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Statement of

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Addressing the Too Big to Fail Problem

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* These remarks reflect my views and not necessarily those of others in the Federal Reserve.

Chairman Dodd, Ranking Member Shelby, and members of the Committee, thank you for the opportunity to review the too big to fail (TBTF) problem with you today. I will develop a simple conclusion in this testimony: The key to addressing TBTF is to reduce substantially the negative spillover effects stemming from the failure of a systemically important financial institution. Let me explain how I have come to that conclusion.

The TBTF problem is one of undesirable incentives which we need to address if we hope to fix the problem. TBTF arises, by definition, when the uninsured creditors of systemically important financial institutions expect government protection from loss when these financial institutions get into financial or operational trouble. The key to addressing this problem and changing incentives, therefore, is to convince these creditors that they are at risk of loss. If creditors continue to expect special protection, the moral hazard of government protection will continue. That is, the creditors will continue to underprice the risk-taking of these financial institutions, overfund them, and fail to provide effective market discipline Facing prices that are too low, systemically important firms will take on too much risk. Excessive risk-taking squanders valuable economic resources and, in the extreme, leads to financial crises that impose substantial losses on taxpayers. Put another way, if policymakers do not address TBTF, the United States likely will endure an inefficient financial system, slower economic growth, and lower living standards than otherwise would be the case.

To address TBTF, policymakers must change these incentives, and I recommend the following steps to achieve that goal. And let me emphasize that these are my personal views.

First, identify why policymakers provide protection to uninsured creditors. If we do not address the underlying rationale for providing protection, we will not credibly put creditors of systemically important firms at risk of loss. The threat of financial spillovers leads policymakers to provide such protection.[1] Indeed, I would define systemically important financial institutions by the potential that their financial and operational weaknesses can spill over to other financial institutions, capital markets, and the rest of the economy. As a result, my recommendations to address the TBTF problem focus on mitigating the perceived and real fallout from financial spillovers.

Second, enact reforms to reduce the perceived or real threat of the spillovers that motivate after-the-fact protection of uninsured creditors. These reforms include, but are not limited to, increased supervisory focus on preparation for the potential failure of a large financial institution, enhanced prompt corrective action, and better communication of efforts to put creditors of systemically important firms at risk of loss. I call this combination of reforms systemic focused supervision (SFS). Other reforms outside of SFS will help address TBTF as well. I also recommend, for example, capital regimes that automatically provide increased protection against loss during bad times and insurance premiums that raise the cost for financial institution activities that create spillovers. I recognize the substantial benefits of highlighting a single reform that would fix TBTF, but I believe a variety of steps are required to credibly take on TBTF.[2]

Third, be careful about relying heavily on reforms that do not materially reduce spillovers. In particular, I do not think that intensification of traditional supervision and regulation of large financial firms will effectively address the TBTF problem. In a similar vein, while I support the creation of a new resolution regime for systemically important nonbank financial institutions, I would augment the new resolution regime with the types of reforms I just noted.

I will now discuss these points quite briefly. I will provide additional detail in the appendix to this testimony.[3]

Spillovers Produce the TBTF Problem

Uninsured creditors of systemically important firms come to expect protection because they understand the motivation of policymakers. Policymakers provide protection, in my experience, believing that such protection will contain costly financial spillovers. Policymakers understand that protecting creditors reduces market discipline, but they judge the costs of such a reduction to be smaller than the fallout from the collapse of a major institution. Policymakers worry about spillovers—for example, the failure of other large financial firms due to their direct exposure to a weak firm or because of a more general panic—and the potential impact they may have on the rest of the economy.

I see three general approaches to addressing concerns over spillovers and thus increasing market discipline (and reducing moral hazard). First, enact reforms that make policymakers more confident that they can impose losses on creditors without creating spillovers that would justify government protection. Second, reduce the losses that failing firms can impose on other firms or markets, which helps reduce spillovers. Third, alter payments systems to reduce their transmission of losses suffered by one firm to others.

Policymakers cannot eliminate spillovers entirely, nor can they credibly commit to never providing protection to creditors of systemically important firms. But they can make significant progress in reducing the probability of providing protection, reducing the number of creditors who might receive protection, and reducing the amount of coverage that creditors receive. These are all valuable results. I will now provide several specific examples of approaches to deal with spillovers.

Examples of Reforms That Credibly Address TBTF by Taking on Spillovers

To take on spillovers, I recommend starting with SFS, a combination of reforms that would identify and better manage spillovers, reduce losses from the failure of systemically important financial institutions, and alter uninsured creditor expectations so that they better price risk-taking. To provide a sense for additional reforms I have endorsed, I will provide two other examples of reforms you might consider beyond SFS. Others have begun endorsing reforms of this type, which indicates that attacking spillovers is not considered impossible.

Systemic Focused Supervision. This approach to addressing spillovers has three components.

Engage in Early Identification. I would focus financial institution oversight, defined broadly, on identifying potential spillovers both in general and for specific firms, and offering recommendations to mitigate them. To my mind, this is conceptually similar to the macroprudential or systemic-risk supervision others have supported. I would concentrate such efforts, which would require significant input from bank supervisors and others, on carefully mapping out the exposures that systemically important firms have with each other and other basic sources of spillovers. Once the responsible supervisory entity documents where and how spillovers might arise, it would take the lead in offering recommendations to address them. This effort either would assure policymakers that a perceived spillover did not in fact pose a significant threat or would direct resources to fix the vulnerability and generate such comfort.

