STATEMENT OF

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on

”DOES THE DODD-FRANK ACT END TOO BIG TO FAIL?”

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Chairman Capito, Ranking Member Maloney, and members of the Subcommittee, thank you for the opportunity to testify today on behalf of the Federal Deposit Insurance Corporation (FDIC) on the question of whether the Dodd-Frank Wall Street Reform and Consumer Protection Act ends "Too Big to Fail."

Prior to the enactment of the Dodd-Frank Act, the market operated in the belief that the largest financial institutions were "Too Big to Fail." This resulted in ineffective market discipline and insufficient consideration of moral hazard by management and investors. The financial crisis of 2008 centered on those institutions that constituted the so-called shadow banking system—a network of large-bank affiliates, special-purpose vehicles, and nonbank financial companies that existed not only largely outside of the prudential supervision and capital requirements that apply to federally insured depository institutions in the U.S., but also outside of the FDIC's process for resolving failed insured financial institutions through receivership.

Further, several of the large, complex U.S. financial companies at the crux of the 2008 crisis could not be wound down in an orderly manner. This required policymakers to take steps that were unpalatable. Bank holding companies, other large financial companies, and major components of their operations were subject to the Bankruptcy Code, as opposed to bank receivership laws. Many of those firms also had major operations outside the U.S., which inevitably would be resolved separately in bankruptcy proceedings, as occurred in the Lehman Brothers, Inc. bankruptcy proceedings. Given the options of a bankruptcy proceeding in the middle of the 2008 financial turmoil or providing financial assistance to avoid potential insolvencies, policymakers in several instances chose to provide financial assistance. Given the absence of a non-bankruptcy option to prevent a disruptive collapse, government assistance was necessary to prevent the effects of these failures from cascading through the financial system, freezing financial markets and stopping the economy in its tracks.

As it happened, these fears were realized when Lehman Brothers, Inc. — a large, complex, nonbank financial company — filed for bankruptcy on September 15, 2008. Anticipating the complications of a long, costly bankruptcy process, counterparties across the financial system reacted to the Lehman Brothers failure by seeking the safety of cash and other government obligations. Subsequent days and weeks saw the collapse of interbank lending and commercial paper issuance, and a near complete disintermediation of the financial system. The only remedy was massive intervention on the part of governments around the world, which pumped equity capital into banks and other financial companies, guaranteed certain non-deposit liabilities, and extended credit backed by a wide range of illiquid assets to banks and nonbank firms alike. Even with these emergency measures, the economic consequences of the crisis have been enormous.

If certain key elements of the Dodd-Frank Act, such as the orderly liquidation authority, had not been adopted, the pre-crisis expectation of government support for the larger financial companies, and the demonstrated reality of the support during the crisis, would have institutionalized a level of moral hazard that would lay the foundation for a future crisis. With the pre-existing expectation of a government backstop, the largest financial companies are insulated from the normal discipline of the marketplace that applies to smaller banks and practically every other private company. Unless reversed, the result is likely to be more concentration and complexity in the financial system, more risk-taking at the expense of the public, and, in due time, another financial crisis. However, the Dodd-Frank Act introduces several measures in Title I and Title II that, together, provide the basis for a new supervisory and resolution framework designed to render any financial institution "resolvable," in a manner that mitigates systemic risk to the financial stability of the U.S. while minimizing moral hazard. This orderly liquidation authority effectively eliminates the implicit safety net of Too Big to Fail that has insulated these institutions from the normal discipline of the marketplace.

The new framework for resolving companies designated as Systemically Important Financial Institutions - or SIFIs – under the Dodd-Frank Act effectively ends Too Big to Fail. Certain tools granted by the Act are critical to imposing the market discipline that previously was lacking in these institutions. The three basic elements of the Dodd-Frank Act that together help end Too Big to Fail are: the power to designate and subject SIFIs to heightened prudential supervision by the Federal Reserve Board ("FRB"); the power to collect the information necessary to plan and prepare for or to avoid the necessity of the resolution of a SIFI, including the requirement for SIFI's to prepare detailed resolution plans; and the orderly resolution authority to ensure that, if necessary, a SIFI can be resolved without recourse to a bailout.

In my testimony I would like to clarify some misconceptions about these authorities and highlight some priorities the FDIC sees for their effective implementation.

