Ending 'Too Big to Fail' Is Going to Be Hard Work

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Let me start by welcoming the Global Interdependence Center to Richmond, Va., and by thanking them for the invitation to speak with you this morning. My topic concerns the relationship between the financial sector and the public sector in the United States. The financial crisis of 2007–08 exposed fundamental flaws in that relationship, and a wide range of reform proposals subsequently emerged, many of which were considered in the debate leading up to the Dodd-Frank financial regulatory legislation of 2010. Some found their way into the act itself, but that did not put an end to debates about finance and government in our postcrisis world. Indeed, an array of proposals have garnered attention in recent months, from breaking up large financial institutions to expanding existing government backstops to a broader range of financial market activities. While many ideas have been put forth, there appears to be widespread agreement on at least one of the goals of financial reform — ending "too big to fail." This morning, I would like to discuss what I believe needs to be done to end "too big to fail." As always, my remarks today will reflect my own views and are not necessarily shared by others in the Federal Reserve System.[1]

The phrase "too big to fail" has become something of an all-purpose descriptor for problems afflicting financial markets. It's actually a bit of a misnomer, though, because of the multiple meanings of the word "failure." One might think that protecting a firm from failure means protecting shareholders from losses. But the incentive problems associated with the phenomenon we call "too big to fail" stem more from the protection of creditors. A firm could "fail" in the sense that its equity is wiped out and management of the firm's operations is removed, but if creditors expect government support that limits their losses, then their incentive to avoid risk will be severely depressed. A firm that can borrow with implicit government guarantees will find debt to be relatively inexpensive and will be more highly leveraged than if its debt were fairly priced.

Broadly stated, "too big to fail" consists of two mutually reinforcing problems. First, creditors of some financial institutions feel protected by an implicit government commitment of support should the institution become financially troubled. Second, policymakers often feel compelled to provide support to certain financial institutions to insulate creditors from losses. Instances of such intervention reinforce creditors' expectations of support and encourage reliance on highly liquid funding sources that make such support more likely. Creditor expectations of support, in turn, force policymakers to intervene in the event of distress, since disappointing those expectations by withholding support would provoke a sudden, turbulent readjustment of investor expectations regarding support for other, similarly situated firms. Perceived guarantees thus encourage fragility, which induces interventions, which encourages further fragility. The result is seriously distorted incentives to monitor and control risk and taxpayer-funded subsidies to financial firms that are widely viewed as deeply unfair.

To end "too big to fail," therefore, we need to bring about two mutually reinforcing conditions. The first is that creditors do not expect government support in the event of financial distress. The second is that policymakers allow financial firms to fail without government support. If we can achieve that commitment and make it credible to market participants, we can improve private sector incentives to avoid fragile financing arrangements and limit risk-taking, thereby reducing the pressure for government intervention.

Allowing a financial firm to fail without government support for creditors does not mean that the operations and activities of the failing firm will simply come to an abrupt halt. Outside of the financial sector, most firms — even relatively large ones — fail by filing for bankruptcy, thereby initiating court-supervised procedures to either restructure obligations and continue operations or liquidate assets and distribute the proceeds to creditors. If it proves more valuable to creditors, collectively, to continue the firm's operations as a going concern than to liquidate, bankruptcy provides a mechanism for doing so. Indeed, several large airline companies have gone through bankruptcy reorganization while continuing regular flight operations.

A key provision of Title I of the Dodd-Frank Act requires that bank holding companies larger than $50 billion in assets, as well as certain nonbank financial companies, draw up detailed plans for their orderly resolution in bankruptcy, without government assistance, and submit them to regulators.[2] In my remarks, I will discuss the work currently underway on these resolution plans, also known as "living wills." I will argue that resolution planning represents the most promising path toward ending "too big to fail." Indeed, I believe that without robust and credible resolution plans, other financial reform strategies will be incomplete and likely to fall short.

We Didn't End 'Too Big to Fail'

Much of the financial reform agenda since the crisis has focused on enhancing the supervision of large financial firms, with the goal of reducing the probability that they experience financial distress. For example, regulators have implemented enhanced capital and liquidity standards for so-called "systemically important financial institutions." Through the capital stress test process, regulators regularly assess whether firms' current and planned capital positions would prove adequate under plausible adverse scenarios. These and other supervisory enhancements are essential to containing moral hazard and improving financial stability.

