Statement by

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before the

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Good morning. I am honored to speak to the Committee about the Dodd-Frank Act and the persistence of "too big to fail."

At the outset, I should point out that within the Federal Reserve System, the Board of Governors has sole authority to write rules implementing the requirements of the Dodd-Frank Act. Federal Reserve Banks supervise financial institutions under authority delegated to them by the Board of Governors. In keeping with Board of Governors guidance, I will not discuss any current or potential Federal Reserve rule-making. I also 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.[1] My views have been informed by both my leadership of the Fifth Federal Reserve District over the last seven years and my experience as a research economist studying banking policy for the prior 25 years.

The problem known as "too big to fail" consists of two mutually reinforcing expectations. First, some 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 and the overuse of forms of debt — such as short-term wholesale funding — that are most likely to enjoy such protection. Second, policymakers at times believe that the failure of a large financial firm with a high reliance on short-term funding would result in undesirable disruptions to financial markets and economic activity. This expectation induces policymakers to intervene in ways that let short-term creditors escape losses, thus reinforcing creditors' expectations of support and firms' incentives to rely on short-term funding. The result is more financial fragility and more rescues.

The Orderly Liquidation Authority of Title II of the Dodd-Frank Act gives the Federal Deposit Insurance Corporation the ability, 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.[2] Title II gives the FDIC the ability to borrow funds from the Treasury (specifically, the Orderly Liquidation Fund at the Treasury) to make payments to creditors of the failed firm. 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 more than they would have received in a liquidation of the firm, the Act provides the FDIC with broad discretion to pay more.[3] This encourages 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 simply to avoid the turbulence of disappointing expectations. We appear to have replicated the two mutually reinforcing expectations that define "too big to fail."

Expectations of creditor rescues have arisen 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.[4] 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.

A financial system without the broad expectation of government rescues for creditors would likely look different — potentially quite different — from the financial system we currently have. Without the expectation of implicit government guarantees, 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 incentive-corroding rescues.

The alternative, accepting the inevitability of an implicit federal backstop and trying to correct the resulting distortions through the regulation of firm size, structure and capital, would lead to far less desirable results, I believe. It would tilt financial innovation toward bypassing regulatory constraints and relying on fragile 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 the unassisted failure of financial firms does not put the financial system at risk. The resolution planning process prescribed by Section 165(d) in Title I of the Dodd-Frank Act provides the road map for this journey.

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. 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 the operations of and funding for their critical operations and material entities.

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 tighter 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.

The living will process can address the frequently heard objections to ending government rescues. Cooperation between international regulators in a crisis is often cited as an impediment to orderly resolution. Forming distinct legal entities for the material overseas operations of globally active firms, with separate capital and liquidity holdings, can solve this problem by facilitating the expeditious sale of material foreign operations and obviating dependence on cross-national negotiations about interaffiliate movements in capital and funding.

The so-called "liquidity needs" of failing institutions is often cited as a stumbling block to resolving financial 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. 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 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 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 why firms were instructed not to assume extraordinary government support in their resolution plans. A financial firm's liquidity requirements in bankruptcy, however, are a direct function of decisions made prior to entering bankruptcy. A credible living will would include plans for funding critical operations, without government support, throughout the resolution process.

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, will provide an objective basis for decisions about how the structure 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 would illuminate efforts to identify ways in which the bankruptcy code could be improved to make the resolution of financial firms more orderly.[5]

Resolution planning will require a great deal of hard work.[6] But I see no other way to ensure that policymakers have confidence in unassisted bankruptcy and that investors are convinced unassisted bankruptcy is the norm. Resolution planning provides the framework for identifying the actions we need to take now to ensure that the next financial crisis is handled appropriately, in a way that is fair to taxpayers and establishes the right incentives.

Once robust and credible resolution plans are in place, we would be in a position to responsibly 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.

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[1] I am grateful to John Weinberg for assistance in preparing this statement.
[2] 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.
[3] See Pellerin and Walter, pp. 16-19.
[4] 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.
[5] See Kenneth E. Scott and John B. Taylor (eds.), *Bankruptcy Not Bailout: A Special Chapter 14*, Stanford, CA: Hoover Institution Press, 2012.
[6] 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.