportunity to possibly preserve the value of the contracts by removing the ability of counterparties to terminate contracts early and sell off the collateral at fire sale prices (Cohen 2011).

[42] The one-day stay lasts until 5:00 p.m. on the business day following the date the FDIC is appointed as receiver. Therefore, the "one-day" stay could last four days if the FDIC is appointed as receiver on a Friday.

[43] For the most part, the FDIC's powers under the OLA to reject or transfer a QFC during their limited one-day stay are much like the powers of the FDIC and bankruptcy trustees under the Federal Deposit Insurance Act and the Bankruptcy Code, respectively, with the exception that they are not supervised by a court nor do they receive counterparty input (Skadden 2010).

[44] In bankruptcy, only contracts or leases that are executory—a contract where both parties have unperformed obligations—may be rejected.

[45] Dodd-Frank Act § 210(c)(9)(A). This is intended to eliminate "cherry picking" (selective assumption and rejection) of QFCs by the debtor.

[46] This differs from the Bankruptcy Code's setoff provision, which allows a creditor to offset all obligations under a single master agreement but not all of the contracts with a single counterparty and its affiliates (Skeel 2010, Cohen 2011). When Lehman filed for bankruptcy, they were a counterparty to 930,000 derivatives transactions documented under 6,120 master agreements (Summe 2011).

[47] If a nondefaulting counterparty has an unsecured claim after terminating a QFC and liquidating any collateral, the claim would then be subject to the same claims process as other unsecured creditors.

[48] If the counterparty were to default at a later time on a separate occasion, they may exercise their close-out rights.

Moreover, a QFC counterparty may find that their contracts are held with a new, and presumably more stable, counterparty or a temporary bridge bank following the one-day stay and, therefore, may have no incentive to terminate (in addition to the fact that it has no ability to terminate), leaving the market undisrupted by their original counterparty's failure while also maintaining what are possibly valuable hedge transactions. Finally, the FDIC may reject (or repudiate) the QFCs of a given counterparty to the debtor, effectively closing them out at the current market value, if they determine that they are somehow burdensome or doing so would otherwise promote orderly administration.[49] However, counterparties may recover, from the FDIC, any damages suffered as a result of the FDIC's rejection of QFCs.[50]

Possible Weaknesses of OLA's One-Day Stay

Some commentators find that the one-business-day stay does not provide the FDIC with sufficient time to identify the potential recipients of the failed firm's derivatives portfolio (Skeel 2010, Bliss and Kaufman 2011, Summe 2011). Given this time constraint coupled with the "all or nothing" approach to the treatment of QFCs (where the FDIC must retain, reject, or transfer all QFCs with a particular counterparty) and the potential systemic risks from its failure to protect a SIFI's QFCs, some suggest that the FDIC is highly likely to transfer all QFC contracts of a given counterparty to a bridge financial institution (i.e., protecting or guaranteeing them in full) (Skeel 2010). After all, if the FDIC does not protect all contracts, then the non-defaulting counterparties may close out and liquidate their contracts upon the expiration of the one-day stay, effectively resulting in the systemic problems previously discussed related to the QFC exemption—closing out the contracts and selling collateral at fire sale prices. Thus, even if various QFC counterparties have differing risk exposures to the defaulting firm, they are all likely to be treated the same and "bailed out." If counterparties believe that their QFCs are likely to be protected by placement in a well-funded bridge company, they are likely to provide more funding (or provide lower-cost funding) to a risky firm than they otherwise would. Further, counterparties may care little about the differing risks associated with the various types of QFCs, because all QFCs of a given counterparty are treated the same. Therefore, while bridge company placement of QFCs may limit systemic risk, it is likely to do so at the cost of increasing moral hazard.