SIFI Designation. The new Financial Stability Oversight Council (FSOC), chaired by the Treasury Secretary and made up of the other financial regulatory agencies, is responsible for designating SIFIs, based on criteria that are now being established. The Dodd-Frank Act specifies a number of factors to be considered when designating a nonbank financial company as a SIFI for supervision by the FRB, including: leverage, off-balance-sheet exposures, and the nature, scope, size, scale, concentration, interconnectedness and mix of activities of the SIFI enterprise. We believe that the ability of an institution to be resolved in a bankruptcy process without systemic impact should be a key consideration in deciding whether to designate a firm as a SIFI. This consideration is consistent with, and implicit in, the analysis of the other factors described above. The FSOC is in the process of developing a combination of qualitative and quantitative measures of potential risks to the U.S. financial stability that may be posed by individual nonbank institutions.

It is important to clarify that being designated as a SIFI will in no way confer a competitive advantage by anointing an institution as Too Big to Fail. The reality is that SIFIs will be subject to heightened supervision and higher capital requirements. They also will be required to develop and maintain detailed, analytical resolution plans showing how they can be resolved under the Bankruptcy Code. The preparation of these plans will require these companies to consider how their businesses can best be structured and operated in a way to maximize shareholder value and achieve a workable set of resolution options. In short, this process should improve efficiency.

Ultimately, a SIFI could be required to restructure its operations if it cannot demonstrate that it is resolvable in an orderly manner under the Bankruptcy Code. However, we fully anticipate that SIFIs will pursue the resolution planning process in a way to meet the statutory requirements. In light of these significant regulatory requirements, the FDIC has detected absolutely no interest on the part of any financial institution in being named a SIFI. Indeed, many institutions are vigorously lobbying against such a designation.

It is essential, however, that the FSOC act expeditiously to gather information and designate the appropriate SIFIs. Otherwise, we face the specter of a "deathbed designation" of a SIFI, whereby the FDIC would be required to resolve the firm under a Title II resolution without the benefit of a resolution plan or the ability to conduct advance planning, both of which are so critical to an orderly liquidation. This situation, which would force the FDIC to exercise its authority as receiver at a severe and possibly crippling disadvantage, must be avoided at all costs. Thus, we need to be able to collect detailed information on a limited number of potential SIFIs as part of the designation process. We should provide the industry with some clarity about which firms will be expected to provide the FSOC with this additional information, using simple and transparent metrics, such as firm size, similar to the approach used for bank holding companies under the Dodd-Frank Act. This should reduce some of the mystery surrounding the process and should eliminate any market concern about which firms the FSOC has under its review. By collecting information in advance of designation, the FSOC can be much more judicious in determining which firms it designates as SIFIs. This will minimize both the threat of an unexpected systemic failure and the number of firms that will be subject to additional regulatory requirements under Title I of the Dodd-Frank Act.

The FSOC issued an Advanced Notice of Proposed Rulemaking ("ANPR") last October and a Notice of Proposed Rulemaking ("NPR") on January 26, 2011, describing the processes and procedures that will inform the FSOC's designation of nonbank financial companies under the Dodd-Frank Act. We recognize the concerns raised by several commenters to the FSOC's ANPR and NPR about the lack of detail and clarity surrounding the designation process. This lack of specificity and certainty in the designation process is itself a burden on the industry and an impediment to prompt and effective implementation of the designation process. That is why it is important that the FSOC move forward and develop some hard metrics to guide the SIFI designation process. The sooner we develop and publish these metrics, the sooner this understandable uncertainty can be resolved. The FSOC is in the process of developing for comment further clarification of the metrics that will provide more specificity as to the measures and approaches we are considering using for designating non-bank firms as SIFIs.

SIFI Resolution Plans. Once designated, the SIFIs will be subject to heightened prudential supervision by the FRB and required to maintain detailed, *credible* resolution plans that demonstrate that they are resolvable under the Bankruptcy Code if they should run into severe financial distress. As noted in Chairman Bair's February 2011 testimony before the Senate Banking Committee, the court-appointed trustee overseeing the liquidation of Lehman Brothers found that the lack of a disaster plan "contributed to the chaos" of the Lehman Brothers bankruptcy and the liquidation of its U.S. broker-dealer.

