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Thank you for the opportunity to appear here today to discuss the Dodd-Frank Act, too-big-to-fail and the resolution of large, complex financial institutions (LCFIs). There remains no single issue more important to the stability of our financial system than the regulatory regime applicable to the entities. Given the unprecedented government assistance required in 2008 and 2009 and all that we have learned since, I think there is a general recognition of the role certain large, mismanaged institutions played in the lead-up to the financial crisis, and the need to take tough policy steps now to ensure that taxpayers are never again forced to choose between standing behind the risky bets of large financial firms or financial collapse. As our economy continues to slowly recover from the financial crisis, we cannot forget the lessons learned, nor can we afford a repeat of the regulatory and market failures which allowed that debacle to occur.

Summary

The Dodd-Frank Act requirements for the regulation and, if necessary, resolution of LCFIs are essential to address the problem of too-big-to-fail and eliminate the need for taxpayer bailouts of failed institutions. I strongly disagree with the notion that orderly liquidation authority (Title

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[1] The independent non-partisan Systemic Risk Council (www.systemicriskcouncil.org) was formed by CFA Institute and the Pew Charitable Trusts to monitor and encourage regulatory reform of U.S. capital markets focused on systemic risk. The views expressed here are my own personal views and do not necessarily reflect the views of the Systemic Risk Council, other Council members or the supporting organizations.

II/OLA) enshrines the "bailout" policies that prevailed in 2008 and 2009. Implicit and explicit too big to fail policies were in effect under the legal structure that existed before Dodd-Frank. Dodd-Frank has abolished them. To the extent the problem of too-big-to-fail and risks of taxpayer assistance remain, it is because (1) regulators have more work to do to reduce the risk of a LCFI failure and make sure rules and processes are in place to ensure their orderly liquidation if they do fail; and (2) markets continue to question whether government can and will follow-through on its plan to allow an LCFI to fail without a bailout. I believe we are on the right track for addressing both of these realities, but more can, and should, be done.

The Problem of Too Big To Fail

There is nothing inherently wrong with size in and of itself. In many business areas, large institutions can achieve significant economies and public benefits. However, size should be driven by market forces, not implied government subsidies. Capital allocation should be determined by investors pursuing sound, innovative business models which promise sustainable returns based on acceptable risk tolerances. It should not be based on highly leveraged bets which promise privatization of benefits but socialization of losses if those bets fail. With the implied government support provided to Fannie Mae, Freddie Mac, and so-called too big to fail financial institutions, the smart money fed the beasts and the smart money proved to be right. As failures mounted, the government blinked and opened up the taxpayers' check book. Because creditors and trading partners were made whole and many executives and board members survived, markets (and management) may view these types of institutions as implicitly backstopped by the government. This results in incentives for "heads I win – tails you lose" risk-taking and funding advantages for these firms relative to their smaller competitors. Taken together, this phenomenon would make already large firms even larger and more risky.

Orderly Liquidation Authority is Essential to Helping End Too-Big-To-Fail

In recognition of the harmful effects of too big to fail policies, a central feature of Dodd-Frank is the creation of a resolution framework which will impose losses and accountability on shareholders, creditors, boards, and executives when mismanaged institutions fail. Under Title II, the government can now resolve a potentially destabilizing financial institution using the same time tested tools the FDIC has used to resolve failing banks for decades. Such tools were not available during the 2008 crisis. The FDIC has made real progress implementing these provisions and spelling out the process that will be used under Title II to resolve large financial institutions, including the bankruptcy-like claims priority schedule that will impose losses on shareholders and creditors, not on taxpayers. We cannot end too big to fail unless markets know that shareholders and creditors will take losses if the institution in which they have invested fails.

To this end, the FDIC, working in consultation with the Federal Reserve Board and international regulators, has developed an innovative strategy for the orderly resolution of a large, internationally active bank which involves seizing control of its holding company through a so-called "single point of entry" approach. In the event of an LCFI failure, the FDIC would use its authority as receiver to form a bridge financial company. The holding company's shareholders and creditors would absorb losses associated with the failure, while some of their claims would be converted to equity to recapitalize the new enterprise.

Improving the Orderly Liquidation Process

While the FDIC has a solid plan and has been working diligently to prepare and address key challenges (among them by making significant progress with foreign governments on cross-border issues)[2] important work still needs to be done.