In response to the concern that a one-day stay is likely to lead to the protection of most QFCs, some observers, such as Thomas Jackson, author of a proposal to create a new chapter in the Bankruptcy Code tailored to the

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[49] Dodd-Frank Act § 210(c)

[50] Damages are calculated as of the date of repudiation. The word "damages" is defined as the "normal and reasonable costs of cover or other reasonable measures of damages utilized in the industries for such contract and agreement claims" Dodd-Frank Act § 210(c)(3)(C).

resolution of SIFIs (Chapter 14), proposes an extension of the duration of the automatic stay for QFCs to three days. Jackson and others argue that a longer stay duration will give the FDIC additional time to make an informed decision regarding how to handle the failing firm's QFC portfolio (Jackson 2011). Jackson's three-day stay appears to be an attempt to balance the desire to give the FDIC more time, against the danger of producing QFC counterparty failures.[51]

Moreover, the protections for derivatives contracts have broadened over the last several decades and this legislation does not account for the differences across QFC products (such as between repos and swaps), or the types of collateral backing QFCs, which some observers believe should be considered. For instance, several observers find that special treatment (i.e., exemption from the stay) should be limited to derivatives collateralized by highly liquid collateral, such as short-term Treasury securities, since there is little reason to assume that such instruments are important for the going-concern value of the bankrupt firm (Herring 2011, Jackson 2011). In Jackson's 2011 Chapter 14 proposal, highly liquid, or otherwise highly marketable, instruments with no firm-specific value remain exempt from the stay so that creditors who rely on the immediate availability of their funds can get them back quickly and without disruption upon the failure of a firm. On the other hand, the exemption is removed (i.e., the stay would apply) for less liquid instruments, such as CDS, in an effort to prevent these creditors from running on the troubled firm. Clearly, there remains a good bit of controversy about the best way to handle the QFC exemption, in both bankruptcy and the OLA, with no obvious best solution.

3. CONCLUSION

While bankruptcy probably provides the ideal failure resolution mechanism for most corporations, it may not be optimal for some financial firms (i.e., SIFIs). Financial firms are typically more heavily dependent on short-term funding, often including a heavy reliance on QFCs, and their balance sheets are opaque. Because of this dependence on short-term funding, a long stay, while the bankruptcy process plays out, is likely to result in financial difficulties for some of the troubled firm's counterparties. Moreover, DIP funding, which is the usual means of keeping a troubled, but viable, firm alive during reorganization, is likely to be quite difficult to arrange, given the opacity of most financial firms. Because of these weaknesses, handling a SIFI through bankruptcy is likely

[51] While the three-day stay may not provide significantly more time than one day to make such valuations, the Dodd-Frank requirement that SIFIs create resolution plans or "living wills" and provisions forcing swaps to be traded on exchanges could expedite the QFC valuation process, improving the ability of the FDIC to make appropriate decisions within a three-day stay period.

to result in significant risks to financial stability. Policymakers are therefore understandably reluctant to allow SIFIs to enter bankruptcy, given that these risks can be mitigated through bailouts. But bailouts, or the expectation that they could be forthcoming, drive down economic efficiency by exacerbating moral hazard problems.

In an effort to address these difficulties, the OLA was created with the explicit goals of mitigating risk to the financial system and minimizing moral hazard. Specifically, the OLA adjusts the way that QFCs are handled and how creditors are paid out. Despite the attempt to achieve these well-founded goals, because they are conflicting, reducing one inevitably leads to an increase in the other. The one-day QFC exemption does not clearly resolve potential risks to financial stability and it also does not go far to ameliorate the moral hazard problem that is apparent when giving QFCs special treatment. Additionally, the ability to pay some creditors more than they would be likely to receive in bankruptcy may reduce systemic risk, but at the cost of increasing moral hazard. In conclusion, the threat of a SIFI's failure, or the failure itself, presents policymakers with a daunting challenge that neither bankruptcy nor the OLA seems capable of fully resolving.

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Our Perspective

Our Perspective is a series of essays that articulates the Richmond Fed's views on issues of particular importance to the Fifth District and the national economy, and their policy implications. The following essay is the Richmond Fed's view on "too big to fail."

Too Big to Fail

The federal financial safety net is intended to protect large financial institutions and their creditors from failure and to reduce the possibility of "systemic risk" to the financial system. However, federal guarantees can encourage imprudent risk taking, which ultimately may lead to instability in the very system that the safety net is designed to protect.

