Feature Article:

"We Must Resolve to End Too Big to Fail"

The following are remarks by FDIC Chairman Sheila C. Bair on May 5, 2011, before the 47th Annual Conference on Bank Structure and Competition sponsored by the Federal Reserve Bank of Chicago.

I am very pleased to have the opportunity to address this conference once again as FDIC Chairman. For nearly 50 years, the Bank Structure Conference has been a vitally important forum for addressing the challenges facing the financial services industry. It all began in the early 1960s as a series of symposia on competition and market structure in what was then, in many respects, a much more heavily regulated banking industry. In those days, branching restrictions, product and service limitations, and interest-rate ceilings were the norm. But by the 1970s, the focus shifted somewhat to the need for banking deregulation in a fast-changing financial landscape.

With the crises of the 1980s, the issues of moral hazard—resulting from the federal safety net and the resulting need for better market discipline—came to the fore. And more recently, the emphasis has shifted again to financial innovation and nonbank financial providers, followed, of course, by debate as to the causes of the recent crisis and the reforms needed to prevent such a disaster from recurring.

Besides its uncanny knack for identifying emerging policy issues, this conference series is also remarkable for the way it brings together three groups of people—academics, bankers, and regulators—who sometimes speak different languages, but who must work together to resolve those difficult issues. And what keeps you coming back to this conference year after year, I suspect, is a shared commitment to some common goals.

All of us have a vital stake in financial stability. And we all want to see a financial system that consistently supports the real economy by efficiently allocating capital and credit to its highest and best use.

Balancing the Government's Role

Because banking and finance are so critical to our economy, and because they are prone to bouts of instability, we have long recognized a vital—but limited—role for government in our financial system. Public confidence, market liquidity, and financial stability are all inherently public goods. Only government has the capacity to carry out prudential supervision, serve as lender of last resort, provide iron-clad guarantees that can forestall runs, and promptly and efficiently resolve banking institutions when they fail.

Under the guidance of statute, the FDIC, the Federal Reserve, and the other banking authorities have long sought to achieve a delicate balance in the role that government plays in the banking industry. One important task is to promote confidence and stability through the deposit insurance guarantee and the lender-of-last-resort function. But it is equally important that we uphold regulatory discipline through prudential supervision and promote market discipline by clearly limiting the extent of the government backstop.

In the wake of the recent crisis, we are working to implement an updated statutory mandate under the Dodd-Frank Act. As we do so, there is once again much debate over the lessons of the crisis and the proper role of government in the financial sector.

On one hand, there is concern that new regulations could impose onerous costs on banks and our economy, stifling financial innovation and economic growth. On the other, there is genuine alarm about the immense scale and seemingly indiscriminate nature of the government assistance provided to large banks and nonbank financial companies during the crisis, and what effects these actions will have on the competitive landscape in banking.

These bailouts were necessary because these institutions had been permitted to become so large, complex, and interconnected that the prospect of their failure was a threat to overall financial stability. They were Too Big to Fail. Richmond Federal Reserve Bank President Jeffrey Lacker recently reminded us of the drawbacks of a federal safety net policy of constructive ambiguity that allows regulators to talk tough during good times, but keep their options open during a crisis. But if there ever was a constructive ambiguity about the scope of the federal safety net and the existence of Too Big to Fail,

it was surely made obsolete by the events of late 2008 and early 2009.

In the wake of that experience, all of us in this room have a vital interest and a collective responsibility to do what it takes to restore the balance between a safety net that ensures stability and public confidence, and the need to place clear and credible limits on that safety net. In short, we must restore market discipline in the financial sector. That will be the focus of my remarks today.

The Roots of the Problem

The financial crisis of 2008 centered on the so-called shadow banking system—a network of large-bank affiliates, special-purpose vehicles, and nonbank financial companies that existed largely outside of the prudential supervision and capital requirements that apply to federally insured depository institutions in the U.S. In addition, the shadow banking system also fell largely outside of the FDIC's process for resolving failed insured financial institutions through receivership.

