CAPITALISM
AND
THE PROCESS OF RENEWAL

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Introduction

Thank you for inviting me here today for what is an especially timely discussion.

Those who are familiar with my public remarks know that I do not accept that some firms are “too big to fail.” I do not believe it's inevitable or desirable to continue to have too-big-to-fail financial institutions because they pose an ongoing threat to financial stability. Now is the time to seriously consider a mandatory resolution process based on an objective set of criteria that puts the largest financial organizations on notice they won’t receive a disproportionate subsidy or guarantee.

When the financial crisis was unfolding, public authorities responded with a number of ad hoc steps. These actions kept afloat several large financial and nonfinancial firms whose collapse many thought would prove devastating to the financial system and the economy. The names of the institutions are well known: AIG, Bear Stearns, Fannie Mae, Freddie Mac and Merrill Lynch. There were also initiatives to support financial sector firms through TARP money.

With few exceptions, the steps taken to support these firms were outside the normal framework established to deal with troubled entities. The related actions raise important questions around too big to fail and whether traditional corporate bankruptcy procedures and bank receiverships are adequate to the task of resolving failed firms. The options chosen also raise important issues of fairness and the equity of outcomes. We know that public assistance involves political choice, which too often undermines market discipline and the process of failure and renewal so essential to the long-run success of our capitalistic system.

In my remarks this afternoon, I will discuss the role that I believe bankruptcy and bank receivership authority must play in a financial crisis, the lessons we should learn from our recent experience, and what steps we should put in place to deal with future disruptions.

The resolution of depository institutions and corporate bankruptcies

Managing insolvency for depository institutions differs markedly from what we do with most other corporations. Although we have many experts here on both bank resolution and corporate bankruptcy, I would like to briefly compare these approaches before discussing issues around the resolution of large failing institutions.

Our approach in dealing with insolvent banks is largely based on the idea that because banks serve a critical role in the payments and credit systems, their failures involve potential costly externalities. Bank failures, of any size, could lead to significant disruptions in the ability of individuals and businesses within a community to carry out timely transactions. Furthermore, if the largest institutions are involved, these disruptions could bring about a systemic breakdown in financial markets and cause substantial harm to the overall economy.

The primary focus in bank resolutions is to protect depositors at the least cost to the insurance fund and, wherever possible, ensure continued access to banking services with minimal disruption to the overall economy. This requires timely action. As such, bank resolutions occur under an administrative process with the FDIC acting as receiver. The FDIC has a number of “superpowers” it can use in its role, including the ability to reorganize or restructure a failed bank, sell portions of the bank’s assets and operations, and repudiate certain types of claims and contracts.

Overall, the bank resolution process moves quickly through prescribed steps.

The failure of nonfinancial corporations involves a more deliberative process. Although the failure of these firms may have a significant effect on individuals and economic outcomes, they do not pose the same type of liquidity and systemic issues as the failure of a bank. Consequently, the resolution process differs in some important ways from that of banks; most notably the resolutions are handled through the bankruptcy courts and are initiated either by a firm's creditors or its managers. The court process concentrates on maximizing the value of the firm and the creditors' claims either through the firm's liquidation or as an ongoing concern. Bankruptcy courts, moreover, could be characterized as part of a "time out" process in which neutral judges work with creditors and other parties to resolve conflicts of interest and protect creditors.

Despite the differences in these two processes, there are important commonalities as well. In both cases there is a strict set of procedures established under the rule of law that sets out, for example, a "priority of claims." Also, both focus on an orderly process and equitable outcomes with care being taken to minimize political factors that might otherwise interfere with the resolution process.

Lessons to be learned

Although we have a legal framework for dealing with failing institutions, we have learned that, in a crisis, the "systemic spillover" that can emerge from failures of our largest institutions and the threat to the broad economy require additional consideration. The most recent examples of this have led to the suspension of normal bankruptcy and bank resolution processes, thus institutionalizing the concept of too big to fail in our economic system.