While capital levels at large U.S. financial firms have improved, some critics argue that substantial further increases in capital requirements are warranted.[3] Higher capital ratios, all else constant, would reduce the probability that a financial firm incurs losses large enough to make it insolvent. One clear lesson of the financial crisis, in my view, is that capital ratios at large financial firms were inadequate. But another lesson of the financial crisis is that we need some attention as well to what actually happens in the event that a large financial firm becomes insolvent, as rare as that may be. Once a firm's capital has been eroded, the fact that it had higher capital before being hit by shocks is of little comfort. The complexity of modern financial firms and the resulting apprehensions about the consequences of their unassisted failure motivated the wide array of government and Fed actions taken during the financial crisis. The anticipation of those responses can have powerful incentive effects in normal times. Because we are unlikely to raise capital levels high enough to completely eliminate the possibility of financial failure, it's essential that we be prepared to handle such failures, should they occur.

Some observers argue that the problems associated with resolving a large or complex financial institution have largely been addressed. In particular, they point to the Federal Deposit Insurance Corp.'s Orderly Liquidation Authority, or OLA, as credible mechanism for resolving financial firms without bailouts. This portion of the Dodd-Frank Act, Title II, gives the FDIC the authority, 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.[4] Many provisions of Title II mirror provisions of the bankruptcy code, and in winding down a firm under the OLA, the FDIC is to be guided by what various claimants would be estimated to receive in a bankruptcy proceeding. But the FDIC does have the ability to deviate in some important ways from what might occur under bankruptcy. In particular, it can make payments to creditors it deems "necessary," and it can draw on funds from the Treasury to do so.[5] Indeed, the FDIC has announced its willingness to do so in some circumstances.[6] This ability, and willingness, opens the door for creditors to believe they might benefit from such treatment and therefore to pay less attention to risk than they should. If expectations of support for financially distressed institutions in orderly liquidation became widespread, regulators would likely feel forced to provide support simply to avoid the turbulence of disappointing expectations. We will have replicated the two mutually reinforcing problems that define "too big to fail."

What to Do?

This feature of the implementation of Title II — that it recreates the capabilities and incentives that originally gave rise to excessive government rescues — motivates the view that more needs to be done in order to truly end "too big to fail." Many recent proposals to address the problem would make structural changes to financial firms — imposing quantitative limits on their size, for instance, or prohibiting certain risky capital market activities.[7] In my view, it makes perfect sense to constrain the scale and scope of financial firms in a way that ensures that they can be resolved in an orderly manner, without government protection for creditors. But how would you know you have chosen the right limits? Is size alone the issue, and if so, how small should you make them? If activities are the problem, which ones make them hard to resolve? And how do you know you haven't gone too far and sacrificed valuable efficiencies that may derive from the current industrial organization of the financial system?

The only approach I can envision to answering such questions is resolution planning — that is, the hard work of mapping out in detail just what problems the unassisted bankruptcy of a large financial firm as it's currently structured might encounter. Such maps would provide an objective basis for judgments about how the structure or activities of such firms need to be altered in order to give policymakers the confidence to choose unassisted bankruptcy in the event of distress, but without going too far and unnecessarily eliminating efficiencies associated with economies of scale and scope. 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.[8]

Living Wills

The Dodd-Frank Act requires that bank holding companies larger than $50 billion in assets, as well as nonbank financial companies supervised by the Fed, submit resolution plans annually to the Federal Reserve and the FDIC.[9] A final rule implementing this provision was announced by the Fed and the FDIC in October 2011. A plan, or "living will," is a description of a firm's strategy for rapid and orderly resolution under the U.S. Bankruptcy Code in the event of material financial distress or failure. It must contain a detailed description of 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 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 operations of and funding for material entities. Firms are required to provide analysis under the three economic scenarios stipulated in the Board of Governors capital stress test analysis — "baseline," "adverse" and "severely adverse." Plans may *not* rely on the provision of extraordinary support by the U.S. government.

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 higher 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.