Lest such an exercise sound like it would be unproductive, I believe that fairly simple failure simulation exercises over the years confirmed the potential spillovers, created by the overseas and derivative operations of some large financial firms, that now bedevil us. I would also note that macroprudential supervision can and should put some of the burden of early identification on the systemically important firms themselves by, for example, requiring them to prepare for and explain the challenges of entering what would amount to a prepackaged bankruptcy.[4]

Enhanced Prompt Corrective Action (PCA). To focus supervisors on closing weak institutions early, which reduces the losses they can impose on others, I recommend incorporating market signals of firm risk into the current PCA regime. The incorporation would require care. Market signals contain noise, but such signals also offer forward-looking measures of firm specific-risk with valuable information for bank and other supervisors.

Improve Communication. The goals here are to establish the credibility of efforts to put creditors at risk of loss and to give creditors the opportunity to alter their behavior. As a result, I recommend that supervisory and other stability-focused agencies clearly communicate the steps in process to avoid full protection. Simply put, creditors cannot read minds and will not alter their expectations and behavior unless they understand the policy changes under way.

SFS is not the only approach to addressing spillovers. Let me highlight two other reforms by way of example.

Develop Capital Instruments to Absorb Losses When Problems Arise. Requiring firms to hold substantially more capital offers a path to absorb losses before they spill over and directly affect other firms. But having to raise expensive capital can either encourage firms to avoid socially beneficial lending or to take on more risk to generate targeted returns. I urge policymakers to examine capital tools that effectively create capital when firms need it most, which reduces their cost and avoids fueling downcycles.[5]

Price for Spillover Creation. A direct way to discourage the types of activities that generate spillovers is to put a price on them because, after all, spillovers impose costs on all of us. Using the early-identification approach noted above to identify the major causes of spillovers would offer a first step. The actual pricing of such activities could occur via something like an insurance premium. The FDIC already has made important progress in creating such an approach for large banks, although the price it charges is capped at a low level at this time.

I now turn to reforms to address TBTF where I am concerned policymakers may be asking too much.

Do Not Rely Too Heavily on Traditional Supervision and Regulation (S&R), Resolution Regimes, or Downsizing

Based on direct observation, I am not convinced that supervisors can consistently and effectively prevent excessive risk-taking by the large firms they oversee in a timely fashion, absent draconian measures that tend to throw out the good with the bad. For this reason, I am not confident that traditional S&R can reduce risk sufficiently such that it addresses the problems associated with TBTF status.[6] While policymakers should improve S&R by incorporating the lessons learned over the last two years, it cannot be the bulwark in addressing TBTF.

I do see clear benefits in increasing the scope of bank-like resolution systems to entities such as bank holding companies. Such regimes would facilitate imposition of losses on equity holders, allow for the abrogation of certain contracts, and provide a framework for operating an insolvent firm. These steps address some spillovers and increase market discipline. But I have long argued that the resolution regime created by FDICIA would not, by itself, effectively limit after-the-fact protection for creditors of systemically important banks.[7] Events over the last two years have largely reinforced those concerns. A bank-like resolution regime for nonbanks, which creates a systemic-risk exception, leaves some potential spillovers remaining, and so it is a necessary but not sufficient reform to address TBTF.

Finally, there has been increased discussion of efforts to address TBTF by making the largest financial firms smaller. My concerns here are practical and do not reflect any particular empathy for managers or equity holders of large firms. In short, I think efforts to break up the firms would result in a focus on a very small number of institutions, thereby leaving many systemically important firms as is. Moreover, I am skeptical, for the reasons noted above, that policymakers will effectively prevent the newly constituted (smaller) firms from taking on risks that can bring down others.

Conclusion

Maintaining the status quo with regard to TBTF could well impose large costs on the U.S. economy. We cannot afford such costs. I encourage you to focus on proposals that address the underlying reason for protection of creditors of TBTF financial institutions, which is concern for financial spillovers. I have offered examples of such reforms. Absent these or similar reforms, I am skeptical that we will make significant progress against TBTF.

[1] We discuss other potential motivations that could lead to TBTF support and why we think spillovers are the most important motivation in Gary H. Stern and Ron J. Feldman, 2009, *Too Big To Fail: The Hazards of Bank Bailouts*, chapter 5.

[2] More generally, see the testimony of Daniel K. Tarullo on March 19, 2009, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs for options for modernizing bank supervision and regulation, including many that seek to foster financial stability.

[3] The appendix includes summaries of the key arguments in our book on TBTF, more recent analysis applying the recommendations in the book to the current crisis, and an initial analysis of proposals to address TBTF by making large financial institutions smaller. Our writings on TBTF can be found at http://www.minneapolisfed.org/publications_papers/studies/tbtf/index.cfm.

[4] Raghuram Rajan made a similar recommendation in "The Credit Crisis and Cycle Proof Regulation," the Homer Jones Lecture at the Federal Reserve Bank of St. Louis, April 15, 2009.

[5] We discuss such a recommendation, based on work by Mark Flannery, briefly on page 128 of the TBTF book. For a more current discussion of this idea, along with other proposals to address TBTF, see the analysis carried out by the Squam Lake Working Group on Financial Regulation at http://www.cfr.org/thinktank/greenberg/squamlakepapers.html.

[6] For a fuller discussion, see Appendix C of the TBTF book.

[7] For a fuller discussion of limitations of the FDICIA resolution process, see Appendix A of the TBTF book.