- ***Regulators must ensure that LCFI's have sufficient long-term debt at the holding company level.*** The success of the FDIC's orderly liquidation authority using this "single point of entry" strategy depends on the top level holding company's ability to absorb losses and fund recapitalization of the surviving operating entities. Currently, nothing requires that firms hold sufficient senior debt to meet this need. I and the Systemic Risk Council agree with the increasing number of financial regulators at the Federal Reserve and FDIC and other experts that we need to address this gap.[3]

  The senior, unsecured long-term debt must be issued at the top level holding company to eliminate the banking organization's ability to game the requirement by redirecting its debt issuance to its insured depositories or other operating subsidiaries. The redirection of debt issuance to subsidiaries would impede the effectiveness of single point of entry resolution. The loss absorption and recapitalization capacity must reside at the top-level holding company and should be based on total (non-risk weighted) assets. In addition, to limit the contagion or domino effect of a LCFI insolvency, the debt must not be an

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[2] See, e.g. FDIC Memorandum of Understanding with Canada Deposit Insurance Corporation. http://www.fdic.gov/news/news/press/2013/pr13051.html. See also "Resolving Global Active, Systemically Important, Financial Institutions," Joint Paper by the FDIC and the Bank of England, Dec. 10, 2012. http://www.fdic.gov/about/srac/2012/gsifi.pdf

[3] See Letter from Systemic Risk Council to Ben Bernanke, Chairman of the Federal Reserve Board, June 6, 2013. http://www.systemicriskcouncil.org/wp-content/uploads/2013/06/SRC-Ltr-Re-LTD-6-7-2013.pdf

eligible investment for any other LCFI or any other bank, nor should other LCFIs be permitted to write credit protection for, or have other real or synthetic exposure to, that debt.

A properly sized long-term debt cushion that meets these parameters would support the FDIC's single point of entry resolution strategy and help assure the markets that the LCFI is indeed resolvable and not too big to fail.[4] The debt cushion could include a minimum subordinated debt requirement to offer some protection for senior bondholders. This would potentially provide a more stable funding structure and greater market discipline as creditors would have the incentive to closely monitor the riskiness of their respective investments. As investors would likely require these LCFIs to pay somewhat higher premiums for the added debt, this approach could have the added benefit of providing a strong incentive to reduce complexity, interconnectivity and growth of these large, complex financial institutions through market forces.

Even with tougher capital standards – which I also strongly support and discuss more below – there is no guarantee that a large bank failure can be prevented in the future. Thus, it is imperative that losses incurred with the failure of an LCFI be absorbed by the

[4] Some have proposed a ratio of 30 percent of equity, subordinated debt, and unsecured long-term debt to total consolidated assets. See comment letter on the Federal Reserve Board's Notice of Proposed Rulemaking to implement Sections 165 and 166 of the Dodd-Frank Act, signed by Sheila Bair, Senior Advisor, Pew Charitable Trusts; Simon Johnson, MIT Sloan School of Management and Senior Fellow, Peterson Institute for International Economics; Anat Admati, Graduate School of Business, Stanford University; and Richard Herring, Co-Director of the Wharton Financial Institutions Center, Wharton School, University of Pennsylvania; March 30, 2012. http://www.federalreserve.gov/SECRS/2012/April/20120403/R-1438/R-1438_033012_107166_399897884753_1.pdf

firm's own shareholders and creditors, and not be forced on other firms through special assessments, or worse, on taxpayers.

- ***The Financial Stability Oversight Council (FSOC) must designate potentially systemic nonbank financial firms for heightened oversight.*** Title I of the Dodd Frank Act requires that the FSOC designate firms for heightened supervision by the Federal Reserve. This enhanced supervision is designed to (1) improve regulation over large, potentially systemic firms; (2) provide regulators with important information to assess and plan for a potential failure; and (3) reduce the likelihood that potential systemic risks will simply grow unnoticed outside the traditional regulatory sphere, including at affiliates of otherwise regulated entities as occurred at AIG, Lehman Brothers and other LCFIs prior to the financial crisis.