Regulators last year required the first round of submissions from the largest U.S. firms and foreign-based companies with significant U.S. assets.[10] These plans reflect considerable effort by covered companies to address requirements of the resolution plan rule. Through the process of developing the plans, firms deepened their understanding of their own structure and operations, as well as the vulnerabilities that may arise in resolution. The plans have provided improved insight into the workings of firms, including their complex legal entity structures, financial and operational interconnectedness across the different affiliates, and those critical operations that are crucial to financial stability. These insights are being used to enhance supervision more broadly and promote industry best practices.

The process of constructing a set of robust and credible living wills must be iterative. Because of the magnitude of the planning efforts required, it made sense to have streamlined requirements for the initial round of submissions; for example, firms were asked for analysis under just one economic scenario, rather than three. First-round submissions have provided valuable lessons learned, both for covered firms and for supervisors, about areas where further analysis is needed. Regulators intend to provide feedback to these firms to help guide subsequent rounds of submissions. Over time, our collective understanding of how the unassisted resolution of a large financial entity works will deepen. Armed with that understanding, we can bolster policymakers' confidence in the plans through appropriate preparations, including structural changes in the nature and organization of the business operations of financial firms. This confidence can move us closer to the day when bankruptcy is as much of a nonevent in finance as it is in the airline industry.

Hard Work Ahead

Several critical challenges must be addressed, however, for the living wills project to succeed. One relates to globally active financial firms with interdependent entities in different national jurisdictions. Achieving an orderly resolution of such a firm can be difficult, because regulatory authorities in different jurisdictions may be concerned primarily with the continuity of operations and taxpayer impact in their own country.[11] One approach to this problem is to require globally active firms to form distinct legal subsidiaries, with separate capital and liquidity holdings, to conduct material overseas operations, so that they can be resolved separately in the event of distress.[12] The ability to expeditiously sell material foreign operations would provide valuable flexibility and would obviate dependence on cross-national negotiations about interaffiliate movements in capital and funding. Widespread use of subsidiarization could well impose additional operational costs on such firms or limit their ability to shift capital among affiliates. If subsidiarization is what it takes to make a resolution plan credible, however, then the resulting burden to private firms should be viewed as a measure of the subsidization attributable to their "too big to fail" status. This is a good example of the types of trade-offs that the living wills work will help us understand.

Subsidiarization has potentially broader uses in the preparation of living wills. One simple approach to resolution is for the highest-level parent company to file for bankruptcy, treating all the (domestic) affiliates as part of a single concern. This parallels the FDIC's announced intention to handle resolutions under its OLA through a "single point of entry." At the same time, however, we should devote ample effort to being able to sell off significant subsidiaries as stand-alone entities where that might make good economic sense. This might mean investing ahead of time in distinct operational infrastructures or in writing service agreements that would survive the bankruptcy of one affiliate. We should not assume that "all hands go down with the ship" in a single-point-of-entry scenario, when preparing sturdy lifeboats might make better sense.

Perhaps the most critical challenge for resolution planning concerns funding. 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 — for example, to pay off certain creditors, such as vendors, rather than retain them in bankruptcy proceedings. 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 OLA 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 is why firms were prohibited from assuming extraordinary government support in their resolution plans.

For large financial firms, creating a credible funding plan that avoids adverse effects, without resorting to government DIP financing, might seem daunting, given their scale and the limited observed size of private DIP financing to date.[13] The scale of a firm's potential liquidity need, however, is heavily influenced by how it manages liquidity prior to experiencing financial distress. Just as operational obstacles to an orderly resolution can be remedied by reorganizing operations ahead of time, funding challenges that would otherwise arise in the bankruptcy of a large financial firm can be contained through appropriate changes in liquidity management in normal times.

One might worry that the changes in liquidity management required to render a resolution plan credible without government-provided DIP financing might squelch socially beneficial maturity transformation. One should also be concerned, however, that "too big to fail" has resulted in a socially excessive scale of maturity transformation, since the associated fragility is more likely to elicit government support to protect creditors than intermediation that does not involve maturity transformation. In my own view, the latter should be our dominant consideration in the wake of this crisis.