Several large, complex U.S. financial companies at the center of the 2008 crisis could not be wound down in an orderly manner when they became nonviable. Major segments of their operations were subject to the commercial bankruptcy code, as opposed to bank receivership laws, or they were located abroad and therefore outside of U.S. jurisdiction. The size and complexity of these institutions, and the inadequacy of the bankruptcy process as a means to preserve value after their failure, rendered these companies Too Big to Fail.

In the heat of the crisis, policymakers frequently resorted to bailouts instead of letting these firms collapse into bankruptcy. The fear was that the losses generated in a failure would cascade through the financial system, freezing financial markets and stopping the economy in its tracks. The worst fears of policymakers were realized when Lehman Brothers—a large, complex nonbank financial company—filed for bankruptcy on September 15, 2008.

The long-term outcome for Lehman creditors clearly demonstrates the shortcomings of bankruptcy as a means to resolve failed financial companies. The firm managing the Lehman bankruptcy reports that more than $75 billion in value was destroyed by the bankruptcy process itself, including tens of billions of dollars from the inability to roll over valuable derivatives contracts. More than two-and-a-half years after Lehman's failure, the process has cost over $1.2 billion in legal and other professional fees, and many creditors still don't know what their claims will be worth.

Anticipating the complications of this process, counterparties across the financial system reacted to the Lehman failure by running for the safety of cash and other government obligations. Subsequent days and weeks saw the collapse of interbank lending and commercial paper issuance, and a near complete disintermediation of the shadow banking system. The only remedy was massive intervention on the part of governments around the world, which pumped equity capital into banks and other financial companies, guaranteed certain nondeposit liabilities, and extended credit backed by a wide range of illiquid assets to banks and nonbank firms alike. Even with these emergency measures, the economic consequences of the crisis have been enormous.

Competitive Implications of Too Big to Fail

The dilemma policymakers faced in the failure of large, complex financial institutions resembles a classic hostage drama, where the imperative of saving lives in the short run comes at the expense of encouraging more hostage-taking in the future. And so it is with the largest U.S. banks and other financial companies, which have every incentive to render themselves so large, so complex, and so opaque that no policymaker would dare risk letting them fail in a crisis. With the benefit of this implicit safety net, these institutions are insulated from the normal discipline of the marketplace that applies to smaller banks and practically every other private company.

Understanding the game, and having recently seen the nation's largest financial institutions receive hundreds of billions of dollars in taxpayer assistance, the market appears to expect more of the same going forward. In February, Moody's reported that its ratings on the senior unsecured debt of eight large U.S. banking organizations received an average "uplift" of 2.2 ratings notches because of the expectation of future government support. Meanwhile, the largest banks continue to enjoy a large competitive advantage over community banks in funding markets. In the fourth quarter of last year, the average interest cost of funding earning assets for banks with more than $100 billion in assets was about half the average for community banks with less than $1 billion in assets. Indeed, I would also argue that well-managed large banks are disadvantaged. Too Big to

Fail narrows the funding advantage they would otherwise enjoy over weaker competitors.

This situation can only be regarded as a new and dangerous form of state capitalism, where the market assumes large, complex, and powerful financial companies are in line to receive generous government subsidies in times of financial distress. Unless reversed, we can expect to see more concentration of market power in the hands of the largest institutions, more complexity in financial structures and relationships, more risk-taking at the expense of the public, and, in due time, another financial crisis.

The New SIFI Resolution Framework

At the core of the reform legislation passed last summer are measures that create a new resolution framework that will apply to the so-called systemically important financial institutions, or SIFIs, that are associated with the problem of Too Big to Fail.

This new SIFI resolution framework has three basic elements. First, the new Financial Stability Oversight Council, chaired by Treasury and made up of the other financial regulatory agencies, is responsible for designating SIFIs based on criteria that are now being established by regulation. Once designated, the SIFIs will be subject to heightened supervision by the Federal Reserve and required to maintain detailed resolution plans that demonstrate that they are resolvable under bankruptcy—not bailout—if they should run into severe financial distress.

Not only will these plans provide valuable advance information that will assist in implementing an orderly resolution, but the law also authorizes the FDIC and the Federal Reserve to require, if necessary, changes in the structure or activities of these institutions to ensure that they meet the standard of being "resolvable" in a crisis.