How Title I Designations Reduce Too-Big-To-Fail. While some have argued that a SIFI designation might be a "positive" for the company – and fuel market perceptions that the company is somehow backstopped by the government, I disagree. The SIFI designation is not a "badge of honor" but a "scarlet letter." It includes no *benefits* from the government, does not reduce any existing regulatory requirements and only *heightens* a firm's required capital and supervision.[5] It does not mean the firm will be resolved under OLA rather than bankruptcy – as a financial company could be resolved under OLA without having been a SIFI (a bad outcome given the need for planning, etc. outlined below) and a SIFI could be made, through effective enhanced prudential standards and resolution planning,

[5] See, e.g., Section 165 which provides that Federal Reserve shall establish prudential standards for these designated firms that "(A) are <u>more</u> stringent than those applicable to other nonbank financial companies and bank holding companies …; and (B) <u>increase</u> in stringency." (emphasis added).

to be resolvable in bankruptcy (a good outcome). In fact the Section 165 requirements for resolutions are aimed at ensuring an orderly resolution *under the bankruptcy code, not orderly liquidation*.[6] This helps explains why LCFIs have pushed back so strongly to avoid this designation.

To the extent LCFIs continue to enjoy a funding advantage from perceptions of being too big to fail, we need to remember that this perception exists whether or not the firm has been designated under Title I. The bailouts of 2008 and 2009 confirmed this perception and reinforced it. Titles I and II are designed to recognize this potential market perception risk and help address it. Eliminating Titles I and II would only take us back to the types of policies that brought us the large, unchecked financial firms whose risks and failures resulted in the 2008 financial crisis and unprecedented government support.

Importance of Title I Designations to Resolution Planning. Moreover, while the market has understandable questions about ability and willingness of regulators to resolve a LCFI – it is clear that regulators will be much better positioned to resolve a failing LCFI; or even *assess* a failing firm's potential impact on the market to determine if it can go into bankruptcy – if regulators (1) have information about the firm's health, exposures, and complexity, (2) can assess the firm's plan for resolving itself and (3) can plan in advance. Such living will information is triggered by designation. Accordingly, to the extent markets and policymakers questions the FDIC's ability to resolve a firm – those questions are certainly more valid if the firm has not be designated under Title I. Regulators should never again have to try to learn about an LCFI's business, assess the

[6] See e.g., DFA Section 165(d) (4).

firm's risk, determine the potential impact its failure would have on the financial markets *and* determine whether bankruptcy is appropriate over a weekend. That is a recipe for bad decision-making, costly and inefficient resolutions and destabilized markets.

Reducing the Use of Orderly Liquidation

As anticipated in the Dodd-Frank Act, a traditional fair, equal and effective bankruptcy process that protects taxpayers and markets is the optimal and first choice for failure. Orderly liquidation is – and should only be – used as a last resort. There are several steps policymaker can – and should – take to help reduce the need to use orderly liquidation authority.

- ***Regulators must strengthen capital requirements so these firms have a meaningful buffer against losses***. Our existing capital regime is incredibly complex, riddled with uncertainty and results in a host of perverse incentives that encourages bad risk management and synthetic risk taking (e.g., through derivatives) at the expense of traditional lending. Not only would a stronger and simpler capital regime provide a meaningful buffer that reduces the likelihood of an LCFI failure, it would reduce the artificial funding advantages available to large firms and give regulators and counter-parties a much better sense of a firm's financial health. While current capital regimes continue to over-rely on risk-weighting and internal modeling a better approach is to simplify our capital rules, strengthen the leverage ratio and eliminate regulatory reliance on a firm's internal models.

Stronger Leverage Requirements. The Basel Committee has developed a SIFI capital surcharge for large, internationally-active banking organizations based on risk-based capital levels but not on leverage. However, the Dodd-Frank Act requires that *both* risk-based capital *and* leverage standards should be higher for SIFIs than for non-SIFIs. The new international leverage ratio under Basel III and the proposed rule is only 3 percent (though the 3 percent does apply to certain off-balance sheet assets). The current U.S. leverage well capitalized standard applicable to FDIC insured banks is 5 percent, though this applies only to on-balance sheet assets. Extensive research conducted on banks that became troubled during the crisis demonstrated that an institution's leverage ratio is a much better predictor of financial health than its risk-based ratio. To be true to Dodd-Frank's mandate for higher capital levels for SIFIs, we believe the Federal Reserve should consider a leverage ratio substantially higher than the Basel III standard of 3 percent, for the largest, complex institutions. The SRC and I believe that leverage for such institutions should be no greater than 12 to 1 reflecting a minimum ratio of approximately 8 percent, and indeed the ratio could be set more than double that, based on available research.[7]