Introduction

Occasional turbulence in financial markets is inevitable. There will always be short-term "shocks" that spark new awareness of previously unknown risks, just as the housing market decline that started in 2006 made clear that some financial institutions had taken on greater risk than many investors had realized.

Shocks, however, do not easily or frequently lead to large-scale panics like the global financial crisis of 2007 and 2008. Many complicated factors led to that outcome. Among the most important factors was a long history of government interventions that led market participants to expect certain firms to be rescued in the event of distress. That "safety net" may make market participants less inclined to protect themselves from risk, making instability and financial panic a more common and severe occurrence.

Part of the government's financial safety net is explicit, such as deposit insurance that protects relatively small investors such as households and small businesses. Commercial banks are charged fees for that service and are supervised, which limits their incentive to take risk.

A large portion of the safety net is ambiguous and implicit, however, meaning that it is not spelled out in advance. For decades the federal government has proven its willingness to intervene with emergency loans when institutions seen as "too big to fail" (TBTF) are on the brink of collapse. Market participants conduct their business making educated guesses about which institutions may be supported in times of distress.

The trouble caused by implicit guarantees is that they effectively subsidize risk. Investors feel little need to demand higher yields to compensate for the risk of loss in their contracts with protected firms since losses are expected to be cushioned by the government. Implicitly protected funding sources are therefore cheaper, causing market participants to rely more heavily on them. At the same time, risk is more likely to accumulate in institutions believed to be protected. The expectation of access to government support reduces the incentive for firms that might be protected to prepare for the possibility of distress by, for example, holding adequate capital to cushion against losses. Meanwhile, investors who have made loans to support activities assumed to be guaranteed face less incentive to assess the risks and related costs associated with extending funds to those firms or markets. This is the so-called "moral hazard" problem of the financial safety net — expectation of government support weakens the private sector's ability and willingness to limit risk.

In essence, the implicit public safety net provides incentive for firms to make themselves relatively more fragile and makes creditors less likely to pay attention to that fragility. Both effects endorse risk and make the firm or activities more likely to require a bailout to remain solvent. This self-reinforcing cycle is the essence of the TBTF problem.

Although the term "too big to fail" has become the popular way to talk about financial safety net issues, it is actually something of a misnomer. The incentive problems created by the safety net stem from the belief on the part of a firm's creditors that they may be protected from losses if the firm experiences financial distress. Protection of some creditors can happen even if the firm fails — that is, even if the shareholders lose everything and management is replaced.

How extensive is the TBTF problem? The nature of the problem does not lend itself easily to study, as argued by Gary Stern, former president of the Federal Reserve Bank of Minneapolis, and Ron Feldman, the Minneapolis Fed's current head of Supervision, Regulation, and Credit, in their book on the subject (Stern and Feldman 2004). There is no list of institutions that governments implicitly view as TBTF, and there is no direct way to observe private markets' suspicions about firms or activities that would appear on such a list. Moreover, the amount of the subsidy provided by implicit support exists only on the margin and is likely to vary across firms and activities. These characteristics make it difficult to directly identify the effects of TBTF treatment on, for example, the relative performance of large and small banks(Ennis and Malek 2005).

Economists have accumulated some evidence, however. Financial institutions ostensibly viewed as TBTF have enjoyed better credit ratings and favorable financial market treatment after mergers expanding their size. Perhaps the most salient evidence of TBTF lies with Fannie Mae and Freddie Mac, the two firms that were most broadly viewed as implicitly supported by a government backstop. For decades markets have been willing to lend more cheaply to these institutions than to competitors that do not benefit from government support. Economist Wayne Passmore at the Federal Reserve Board of Governors has estimated the value of that subsidy between $122 billion and $182 billion (Passmore 2005). Suspicions of government support were proven correct when the firms were taken into government conservatorship during the financial crisis.