Finally, the law provides for a third alternative to bankruptcy or bailout—an Orderly Liquidation Authority, or OLA, that gives the FDIC many of the same trustee powers over SIFIs that we have long used to manage failed-bank receiverships. While this authority strictly prohibits bailouts, the FDIC could use it to conduct advance planning, to temporarily operate and fund the institution under government control to preserve its value as a going concern, and to quickly pay partial recoveries to creditors through advance dividends, as we have long done in failed-bank receiverships. The result would be a faster resolution of claims against the failed institution, smaller losses for creditors, reduced impact on the wider financial system, and an end to the cycle of bailouts.

The history of the recent crisis is replete with examples of missed opportunities to sell or recapitalize troubled institutions before they failed. But with bailout off the table, management will have a greater incentive to bring in an acquirer or new investors before failure, and shareholders and creditors will have more incentive to go along with such a plan in order to salvage the value of their claims. These new incentives to be more proactive in dealing with problem SIFIs will reduce their incidence of outright failure and also lessen the risk of systemic effects arising from such failures.

Doubts and Misconceptions about the New Resolution Framework

The problem is that, even as we put this game plan into action, some still don't believe that policymakers have the means or the will to take the difficult steps needed to close down the SIFIs in a crisis, and will ultimately back down and just bail them out again. Part of the problem is a misunderstanding of the process. And part of it is a low opinion of the political will in Washington to make hard and unpopular decisions.

For example, we have heard some say that being designated as a SIFI will confer a competitive advantage by anointing an institution as Too Big to Fail. But the reality is that SIFIs will be subject to heightened supervision and higher capital requirements. They will also be required to maintain resolution plans and could be required to restructure their operations if they cannot demonstrate that they are resolvable.

Needless to say, nobody is signing up in advance to be a SIFI. In fact, it is just the opposite. It might be far better to fall just short of SIFI status in terms of size, complexity, and interconnectedness. In that case, your institution would be spared all of the additional regulatory burdens, but policymakers could still face significant challenges in effecting an orderly resolution in a crisis. That's why it is important that the FSOC move forward and develop some hard metrics to guide the SIFI designation process. We need to be able to gather information on a broad range of potential SIFIs in order to develop a sense of the difficulties that might arise in resolving them.

Ultimately, the "resolvability" of an institution should determine if it is designated as a SIFI. Upholding this standard will be essential if we are to avoid the "death-bed designation" of SIFIs that would put the resolution authority in the worst possible position in a crisis.

Misunderstandings also abound as to the nature of the Orderly Liquidation Authority. Some have called it a bailout mechanism, while others see it as a fire sale that will destroy the value of receivership assets. Neither is true.

While it is positioned as a backup plan in cases where bankruptcy would threaten to result in wider financial disorder, the OLA is actually a better-suited framework for resolving claims against failed financial institutions. It is a transparent process that operates under fixed rules that prohibit any bailout of shareholders and creditors or any other type of political favoritism, which is a legitimate concern in the case of an ad-hoc emergency rescue program. Not only would the OLA work faster and preserve value better than bankruptcy, but the regulatory authorities who will administer the OLA are in a far better position to coordinate with foreign regulators in the failure of an institution with significant international operations.

The FDIC has made considerable progress in forging bilateral agreements with other countries that will facilitate orderly cross-border resolutions. And we currently co-chair the Cross Border Resolutions Group of the Basel Committee.

It is worth noting that not a single other advanced country plans to rely on bankruptcy to resolve large, international financial companies. Most are implementing special resolution regimes similar to the OLA. Under the OLA, we can buy time, if necessary, and preserve franchise value by running the institution as a bridge bank, and then eventually sell it in parts or as a whole. It is a game-changer in terms of the ability to provide continuity and minimize losses in financial institution failures.

Resolution Plans Must Be Credible and Actionable

A major improvement in the SIFI resolution process is also one that, in my opinion, has been somewhat underestimated by the skeptics. And that is the requirement for SIFI resolution plans.

When a large, complex financial institution gets into trouble, time is the enemy. The larger, more complex, and more interconnected a financial company is, the longer it takes to assemble a full and accurate picture of its operations and develop a resolution strategy. By requiring detailed resolution plans in advance, and authorizing an on-site FDIC team to conduct pre-resolution planning, the SIFI resolution framework regains the informational advantage that was lacking in the crisis of 2008.