Reducing Regulatory Reliance on Internal Models. Not only do models routinely fail in a crisis (precisely when we need loss absorbing shareholder equity most) – their use for regulatory capital purposes can create perverse incentives for risk management and real competitive advantages for larger firms relative to smaller firms doing the same activity. Minimum risk-based capital requirements should be just that: a minimum. If internal models identify additional risks that require higher capital, firms should be required to

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[7] See Comment Letter from Systemic Risk Council, October 4, 2012. http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Fact_Sheets/Systemic_Risk/Final-SRC-Capital-Comment-Letter-10-4-12.pdf

raise more equity. Management, boards, examiners, investors and counter-parties deserve an objective and clear minimum risk-based capital baseline.[8]

- ***Improve public disclosure about LCFIs' activities and risks*** so that investors can make better decisions about these companies – so markets and policymakers can feel comfortable that a firm can fail – in bankruptcy – without destabilizing the financial system. Improved disclosure about the level of a large financial institution's unencumbered assets could increase the chances that debtor-in-possession financing could be seamlessly arranged in a bankruptcy process without disrupting payments processing and credit flows. In addition, greater disclosure about a firm's corporate structure – and profitability by business line could facilitate the market's ability to determine the optimal size and structure for financial institutions. It would also allow investors to see if firms are too big/too complex to manage and would provide better shareholder value if broken up into smaller, simpler pieces.

- ***Consider requiring that LCFIs "subsidiarize" their corporate structure*** to rationalize their legal structures along business lines and significant international operations to reduce the risk of contagion from one part of the firm to another, and to provide better, more specialized management for each of the firm's component parts. Not only would this help improve the transparency and management of their operations, it would make it much easier for investors, firms or bankruptcy courts to value the firm by business line

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[8] See Statement by the Systemic Risk Council on Bank Capital Requirements, Nov. 2012. http://www.systemicriskcouncil.org/2012/11/statement-by-the-systemic-risk-council-on-bank-capital-requirements/
See also, Comment Letter to the Securities & Exchange Commission Regarding Internal Risk Models, Jan. 2013. http://www.systemicriskcouncil.org/2013/01/systemic-risk-council-letter-to-sec-about-internal-risk-models/

and international operations and spin-off operations when needed, whether as a going concern or in a bankruptcy or resolution.

Designated Financial Market Utilities

While substantial debate has circulated around Titles I and II of the Dodd-Frank Act, I have been surprised at the lack of concern over the designation of "financial market utilities," and particularly Section 806 which permits the Federal Reserve to provide safety net access to designated financial market utilities. Indeed, I have been struck by the strong arguments against Title I SIFI designations – which brings with it *no* government benefits – and the lack of controversy surrounding the designation of financial market utilities – which does. This potential Federal Reserve lifeline not only gives these firms a real advantage over other "non"systemic competitors, it opens up taxpayers to potential losses and creates moral hazard as these firms can weaken their risk-management standards knowing emergency support is potentially available in a crisis. At a minimum, if these clearinghouses are going to enjoy discount window access, they should be subject to the same types of enhanced prudential supervision and resolution planning applicable to large bank holding companies, but an even better approach would be for the regulators to revoke these designations and roll back this unwarranted expansion of the government safety net. Indeed, we saw the results with Fannie Mae and Freddie Mac when lightly regulated, for-profit entities were able to enjoy access to government backing which fueled private profit taking and market share dominance over those which did not enjoy such government largesse. Title VIII FMUs will very likely become the new GSEs and a new source of system instability if left unaddressed.

Conclusion

Thank you again for the opportunity to be here today. This remains an enormously important issue and the Committee is right to keep a very close eye on it. I am hopeful that policymakers will continue to move forward and implement the reforms needed to safeguard our financial system and the economy. Financial reform and system stability are not partisan issues. Both parties want to end too-big-to-fail, and though there may be different perspectives on how to achieve that goal, through open dialogue, discussion, and collaboration, we can achieve it. We must.