When a large, complex financial institution gets into trouble, time is the enemy. The larger, more complex, and more interconnected a financial company is, the longer it takes to assemble a full and accurate picture of its operations and develop a resolution strategy. By requiring detailed, analytical resolution plans in advance, and authorizing an on-site FDIC team to conduct pre-resolution planning, the Dodd-Frank Act gives the FDIC, the FRB and the FSOC information from the largest potentially systemic financial companies that will allow for extensive advance planning both by regulators and by the companies themselves. The SIFI resolution plan framework under the Dodd-Frank Act provides the informational advantage that was lacking in the crisis of 2008.

The FDIC recently released a paper detailing how the filing of resolution plans, the ability to conduct advance planning, and other elements of the framework could have dramatically changed the outcome if they had been available in the case of Lehman.[1] Under the new SIFI resolution framework, the FDIC should have a presence at all

[1] "The Orderly Liquidation of Lehman Brothers Holdings under the Dodd-Frank Act," *FDIC Quarterly*, Vol. 5, No. 2, 2011. http://www.fdic.gov/regulations/reform/lehman.html

designated SIFIs, working with the firms and reviewing their resolution plans as part of their normal course of business. If this is the case, the onsite presence of the FDIC would not be seen as a signal of distress, but rather as a positive sign that management is routinely being encouraged to consider fully any downside consequences of its actions, to the benefit of the institution and the stability of the system as a whole.

The law also authorizes the FDIC and the FRB to require, if necessary, changes in the structure or activities of these financial institutions to ensure that they meet the standard of being resolvable through bankruptcy in a crisis. The FDIC hopes that the SIFIs themselves will take action to meet the statutory requirements because it will improve efficiencies and make our system more resilient. Certainly, the FDIC and the FRB must be willing to use their authority actively to require organizational changes that promote the ability to resolve SIFIs, if a resolution plan is not credible.

As currently structured, many large banks and nonbank SIFIs maintain hundreds - even thousands - of subsidiaries and manage their activities within business lines that cross many different organizational structures and regulatory jurisdictions. This can make it very difficult to implement an orderly liquidation of one part of the company without triggering a costly collapse of the entire company. To solve this problem, the FDIC and the FRB must be willing to insist on organizational changes that better align business lines and legal entities well before a crisis occurs. Unless these structures are rationalized and simplified in advance, there is a real danger that their complexity could make a SIFI resolution far more costly and more difficult than it needs to be.

Such changes are also likely to have collateral benefits for the firm's management in the short run. A rationalized organizational structure will put management in a better position to understand and monitor risks and inter-relationships among business lines, addressing what many see as a major factor that contributed to the crisis. That is why—well before the test of another major crisis—we must put in place high informational standards for resolution plans and be willing to insist on organizational changes *where necessary* in order to ensure that SIFIs meet the standard of resolvability.

The Dodd-Frank Act requires the FDIC and the FRB jointly to issue final regulations within 18 months of enactment to implement new resolution planning and reporting requirements. These rules will apply to bank holding companies with total assets of $50 billion or more and nonbank financial companies designated by the FSOC as SIFIs. A Notice of Proposed Rulemaking for such a joint rule on *Resolution Plans and Credit Exposure Reports* was published in April, and the comment period closed last week. Under the NPR, covered companies would be required to submit a credit exposures report on a quarterly basis to outline the nature and extent of their exposures. Additionally, covered companies would be required to submit a resolution plan within 180 days of the final regulation. The NPR indicates that resolution plans should identify and map covered companies' business lines to legal entities and provide integrated analyses of their corporate structure; credit and other exposures; funding, capital, and cash flows; domestic and foreign jurisdictions in which they operate; their supporting information systems and other essential services; and other key components of their business operations. As part of that rulemaking, the agencies are working diligently to develop a thoughtful and substantive process for reviewing resolution plans to determine whether a plan is both credible and would facilitate an orderly resolution of the company under the Bankruptcy Code. If after two years, and the imposition of more stringent standards, the resolution plan still does not meet the statutory standards, the FDIC and the FRB may, in consultation with the FSOC, direct a company to divest certain assets or operations. The resolution plan requirement in the Dodd-Frank Act appropriately places the responsibility on financial companies to develop their own plans "for rapid and orderly resolution in the event of material financial distress or failure" with review by the FDIC and the FRB.