While the extent of the TBTF problem has not been conclusively determined, the Richmond Fed believes that it is significant. This intuition is based on past experience. The history of government interventions — from the bailout of Continental Illinois National Bank and Trust Company in 1984 to the public concerns raised during the Long Term Capital Management crisis in 1998 — shaped market participants' expectations of official support leading up to the events of 2007–08.

Why Does This Problem Exist?

It is easy to see why the TBTF problem developed. The potential damage from a large firm's failure is so great that governments feel compelled to intervene. That damage comes from at least three forms of spillovers. Most directly, when a firm fails, it may be unable to honor its financial obligations to other firms, which can snowball until other firms are jeopardized despite being fundamentally sound (Athreya 2009). To some extent, firms will protect themselves from this possibility by charging a premium to counterparties whose risks are unclear. However, the expectation of safety net protection reduces the likelihood that a firm will face the full cost of that risk, so it will be less likely to charge those higher premiums.

A large failure also can provide information about real risks in the economy. However, it is not obvious that it would be desirable or even possible to stop that kind of information from spreading.

Finally, a large firm's failure can cause market participants to scramble to reassess which of their counterparties are likely to receive government support. This type of panic contributed to the most tumultuous days of the financial crisis after the failure of investment bank Lehman Brothers in September 2008.

Earlier that year, the investment bank Bear Stearns was rescued when the Federal Reserve lent funds to JPMorgan Chase to purchase the ailing bank, the first time the Fed had directly extended financing to an investment bank. This unprecedented action, along with others taken to treat the financial market strains, likely signaled that similar support would be available for other firms. Yet in September, Lehman Brothers, at nearly twice the size of Bear Stearns, was allowed to fail.

The government appeared to be offering support on a case-by-case basis in a time of already extraordinary market uncertainty (Steelman and Weinberg 2008). But by that time, many investors were too entrenched in their contracts to charge premiums for the risks to which they now understood they were exposed — in particular, the risk that the government would not prevent failures. Lehman's failure was a turning point after which the financial crisis escalated severely, leading to extraordinary volatility and worsening the downturn in global economic activity. This type of panic — resulting from reassessment of the likelihood of protection — would cease to exist if the government's safety net boundaries were made explicit and transparent in advance.

In other words, the negative, long-term effects of a large firm's failure can be amplified by government support. In the short term, the spillovers create pain. In the extreme, they could translate to reduced economic activity, increased unemployment, and restricted credit to households and businesses. They make the case for intervention appear stronger, even as policymakers understand the moral hazard problems that intervention creates for the future.

For this reason, ambiguity around the implicit safety net nearly guarantees that it will grow ever larger over time (Lacker and Weinberg 2010). According to Richmond Fed estimates, the proportion of total U.S. financial firms' liabilities covered by the federal financial safety net has increased by 27 percent during the past 12 years. The safety net covered $25 trillion in liabilities at the end of 2011, or 57.1

percent of the entire financial sector. Nearly two-thirds of that support is implicit and ambiguous (Marshall, Pellerin, and Walter 2013).

What Can Be Done?

In the wake of the financial crisis, most policymakers agree that TBTF is a problem that must be addressed to reduce the frequency and magnitude of future financial crises. There is no consensus on solutions, however.

Many advocate broadening the scope of regulation to include all institutions and markets that could be a source of shocks that lead to financial crises. This is often referred to as systemic risk regulation. However, more regulation alone cannot be the answer. Regulations impose burdens of their own, creating incentive to innovate around them, forcing regulators and rule makers to carefully follow and adapt to an ever-changing financial landscape (Lacker 2011). Staff at the Federal Reserve and other regulatory agencies put significant resources toward understanding the institutions and markets they supervise. Yet it will always be a challenge for them to be as intimately familiar with the complex financial arrangements into which a given firm has entered as that firm is itself.

Therefore, it is essential for firms to face incentives, separate from the requirements of regulators, to limit their own risk. This is called market discipline, and it is a critical element of a well-functioning and stable financial system (Hetzel 2009). Market discipline is created when creditors expect to face the full costs of a firm's losses, and so they have a greater interest in monitoring the risk of firms with which they do business. By definition, implicit guarantees erode market discipline.