Even outside of the banking system, major securities firms and AIG, an insurance company, were thought to be systemically significant because of their many connections and exposures with other firms and markets. Therefore, it was concluded they could not be put through bankruptcy. Many view the bankruptcy of Lehman Brothers and its aftermath as a justification for bailing out other large financial institutions.

But we have also learned, or been reminded, that too big to fail has adverse consequences as well. Every financial crisis leaves a trail of losses embedded among market participants. The process of recovery must start with the recognition of these losses, which then must be distributed among the participants. Moreover, in some instances the extent of the losses ultimately requires the recapitalization or closing of the institutions and the replacement of the management responsible for the failure. When exceptions are made to this process for any set of institutions, especially our largest, this process of recovery is delayed or compromised. In addition, taxpayers most often must bear the burden of recapitalizing too-big-to-fail institutions, placing billions of dollars of their funds at risk. And too often, the management who created the problems or who failed to demonstrate the leadership necessary to properly run the institution remains in place.

Such interventions tend to break down market discipline and involve public authorities, not the market, choosing winners and losers. In FDIC receivership or bankruptcy, institutions and claimants must deal with using tested procedures and a set of rules that help ensure that all parties, regardless of size, are treated comparably. With too big to fail, this process is suspended and firms are treated differently based on one criterion: size.

Thus, while in the middle of a crisis, short cuts to tested resolution processes may appear and even be necessary, they almost certainly leave us with a less efficient and less competitive marketplace.

What steps should we take?

As policymakers consider the administration's recent proposal for a new resolution authority for systemically important financial institutions, it is crucial that we ask ourselves several important questions. For example, given what we have learned from this crisis, how can we address the issue of systemic vulnerability that is inherent in any system with institutions allowed to be too big to fail? How can we better assure that managers, stockholders and creditors know that there will be a credible system that puts them at risk? And how can we resolve large institutions without raising systemic concerns or disrupting key financial activities or markets? I suggest there are three fundamental steps to addressing the matter of too big to fail.

First, there needs to be a set of basic rules of performance that apply to systemically important institutions. I would emphasize that these rules need to be easily understood and enforceable. For example, I strongly support simple leverage standards for setting capital requirements at financial institutions. Leverage restrictions, once assigned, are simple to understand and calculate. They are straightforward to enforce and, if enforced appropriately, are countercyclical. Risk-based capital standards, in contrast, are complex, procyclical, and easier to avoid. Many institutions, in fact, have significantly underestimated their risk exposure over the last few years. These errors could have left them with even greater capital shortages if they had been free to follow a true risk-based capital approach. While no system is perfect, clear and firm rules are easier to understand and enforce. Principles-based oversight is an exercise in philosophy, not a supervisory framework.

Second, there must be a clearly defined resolution regime for systemically important firms that are in financial trouble. When addressing serious problems, such a regime should set forth fundamental steps that ensure a continuity of key operations but which also carefully confine policymakers from making special exceptions to a defined process.

Some have well illustrated the responses associated with the recent crises to an emergency crew acting to save a burning home before it destroys the entire neighborhood. I agree that acting to save the neighborhood was important. However, to extend the metaphor, if the fire was started by a homeowner who ignored fire codes and smoked in bed, should the neighbors be required to rebuild the home at twice its original size at their expense?

While we could have addressed the too big to fail issue with current tools, a statutorily sanctioned resolution process would significantly improve our ability to deal with failed large bank holding companies and large nonbank financial institutions. The Treasury Department's plan for Financial Regulatory Reform and its resolution regime for failing bank and other financial holding companies provide a starting point for discussing the issue of too big to fail institutions, but it is only a start.