Orderly Liquidation Authority (OLA) Finally, the law provides for an alternative to bankruptcy -— an orderly liquidation authority (OLA) that gives the FDIC many of the same receivership powers over SIFIs that we have long used to manage failed-bank receiverships. Bailouts are not permitted.

There appear to be a number of misconceptions as to the nature of the OLA. Some have called it a bailout mechanism, while others see it as a fire sale that will destroy the value of receivership assets. Neither has any basis in reality under the Dodd-Frank Act. The Dodd-Frank Act expressly bars any bailout and prohibits taxpayers from bearing any losses in a resolution. While it is positioned as an alternative resolution mechanism in cases where proceeding through bankruptcy would result in wider financial disorder, the OLA is actually a better-suited framework for resolving claims against failed financial institutions. It is a transparent process that operates under fixed rules that bar *unequivocally* any bailout of shareholders and creditors, which can be a concern in the case of an ad-hoc emergency rescue program. Not only would the OLA work faster and preserve value better than bankruptcy, but the regulatory authorities who will administer the OLA are in a far better position to coordinate with foreign regulators in the failure of an institution with significant international operations. Further, under the OLA, we can minimize systemic risk and preserve franchise value by running the institution as a bridge financial company, and eventually selling it in parts or as a whole. It is a powerful tool that greatly enhances our ability to provide continuity and minimize losses in SIFI failures.

While Title I of the Dodd-Frank Act significantly enhances the regulators' ability to conduct advance resolution planning for SIFIs and large bank holding companies, Title II vests the FDIC with legal resolution authorities similar to those that it already has with respect to insured depository institutions. If the FDIC is appointed as receiver for a covered financial company, it is required to carry out an orderly liquidation of the company in a manner than ensures that creditors and shareholders appropriately bear the losses of the financial company while maximizing the value of the company's assets, minimizing losses, mitigating risk, and minimizing moral hazard. Under this authority, common and preferred stockholders, debt holders and other unsecured creditors will know that they will bear the losses of any institution placed into receivership, and management will know that it could be replaced. These new requirements will ensure that taxpayers will bear no losses.

The history of the recent crisis is replete with examples of missed opportunities to sell or recapitalize troubled institutions before they failed. But with bailout now off the table by legislative direction, management will have a greater incentive to bring in an acquirer or new investors before failure, and shareholders and creditors will have more incentive to go along with such a plan in order to salvage the value of their claims. In addition, if the institution should ultimately fail, management that is substantially responsible for the failure will be subject to the claw-back of compensation earned during the two previous years. These new incentives to be more proactive in dealing with problem SIFIs should reduce the incidence of outright failure and also lessen the risk of systemic effects arising from such failures.

In implementing the Act's requirements, our explicit goal is that all market players should understand that bailouts are no longer an option. We anticipate that financial institution credit ratings should, over time, fully reflect this fact. Indeed, early this month Moody's placed under review for potential downgrade the "uplift" based on systemic support assumptions that it had previously provided to the deposit, senior debt, and senior subordinated debt ratings of certain large financial companies. Moody's announcement stated that, "The U.S. government's intent under Dodd-Frank is very clear. Going forward it does not want to bail out even large, systemically important banking groups."

The FDIC has issued an Interim Final Rule (IFR) and an NPR to implement certain provisions of Title II, providing clarity and certainty with respect to how key components of the OLA will be implemented. Among other things, this NPR addresses the power to recoup compensation from senior executives and directors when they are materially responsible for the failure of a SIFI; the priorities of expenses and unsecured claims; the claims process; and the treatment of secured claims. These rules provide a roadmap for creditors to better understand their substantive and procedural rights under Title II and thus allows for increased certainty in the planning of transactions and the conduct of business under this new regime. The comments received to the IFR and the NPR are being reviewed, with the expectation of a Final Rulemaking being issued in the coming month.

International Coordination. One of the key lessons of the recent financial crisis is that we must always be prepared to resolve large, globally active, interconnected financial companies. The structures of these companies are highly complex, and the issues associated with their resolutions can be challenging. However, with planning and cross-border coordination, disruptions to global financial markets can be minimized.

First, there is a need for an effective resolution process in every jurisdiction. We also believe that a greater convergence of resolution regimes across countries would be beneficial in dealing with crisis situations.