As regulatory reform continues, it is critical to create rules and policies that support market discipline rather than merely attempting to supplant it with regulation. In the Richmond Fed's view, adopting stronger regulations without changing what people believe about the boundaries of the implicit public safety net would fail to address a major source of the very risks that regulations attempt to minimize.

A useful first step would be for policymakers to publicly commit to adhering to a safety net policy that is transparent and limited in scope. Reasonable people can debate the exact contours of the safety net's boundaries. In the Richmond Fed's view, the safety net should focus on smaller creditors because, as discussed, a larger safety net has proven to grow inexorably over time. Regardless of where the safety net boundaries ultimately are drawn, making those boundaries explicit should be at the forefront of policymakers' efforts to address the TBTF problem.

The actions of the federal government, including the Federal Reserve, over the past several years have no doubt made it harder for commitments against intervention to be credible. In fact, due to that complication, some view bailouts as inevitable, believing it would make more sense for the government to make its guarantees explicit and then charge the associated firms fees for that service to make those activities rightfully costly.

However, the Fed has some experience dealing with seemingly insurmountable credibility problems. Many onlookers thought it would be impossible for the Fed to establish credibility that it would fight inflation in the late 1970s. The solution then was to build a reputation for being willing to tighten monetary policy to dampen inflation even if it meant higher unemployment in the short run. Similarly, only building a reputation to limit lending powers — perhaps by letting large firms fail, which could cause disruptions for parts of the financial sector — can avoid the moral hazard the central bank's lending authority has the potential to create (Goodfriend and Lacker 1999). The stance of the Richmond Fed is that, like in the 1970s, the long run benefits of credibility are likely to outweigh the short-term costs of the measures taken to establish it.

One step that could help establish credibility against intervention without enduring an institution's costly failure is the creation of "living wills." Living wills are blueprints, written by firms and approved in advanced by regulators, for winding down large financial institutions in the event of financial distress. The purpose of living wills is for firms to plan for how their operations could be unwound in a manner that minimizes spillovers and is unassisted from government protection of creditors, preferably with lower costs than a process featuring government assistance. Therefore, living wills present policymakers with a viable alternative to emergency "bailouts" in a crisis. The more precisely living wills are written, the more likely regulators would be to invoke them instead of bailouts in a crisis, and the more likely that firms and creditors would be to operate without the expectation of government assistance (Lacker and Stern 2012). Living wills have the potential to truly end the TBTF problem by making the government safety net the less attractive option in a crisis.

The Dangers of Discretion

To help reduce the possibility that a large firm would have to fail for the Fed's commitment to be demonstrated, an additional option is for policymakers to be "tied to the mast" with explicit rules that limit their ability to intervene. A guiding principle for ongoing regulatory reform should be limiting policymakers' discretion to provide loans or other means of support to distressed firms. This would prevent market participants from pricing the possibility of that support into contracts (Lacker 2010).

Some aspects of reform have the potential to broaden policymakers' discretion if not implemented carefully. For example, regulating systemic risk requires some specificity about what makes an institution systemically important. That alone is a difficult question. Despite the notion that some firms are "too big to fail", size is not the only determinant of riskiness. A firm's connectedness to others in the financial system is also important. Connectedness, however, is often hard to determine; there are many possible direct and indirect avenues through which one firm may be exposed to others, and those exposures evolve continuously with innovation (Price and Walter 2011). Therefore, the basic task of identifying systemically important firms necessarily entails discretion (Grochulski and Slivinski 2009).

One provision of regulatory reform gives the government authority to step in to unwind the liabilities of failing large financial institutions and allocate losses among creditors. It is difficult to specify in advance the terms of such arrangements since designating any threshold for which creditors will bear losses creates considerable incentive for investors to place themselves on the beneficial side of the line, subsidizing activities located there. For example, the Orderly Liquidation Authority, established by recent regulatory reform efforts, gives the Federal Deposit Insurance Corporation broad discretion over how it balances the competing goals of maintaining financial stability (perhaps bailing out short-term creditors) and limiting moral hazard (perhaps allowing creditors to bear losses) (Pellerin and Walter 2012). To the extent that such discretion is unavoidable, it should include clear terms of accountability like the least-cost resolution requirements that apply to the Federal Deposit Insurance Corporation when it unwinds failing banks (Lacker and Weinberg 2010).