In the proposal there are a number of issues that deserve careful consideration. They include, for example, how solvency recommendations would be determined among the consolidated and financial subsidiary regulators. Also, the process will need to be much more specific in how we determine which institutions and activities would be regarded as systemic and come under the federal safety net or public protection. For example, I would limit such boundaries to those institutions that are directly and indirectly part of our economy's plumbing:

our system for payments and for the provision of liquidity. Inside these boundaries would be all banks and bank holding companies and any institution that has direct access to the payments system and to the Federal Reserve discount window. On the other hand, hedge funds would be outside the boundaries of the safety net, although they could be required to register and report under SEC rules. The plan must also more precisely define how the cost of resolving a large institution would best be distributed. Such costs are substantial and should be allocated to those institutions that benefit the most from the public safety net.

The most important part of any plan, however, will be the requirement that public authorities resolve such institutions by taking them into receivership and restructuring them to emerge under new and more careful management and ownership. This step should be taken whenever the chartering and supervisory authorities judge an institution to be insolvent from a liquidity or balance sheet perspective, and I would advocate no exceptions. If a resolution process exists, then few, if any, exceptions will be necessary.

Under the pressure of a crisis, as we have seen, it is difficult to avoid a piecemeal approach to dealing with systemically important institutions with all of the unintended consequences that seem to follow. Thus, our energies in refining the proposed legislation should focus on how best to narrow the exceptions and assure that a receivership or bankruptcy framework operates according to the rule of law and insulated from political interference. In banking, Congress has set the receivership rules with independent regulators making solvency decisions and carrying out the resolution process. A similar format must be part of the resolution process for systemically important, large financial organizations.

Third, in resolving issues around any failed firm, especially too big to fail firms, management and stockholders must be accountable for their actions. Restructured firms must have new – and more careful – management and ownership.

Too often institutions drift without a clear vision of the organization's goals with no one making the hard decisions. Other shortcomings include a failure or unwillingness to understand the financial instruments the institution holds, relying on mechanics rather than sound judgment. Too often management has a greater concern for expanding the balance sheet than for managing existing activities. Within today's largest organizations, we have learned of individuals who willingly carried a hefty title for the purpose of representation of the organization but with no understanding – and no requirement or desire to understand – the business lines, operations or condition of the organization. From the volume of complaints blaming rating agencies for the current crisis, it seems that far too few senior executives in these largest organizations believed it was their responsibility to understand the financial products their company was buying and trading in quantities of billions and trillions of dollars. This is not only unacceptable, but also a dereliction of duty.

Dealing with leadership issues is challenging and should be addressed by respective boards and stockholders. But if a board fails to do so, then the company's likelihood of failure increases. When failure occurs, certainly new management must be required as part of any resolution process. One might observe that a CEO and his board of directors are hardly in a position to be angry with any government-imposed restrictions on compensation when they neglected their responsibility to manage a sound company.

A final point that needs to be highlighted is that there must be confidence in the fairness of any resolution process if it is to be successful over time. Capitalism works only if all competitors are held to the same standard and have equal opportunities to succeed or fail. With too big to fail, capitalism is compromised and equity of opportunity is sacrificed to expediency.

The vast majority of banks in the United States have complied with regulations and requirements that, though necessary, are costly. These banks have played by the rules or suffered the consequences of not doing so during market turmoil. Understandably, today these smaller institutions are concerned about the prospect of increased regulatory requirements and an increased competitive advantage that flows to the largest firms. Such an outcome would undermine confidence in the market system that has brought this country past success.

Conclusion

The current crisis has made it clear that the group of systemically important firms that might be deemed worthy of special consideration by policymakers is larger than previously thought. This extension of the too big to fail concept, along with the wide variety of public assistance and guarantees we've seen used in recent months, make it even more important that policymakers find ways to deal with large failing institutions.

Failing to have a process that operates according to the rule of law and is free of political influence means an even larger section of our financial markets will operate on the assumption that the idea of failure – a key element in market discipline – does not apply in all instances. Once this happens, it will be difficult for other institutions to survive and compete, and for our markets to be competitive and efficient. Importantly, it will not be realistic for any authority in any regulatory structure to oversee a system where incentives remain to take on excessive risk.