Second, there must be sufficient supervisory and resolution resources within each country to deal with the scale of a firm's operations within that country. If these resources do not exist, resolution strategies will not be credible and the problem of Too Big to Fail will remain in those jurisdictions.

Third, supervisors need to understand, well in advance, the sometimes complex group structure of a conglomerate. These structures, designed to maximize economic return and minimize taxes, tend to result in economic transactions that extend across legal entities and national borders, making it difficult for one national authority to settle claims and complete transactions in a resolution.

Finally, and related to the prior point, there is a need for close cooperation and dialogue between national authorities both before and during a crisis. In such situations, the ability to share supervisory information and even liquidity resources is key to the ability to resolve the institution without creating wider systemic effects.

There is currently no international insolvency framework to govern how cross-border financial institutions will be resolved. It does not appear that creating such a framework is a realistic near-term goal because a binding, comprehensive international insolvency framework would require countries to resolve difficult questions about who will pay for the resolution. The direct connection between the resolution of financial institutions and who bears the financial burden for losses means that each national authority will tend to protect its domestic creditors and its financial resources. As a result, most countries have ‘ring-fenced’ or acted to separately resolve financial firms within their borders with limited regard for the resolution of related companies located outside its borders. However, when national authorities fail to cooperate in resolving a cross-border crisis this can create adverse consequences both for other countries and potentially even for the country that ring fences by reducing the recoverable value of the financial company and creating disruptions for the financial system that rebound to that country’s detriment.

There are efforts underway to better deal with these challenges by coordinating resolution processes across national jurisdictions. The FDIC and other U.S. regulatory authorities have been leaders internationally, both in promoting best practices and in promoting convergence of practices. I co-chair the Cross-Border Resolutions Group (CBRG) of the Basel Committee, which released a report last year outlining several important goals for enhancing the cross-border resolutions process. This report outlined specific recommendations for improvements in national laws to achieve a more effective resolution of financial institutions and prevent the past resort to bailouts. The recommended reforms incorporate the powers the FDIC has long had to resolve failing banks. Those powers are now incorporated into Title II of the Dodd-Frank Act.

In view of many countries’ unhappy experience with legal frameworks that were not up to the task in 2007 and 2008, many countries have concluded that significant reforms are necessary. The Financial Stability Forum (FSB) and the G-20 leaders have endorsed these recommended reforms and the CBRG is now assessing the progress in implementing them. While progress has been made, much more remains to be done.

While it would be helpful to negotiate broad agreements in advance that would coordinate resolutions activities and share financial burden, there are inevitable limitations to any approach that subordinates sovereign interests to international authorities. Instead, much progress is being made on these issues through bilateral discussions, which appear to be the best way forward in creating a more predictable cross-border resolutions process. The FSB is coordinating work underway in many countries to develop effective recovery and resolution plans for internationally active financial institutions. In the U.S., the federal banking regulators along with the Securities and Exchange Commission are pursuing this work as well. These efforts are already providing important insights into how the resolvability of SIFIs can be improved. Obviously, in the U.S., these efforts will assist the FDIC and the FRB in our joint work on final rules to govern resolution plans under the Dodd-Frank Act and in the review of the resulting plans.

It is worth noting that no other advanced country plans to rely on bankruptcy to resolve large, international financial companies. The resolution framework and the statutory powers included in Title II of the Dodd-Frank Act have, in fact, become the international standard.

Conclusion

In summary, the measures authorized under the Dodd-Frank Act to create a new, more effective SIFI resolution authority will go far toward reducing risk-taking in our financial system by subjecting every financial institution, no matter its size or degree of interconnectedness, to the discipline of the marketplace. Prompt and effective implementation of these measures will be essential to constraining the tendency toward excess leverage in our financial system and our economy, and in creating incentives for safe and sound practices that will promote financial stability in the future.

In light of the ongoing concern about the burden arising from regulatory reform, we think it is worth mentioning that none of these measures to promote the resolvability of SIFIs will have any impact at all on small and midsized financial institutions except to reduce the competitive disadvantage they have long encountered with regard to large, complex institutions. There are clear limits to what can be accomplished by prescriptive regulation. That is why promoting the ability of market forces to constrain risk taking will be essential if we are to achieve a more stable financial system in the years ahead.