Statement

Subcommittee on Regulatory Reform, Commercial and Antitrust Law of the Committee on the Judiciary

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Good morning. I am honored to speak to the Subcommittee about the bankruptcy code and financial institution insolvency. In my remarks, I will discuss why I believe it's so important to improve our bankruptcy code to make it feasible to resolve failing financial firms in bankruptcy. At the outset, I 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. My views have been informed by both my experience leading the Fifth Federal Reserve District over the last seven years and as a research economist studying banking policy for the prior 25 years.

The events of 2008 provided evidence, in my view, of glaring deficiencies in the way financial institution distress and insolvency are handled, particularly at large institutions.[1] The problem — widely known as "too big to fail" — consists of two mutually reinforcing expectations. First, many 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. Moreover, it leads to overuse of types of borrowing — such as short-term wholesale funding — that are more fragile and more likely to prompt the need for such protection. Second, policymakers may well worry that if a large financial firm with a high reliance on short-term funding were to file for bankruptcy under the U.S. bankruptcy code, it would result in undesirable effects on counterparties, financial markets and economic activity. This expectation induces policymakers to intervene in ways that allow short-term creditors to escape losses, such as through central bank lending or public sector capital injections. This reinforces creditors' expectations of support and firms' incentives to grow large and rely on short-term funding, resulting in more financial fragility and more rescues.

Expectations of creditor rescues have increased 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.[2] 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.

In response to the experience of 2008, Title I of the Dodd-Frank Act laid out a planning process for the resolution of failed financial institutions. 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. Among other things, 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 critical operations and funding.[3]

The Federal Reserve and the Federal Deposit Insurance Corporation 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 more capital, increase 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.

If there is a determination that, among other things, the firm’s failure under the U.S. bankruptcy code would have serious adverse effects on “U.S. financial stability,” 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. One difference between a Title II receivership and the bankruptcy code is that Title II gives the FDIC the ability to borrow funds from the U.S. Treasury (specifically, the Orderly Liquidation Fund at the Treasury) to make payments to creditors of the failed firm or to guarantee the liabilities of the failed firm.[4] 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 less than they would have received in a liquidation of the firm, the Act provides the FDIC with broad discretion to treat similarly situated creditors differently.[5] This can encourage 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 to these short-term creditors to avoid the turbulence of disappointing expectations. This would replicate the two mutually reinforcing expectations that define “too big to fail.”

Clearly, the Dodd-Frank Act envisions bankruptcy without government support as the first and most preferable option in the case of a failing financial institution, and for good reason, in my view. If resolution in bankruptcy without the expectation of implicit government guarantees comes to be expected as the norm, 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 the creditor rescues that do so much damage to incentives.

The alternative to robust plans for resolution in bankruptcy is to institutionalize the capacity to provide public sector rescues for financial firm creditors outside of bankruptcy, through Title II. This would be a far less desirable path, I believe. Trying to correct these incentive distortions through the regulation of firm size, structure and capital is likely to fall short. This path thus would fundamentally undermine the incentives of financial institutions and their creditors to plan effectively for Title I resolution. And it would continue to tilt financial innovation toward bypassing regulatory constraints and relying on the fragile short-term 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 policymakers have confidence in the unassisted failure of financial firms under the U.S bankruptcy code and that investors are thereby convinced that unassisted bankruptcy is the norm. This is why I believe it is vitally important to ensure our bankruptcy laws are well crafted to apply to large financial institutions.

In evaluating alternative approaches to insolvency and bankruptcy provisions, it would be a mistake to assume that the behaviors of financial firms and their creditors will remain unchanged. For example, I have stressed that the heavy reliance of large financial institutions on wholesale funding markets evolved under the growing expectation of public sector rescues, and is likely to depend sensitively on that expectation. In the absence of that expectation, firms and their creditors would have strong incentives to reduce reliance on fragile short-term funding.

This is relevant to the frequently heard claim that the large "liquidity needs" of failing financial institutions is a stumbling block to resolving such 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 — 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 the continuation of ongoing operations.

The point is that if repayment of short-term obligations in bankruptcy depends on large amounts of DIP financing that would be difficult for a financial institution to obtain, one would expect to see less reliance on short-term credit (at least as long as government-provided DIP financing was not expected to fill the gap). Moreover, an inability to fund necessary operations in bankruptcy is likely to compromise the credibility of a Title I resolution plan. In this case, regulators would be warranted to require less reliance on short-term funding in the first place.

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 and 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 submitted resolution plans. Public sector support can be underpriced and distortionary, and can reallocate returns between creditor classes outside the procedural safeguards of bankruptcy. Discretionary government provision of DIP financing would undermine the integrity and purpose of the bankruptcy code.

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, should provide an objective basis for decisions about how the structure, financing 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 should illuminate efforts to identify ways in which the bankruptcy code could be improved to make the resolution of financial firms more orderly.[6]

Robust and credible resolution plans will position us to 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 in bankruptcy, thereby contributing to a more stable and competitive playing field.

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[1] The inherent problems have been widely noted by economists going back decades before the crisis. See John H. Kareken and Neil Wallace, "Deposit Insurance and Bank Regulation: A Partial Equilibrium Exposition," Journal of Business, July 1978, vol. 51, pp. 413-38; John H. Kareken, "Deposit Insurance Reform or Deregulation Is the Cart, Not the Horse," Federal Reserve Bank of Minneapolis Quarterly Review, Spring 1983, vol. 7, no. 2; Douglas Diamond and Philip Dybvig, "Bank Runs, Deposit Insurance and Liquidity," Journal of Political Economy, June 1983, vol. 91, no. 3, pp. 401-19; Marvin Goodfriend and Jeffrey M. Lacker, "Limited Commitment and Central Bank Lending," Federal Reserve Bank of Richmond Economic Quarterly, Fall 1999, vol. 85, no. 4, pp. 1-27; Gary Stern and Ron Feldman, "Too Big To Fail: The Hazards of Bank Bailouts," Washington, D.C.: Brookings Institution Press, 2004. See also Huberto M. Ennis and Todd Keister, "On the Fundamental Reasons for Bank Fragility," Federal Reserve Bank of Richmond Economic Quarterly, First Quarter 2010, vol. 96, no. 1, pp. 33-58; Federal Reserve Bank of Richmond Economic Quarterly, First Quarter 2010, A Special Issue on the Diamond-Dybvig Model and Its Implications for Banking and Monetary Policy.

[2] 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.

[3] 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. The Federal Reserve's Regulation QQ governing resolution planning can be found at http://www.gpo.gov/fdsys/pkg/FR-2011-11-01/pdf/2011-27377.pdf.

[4] 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.

[5] See Pellerin and Walter, pp. 16-19.

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