The FDIC recently released a paper detailing how the filing of resolution plans, the ability to conduct advance planning, and other elements of the framework could have dramatically changed the outcome if they had been available in the case of Lehman. Under the new SIFI resolution framework, the FDIC should have a continuous presence at all designated SIFIs, working with the firms and reviewing their resolution plans as part of their normal course of business. So our presence will in no way be seen as a signal of distress. Instead, it is much more likely to provide a stabilizing influence that encourages management to more fully consider the downside consequences of its actions, to the benefit of the institution and the stability of the system as a whole.

As far-reaching as these changes are, their ultimate effectiveness will still depend on the willingness of the FDIC and the Federal Reserve to actively use their authority to require organizational changes that promote the ability to resolve SIFIs. As currently structured, many large banks and nonbank SIFIs maintain thousands of subsidiaries and manage their activities within business lines that cross many different organizational structures and regulatory jurisdictions. This can make it very difficult to implement an orderly resolution of one part of the company without triggering a costly collapse of the entire company.

To solve this problem, the FDIC and the Fed must be willing to insist on organizational changes that better align business lines and legal entities well before a crisis occurs. Unless these structures are rationalized and simplified in advance, there is a real danger that their complexity could make a SIFI resolution far more costly and more difficult than it needs to be.

Such changes are also likely to have collateral benefits for the firm's management in the short run. A simplified organizational structure will put management in a better position to understand and monitor risks and the

inter-relationships among business lines, addressing what many see as a major challenge that contributed to the crisis. That is why—well before the test of another major crisis—we must define high informational standards for resolution plans and be willing to insist on organizational changes where necessary in order to ensure that SIFIs meet the standard of resolvability.

What You Can Do to Shape the Outcome

In the wake of a crisis, there is a natural tendency for memories to fade. The economic pain caused by the financial crisis will subside in time, and even the Bank Structure Conference will eventually move on to consider other topics and other challenges. In an ever-changing financial landscape, it can be difficult to maintain a long-term focus on the lessons of the last crisis and the imperatives of preparing to deal with the next one. Most of all, it is extremely difficult to overcome the political resistance that comes from large, powerful financial organizations when they are asked to make potentially costly changes at a time when the danger of a financial crisis appears remote.

As I mentioned at the outset, everyone in this room has a vital stake in the outcome of these reforms. And, because this is such a knowledgeable and influential group, all of you have a role to play in their failure or their success. Given the challenges before us, one response that many seem to have is a certain cynicism and detachment about the process. It's easy to be a doubter and simply resign yourself to the idea that it is just too difficult, and that we will never be able to really put an end to Too Big to Fail.

If enough of us do that, then the ratings agencies will end up being right in terms of their expectation of future government support. Open-ended state subsidies to large financial companies in times of crisis could become a permanent part of the landscape, with all of the attendant implications that has for risk-taking and the competitive structure in banking.

But, knowing this group as I do now, after almost five years as FDIC Chairman, I think you have a far more productive role to play in shaping the outcome of this critical policy debate. I urge you to actively use your influence to ensure that the new SIFI resolution framework will be equal to the great task that is before us. Conduct your own analysis of the regulations as they are proposed, and engage the process in comment letters, op-eds, blog posts, and research papers. Ask the hard questions that need asking:

Are regulators carrying out the intent of the reforms?

Are all the right firms designated as SIFIs?

Are they developing credible resolution plans?

Are the largest financial companies structured in a way that renders them resolvable in a crisis?

Is progress being made in coordinating resolution regimes on the international front?

And, most important, are we meeting the market test of credibility? The answer to this question will be evident in credit spreads, funding costs, and other market indicators.

Conclusion

While it is important that you critique the actions of all parties to this debate—including regulators, financial companies, and other market participants—it is equally important that you use your knowledge and your influence to help explain the parameters of this debate and the stakes involved to the American people. These issues are complex and are generally not well-understood by the public. But the people in this room are among the world's leading experts on these issues. With your active engagement, I am confident that we can build the broad-based political support that will be needed to change the status quo and build the foundation for a stronger and more competitive financial sector in the years ahead.