Conclusion

Many onlookers believe financial crises and excessive risk-taking are inherent features of a market system. The view of the Richmond Fed is that poor incentives, often provided by well-intended but unwise market interventions, are more likely to be behind episodes of financial panic. The financial crisis of 2007–08 was the culmination of many factors, but chief among them was the long history of government intervention that extends back at least to the early 1980s. Such interventions created incentives for increased risk-taking. These incentives are much harder to correct than they were to create, but doing so is imperative to financial stability in the future.

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April 9, 2013 speech by Richmond Fed President Jeffrey M. Lacker

Too Big to Fail
A full list of related research and speeches from the Richmond Fed

Questions for the record following the hearing on "Examining How the Dodd–Frank Act Could Result in More Taxpayer-Funded Bailouts"

Richard W. Fisher
President and CEO
Federal Reserve Bank of Dallas

Submitted electronically to Terrie Allison
Editor, Committee on Financial Services

The views expressed are the author's and do not necessarily reflect official positions of the Federal Reserve System.

Questions for the record following the hearing on
"Examining How the Dodd–Frank Act
Could Result in More Taxpayer-Funded Bailouts"

From Chairman Emeritus Spencer Bachus

For Richard W. Fisher
President and CEO
Federal Reserve Bank of Dallas

Committee on Financial Services
U.S. House of Representatives

July 29, 2013

> Q.1: In the name of solving "too big to fail," some, including Federal Reserve Governor Tarullo, have proposed increased capital requirements beyond what Basel III mandates, as well as liquidity controls and restrictions on nondeposit borrowing, greater reliance on equity funding and a tax on size in the form of a surcharge for the largest and most complex institutions. In your opinion, will the rest of the world's financial services regulators follow if proposals such as those are adopted in this country?

The simple answer is "yes." One country has to set the standard of excellence. The United States of America, as the largest and most integral economy on the planet, should be the exemplar in having the strongest, best-capitalized and most resilient financial system. To set the goal any lower would be to abdicate our global economic leadership position.

Regulators must achieve a delicate balance between regulation and growth. Too much regulation can stifle growth; so can too little or ineffective regulation, as evidenced by the financial crisis. Massive taxpayer exposure resulted from "too big to fail" (TBTF) banks responding to the perverse incentives of subsidies implicitly granted to the banking industry's giants. Such taxpayer exposure is not something that should be embedded into the fabric of our financial system. The rest of the world looks to the U.S. as a global leader in financial services. Having the biggest, most complex banks does not guarantee economic success in a competitive global economy. A well-capitalized, transparent and accountable banking system—characterized by stability, safety and soundness—engenders such confidence and global prestige advantage.

Q.2: How would any resulting disparity between U.S. regulations and the rest of the world affect the ability of U.S. banks to support economic growth and job creation here?

A *New York Times* editorial on July 28, titled, "Not Too Big to Fail," addresses this point well: "Big banks invariably argue that new [capital] rules will impede their ability to thrive and, in the process, harm the economy... It is not the banks that need protection from regulation; it is the public that needs protection from banks that are regarded as too big to fail." We at the Dallas Fed agree with the editorial board's conclusion that absent higher capital requirements and other structural reforms needed to eliminate bailouts, "taxpayers and the broader economy will remain at risk for further bank failures and another financial catastrophe."

Would our biggest banking institutions migrate elsewhere if U.S. regulators push for smaller, simpler, less-risky banking behemoths? Will efforts to reduce the complexity of big banks through structural reforms and increased capital and liquidity requirements prompt these institutions to move their universal banking activities abroad? Such havens for lower capital standards and lighter regulatory touch are already available, but the grass over there does not appear to be greener. Many of these countries have been nearly bankrupted by the failure of their own giant banks, some of which have assets greater than their nations' GDPs. Do you suspect their taxpayers welcome the prospect of propping up more TBTF banks?