Conclusion

In conclusion, it's vitally important that regulators work together to ensure the adoption of robust and highly credible resolution plans for large financial institutions. The financial industry also has an interest in ending "too big to fail" and thereby strengthening reliance on market discipline, because the alternative implies an ever-expanding blanket of safety and soundness regulations that threatens to smother the ability to offer useful financial products and services.

The living wills program will require a great deal of hard work and detailed analysis. But I see no other way to reliably identify exactly what changes are needed in the structure and operations of financial institutions to end "too big to fail." I see no other way to achieve a situation in which policymakers consistently prefer unassisted bankruptcy to incentive-corroding intervention and investors are convinced that unassisted bankruptcy is the norm.

Credible living wills may require significant changes for financial firms. They could lead to more capital, less complex relationships among affiliates and perhaps even to smaller firms. "Too big to fail" is unsustainable. Ambiguous implied commitments induce fragilities that in turn induce intervention that expands implied commitments. Richmond Fed economists estimated that, at the end of 1999, about 45 percent of financial sector liabilities were explicitly or implicitly government guaranteed. At the end of 2011, as a result of the precedents set during the crisis, they estimated the figure to have grown to 57 percent.[14] This fraction is likely to continue to grow unless we end "too big to fail." And to end "too big to fail," we need to do the hard work of learning what it takes to make all firms safe to fail without government rescues.

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[1] I am grateful for assistance from John Weinberg in preparing these remarks.

[2] See section 165(d) of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

[3] See Anat Admati and Martin Hellwig, "The Banker's New Clothes: What's Wrong with Banking and What to Do about It," Princeton, NJ: Princeton University Press, 2013.

[4] For a comparison of the Orderly Liquidation Authority provisions with the 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.

[5] Funds paid in excess of what a creditor would have received in bankruptcy must be recovered from the disposition of the failed firm's assets, or if this amount is insufficient, from clawing 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. See section 210(o) of the Dodd-Frank Wall Street Reform and Protection Act.

[6] See remarks by Martin J. Gruenberg, acting chairman of the FDIC, to the Federal Reserve Bank of Chicago Bank Structure Conference, May 10, 2012. Gruenberg stated: "The new resolution authority comes with access to a new source of liquidity support provided by the Dodd-Frank Act: the Orderly Liquidation Fund, or OLF, located in the Treasury Department. The OLF must either be repaid from recoveries on the assets of the failed firm or from assessments against the largest, most complex financial companies. Taxpayers cannot bear any loss from the resolution of a financial company under the Dodd-Frank Act. The OLF does address a critical issue to prevent a system-wide collapse, as we saw with the Lehman bankruptcy, because it provides an emergency source of liquidity to allow the bridge financial company to complete transactions that provide real value and prevent contagion effects. While the OLF can be a source of direct funding for the resolution, it can also be used to provide guarantees, within limits, on the debt of the new company."

[7] See, for instance, Richard W. Fisher and Harvey Rosenblum, "Vanquishing Too Big to Fail," in the Federal Reserve Bank of Dallas 2012 Annual Report, and Thomas M. Hoenig, "Financial Reform: Post Crisis?" Address to Women in Housing and Finance, Washington, DC, February 23, 2011.

[8] See Kenneth E. Scott and John B. Taylor (eds.), "Bankruptcy Not Bailout: A Special Chapter 14," Stanford, CA: Hoover Institution Press, 2012.

[9] See section 165(d) of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

[10] The public portions of the plans are available at http://www.federalreserve.gov/bankinforeg/resolution-plans.htm.

[11] Jonathan Fiechter, İnci Ötker-Robe, Anna Ilyina, Michael Hsu, André Santos, and Jay Surti, "Subsidiaries or Branches: Does One Size Fit All?" IMF Staff Discussion Note, March 7, 2011.

[12] The Board of Governors recently proposed requiring foreign banking organizations with a significant U.S. presence to create an intermediate holding company over their U.S. subsidiaries to help facilitate enhanced supervision and regulation. See http://www.federalreserve.gov/newsevents/press/bcreg/20121214a.htm. See also, Daniel K. Tarullo, "Regulation of Foreign Banking Organizations," Address at the Yale School of Management Leaders Forum, New Haven, CT, November 28, 2012.

[13] Lyondell Chemical Company received $8.5 billion in private DIP financing in 2009, the largest case of such financing thus far.

[14] 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.