Further, poorly regulated banking systems suffer from impairment of the transmission mechanism of monetary policy. Ample liquidity is not effectively distributed to where it is most needed. Job-creating small- and medium-sized businesses do not flourish in the face of bigger competitors who can game the system.

An undercapitalized banking system suffers from frequent and recurring financial crises whenever bank failures surge. An appropriately regulated, well-capitalized banking system maintains the confidence of its financial market participants and fuels economic growth. Higher capital requirements strengthen a bank's ability to absorb potential losses. Other structural reforms will help make banks' losses less likely, less severe, or both. In the long run, strong, capitalist economies underpinned by stable financial systems attract international capital flows. An undercapitalized banking system still unreformed from past sins is a recipe for economic stagnation and an inability to compete in a globalized marketplace.

Q.3: Have you performed any analysis on the impact of high capital requirements and new regulatory mandates on economic growth?

Here's a rather simplistic but illustrative exercise: Imagine a case where banks were allowed to fund themselves with near-zero levels of equity capital. In the absence of nationalization, how long could such banks operate. Who would provide credit to them? The notion that ever-lower capital ratios would promote sustainable economic growth is an absurdity.

Laws can be too complex and regulations too numerous and burdensome to foster an environment of strong job creation, business investment and expenditure. I have heard these complaints from main street community banks and their customers affected by Dodd–Frank. It's also true that capital ratios can be set too high that they stifle growth. I will reiterate that regulators must achieve a delicate balance between regulation and growth. But I have not heard any small community banks, or regional banking organizations suggest that we are anywhere close to such a predicament.

Arguments persist over the "right" amount and kind of capital, but no one outside of big banks' lobbies argues that more capital is a bad thing. Strong institutions are those that are strongly-capitalized and equipped to sustain shocks. Having a stronger capital level gives confidence to investors, creditors and customers alike. And in the long run, stronger-capitalized, simple and accountable banks are good for the broader economy—they are less prone to destabilizing losses and proliferation of systemic risks.

Response to Questions from
the Honorable Spencer Bachus
by Thomas Hoenig

Q1: In the name of solving "too big to fail," some, including Federal Reserve Governor Tarullo, have proposed increased capital requirements beyond what Basel III mandates, as well as liquidity controls and restrictions on non-deposit borrowing, greater reliance on equity funding, and a tax on size in the form of a surcharge for the largest and most complex institutions. In your opinion, will the rest of the world's financial services regulators follow if proposals such as those are adopted in this country?

A1: Yes, I would suggest that the United States has the opportunity to lead the rest of the world in strengthening the financial industry. Countries that are most successful have strong economies and strong financial systems. Banks must hold capital levels that the market has historically required when no government safety net protected creditors from loss. Stronger capital levels support risk taking and lending to private firms while allowing for mistakes without weakening the entire financial system. Confidence is a key to the stability of the financial system, and adequate capital and strong liquidity serves to instill confidence among the public in its financial firms. Low capital and inadequate liquidity tends to worsen the effects of a financial upheaval on a nation's economic system, as we only too recently learned. It's time for the United States to compete in the global economy from a position of strength once again, and that includes taking the lead on financial regulatory policy. (See article from August 1 Wall Street Journal, which states the U.S. leads the world in imposing stricter capital rules on the biggest banks.[1])

Q2: How would any resulting disparity between U.S. regulations and the rest of the world affect the ability of the U.S. banks to support economic growth and job creation here?

A2: U.S. regulations requiring more capital, more disclosure, and more separation of speculative trading activities from commercial bank activities will strengthen the U.S. banking system relative to foreign bank operations and make our banks more competitive and successful over time. Capital is a source of strength, not a burden. A potential disparity in terms of U.S. institutions being better capitalized compared with their foreign counterparts puts our financial firms not only in a much stronger competitive position, but also in a position to continue to lend through both good times and bad in support of U.S. economic growth and job creation.

Q3: Have you performed any analysis on the impact of high capital requirements and new regulatory mandates on economic growth?

A3: Analysis that has been done on the impact of capitalization levels on economic growth finds that during economic downturns, banks with stronger capital levels do not reduce their lending activities to the same extent that banks with weak capital do. In reviewing data since 1999

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[1] http://online.wsj.com/article/SB10001424127887323997004578640314202979922.html?KEYWORDS=Crittenden

regarding the relationship between equity and loan levels for the eight U.S. globally systemic banks, there is no evidence that higher capital leads to lower loan volumes. Studies of stronger capital requirements have been conducted by research staff within the IMF and BIS, and their findings show that banks with strong tangible common equity levels are better able to maintain lending during a crisis, a key factor influencing the speed of the recovery. (See IMF Working Paper: "Balance Sheet Strength and Bank Lending During the Global Financial Crisis" by Kapan and Minoiu, May 2013, http://www.imf.org/external/pubs/ft/wp/2013/wp13102.pdf.)

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Jeffrey M. Lacker
President

August 5, 2013

The Honorable Spencer Bachus
2246 RHOB House Office Building
Washington, DC 20515

Dear Representative Bachus:

I am writing to respond to the questions you submitted following the House Committee on Financial Services hearing entitled, "Examining How the Dodd-Frank Act Could Result in More Taxpayer-Funded Bailouts" on June 26, 2013.

1) Question: In the name of solving "too big to fail," some, including Federal Reserve Governor Tarullo, have proposed increased capital requirements beyond what Basel III mandates, as well as liquidity controls and restrictions on non-deposit borrowing, greater reliance on equity funding and a tax on size in the form of a surcharge for the largest and most complex institutions. In your opinion, will the rest of the world's financial services regulators follow if proposals such as those are adopted in this country?

   Answer: It is difficult to predict what other regulators in countries will do. I believe we should strive to adopt financial regulations that we view as most appropriate to adopt on a global basis. Other countries may learn from our example and move toward our arrangements, although that process may take an extended period of time. Some countries may retain distinct regulatory policies, viewing them as more appropriate for their specific circumstances.

2) Question: How would any resulting disparity between U.S. regulations and the rest of the world affect the ability of U.S. banks to support economic growth and job creation here?

   Answer: In general, capital will find its way to good U.S. investment opportunities, even if foreign countries adopt less restrictive financial regulations. If so, and if foreign countries provide their banks more generous financial safety net support, then foreign banks might engage in excessive risk-taking in the U.S., recreating some of the conditions that we saw in the lead up to the recent crisis. In that case, home country rescues for foreign banks operating in the U.S. can result

The Honorable Spencer Bachus
August 5, 2013
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in implicit transfers from foreign taxpayers to U.S. borrowers. But such over lending can cause serious distortions in resource allocation in the U.S., and significant economic hardship for American citizens. Matching the laxity of overseas financial regulations would likely make the damage worse.

3) Question: Have you performed any analysis on the impact of high capital requirements and new regulatory mandates on economic growth?

Answer: We have not performed quantitative analysis of the growth effects of high capital requirements and new regulatory mandates here at the Richmond Fed. Having said that, the sharp decline in economic activity during 2008 and early 2009 is strong circumstantial evidence that insufficient capital and liquidity can be very costly over time. Achieving adequate levels of capital and liquidity through regulatory mandates, rather than as a result of competitive market discipline, imposes its own economic costs, however. Compliance can be resource-intensive and for some regulated entities, benefits may fall short of costs. In addition, the potential for financial activity to bypass regulation necessitates the policing of unregulated activities. Greater reliance on competitive market forces to incent prudent levels of capital and liquidity can avoid the excessive burdens of regulatory mandates, but that approach requires credibly scaling back the federal financial safety net, which Richmond Fed research estimates covers approximately 57 percent of financial sector liabilities at the end of 2011.

Thank you for the opportunity to respond.

Sincerely,