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Before the

United States House of Representatives

Committee on Financial Services

Tuesday, July 21, 2009

Chairman Frank, Ranking Member Bachus, and members of the committee, my name is Paul Mahoney. I am the dean of the University of Virginia Law School, where my teaching and research interests include contracts, securities regulation, derivatives regulation, and law and development.

I appreciate the opportunity to present my views, simply as an observer of the financial services industry and not on behalf of any industry or organization. I will discuss those portions of the Obama Administration's financial regulatory reform proposals that deal with the largest financial institutions—so-called "Tier 1 Financial Holding Companies". The Treasury Department's white paper *Financial Regulatory Reform: A New Foundation* defines a Tier 1 FHC as "any financial firm whose combination of size, leverage, and interconnectedness could pose a threat to financial stability." That definition makes clear that the proposal accepts the view that these large and interconnected institutions are "too big to fail" because of their systemic importance.

The white paper proposes creation of a special resolution regime outside the normal bankruptcy process for financial holding companies that would be triggered when, in the Treasury's view, the "stability of the financial system is at risk." It appears that this standard would typically be met in the case of the failure of a Tier 1 FHC in light of the definition of that term. When Treasury triggers the special resolution regime, it will have the authority to lend the institution money, purchase its assets, guarantee its liabilities, or provide equity capital. I think it is fair to use the term "bailout" to describe that combination of powers and I use it as such.

Federal regulators have not paid sufficient attention to sources of systemic risk, or risks that affect the entire financial sector rather than a single firm. The creation of a council tasked with identifying and warning functional regulators about sources of systemic risk is a good idea. Taking a close look at the process for resolving insolvent financial holding companies in order to prevent uncertainty and delay is also a good idea. Nevertheless, the identification of particular firms as too big to fail and, therefore, the beneficiaries of an implicit government guarantee, is a bad idea. I also believe oversight and enforcement powers should remain with the functional regulators and the systemic risk council should serve in an advisory role.

Since the beginning of the current financial downturn, the federal government has provided cash infusions, guarantees, and subsidies potentially amounting to trillions of dollars to prevent the collapse of large financial institutions. Given the cost of these bailouts and the potential they create for future moral hazard, Congress is rightly determined to minimize the likelihood of their repetition in the future.

There are two general schools of thought on how best to avoid future bailouts. The first holds that it was an error to help creditors of the failed institutions avoid losses that they would have realized in a normal bankruptcy proceeding and that the focus of policy going forward should be to make it clear that the mistake will not be repeated. While the government cannot easily commit never to do something in the future, Congress could limit the Treasury's and Federal Reserve's authority to commit funds to distressed financial holding companies institutions outside the ordinary bankruptcy or resolution process.

The alternative is to concede that the government will not refuse to bail out large and systemically important financial institutions. Under this approach, Congress should focus on limiting the risks that these institutions may take in order to minimize the likelihood that they will become financially distressed. If these efforts fail and a systemically important institution becomes financially distressed, a bailout will follow as a matter of course. The administration's financial reform blueprint takes this approach.

I believe the first approach will produce a healthier financial services industry that will make fewer claims on taxpayer dollars. It is based on a sounder premise—that the best way to reduce moral hazard is to ensure that economic agents bear the costs of their own mistakes. The administration's plan is premised on the view that regulatory oversight will compensate for misaligned incentives.

The central argument for trying to avoid bailouts through regulatory oversight rather than insisting that financial institutions bear the cost of their mistakes is that some financial institutions are "too big to fail." Putting such institutions through bankruptcy or a similar resolution process, and thereby requiring their creditors and counterparties to recognize losses or sell collateral, could spread contagion, meaning that other banks or financial institutions may also fail as a consequence. Widespread bank failures, in turn, may reduce the availability of credit to the real economy, causing or exacerbating a recession.

These arguments are plausible but it is not clear that the magnitude of the problem is sufficient to justify the scale of government intervention that we have seen in the past year. It is important to note that the loss of bank capital in the recent crisis was not just the result of a temporary liquidity problem—it was the consequence of sharp declines in real estate and other asset values. A bailout can redistribute those losses to taxpayers, but it cannot avoid them. The TARP fund was conceived initially as a system for purchasing illiquid bank assets and then selling them back once the perceived liquidity crisis was past. Once it became clear that the problem was solvency, not liquidity, the program was changed and the funds used to recapitalize financial institutions.

The bankruptcy process is an alternative means of recapitalizing an insolvent institution. Bankruptcy does not imply or require that the firm's assets, employees, and know-how disappear. Instead, it rearranges the external claims on the firm's assets and cash flows. The holders of the firm's equity may be wiped out entirely, while unsecured creditors may have to substitute part or all of their debt claims for equity claims, thereby re-establishing a sound capital structure. If the insolvent financial institution still has the skill and experience to facilitate credit formation, it will continue to do so under new ownership, management, and financial structure. Of course, the bankruptcy process is subject to inefficiencies and delays and these should be addressed when possible. But they do not require an alternative regime of bailouts.

A bailout regime creates substantial moral hazard problems that impose costs on the banking sector continuously, not just during crises.[1] Because creditors of too big to fail financial institutions anticipate that they will be able to shift some or all of their losses to taxpayers, they do not charge enough for the capital they provide. The financial institution, in turn, does not pay a sufficient price for taking risk. The result is a dangerous feedback loop: large banks have access to cheap capital, which causes them to grow even larger and more systemically important while taking excessive risks, all of which increase the probability of a crisis. Thus a bailout regime leads to more frequent crises even as it attempts to insulate creditors from them.

The Administration believes that its proposal will alleviate moral hazard and decrease the concentration of risk in "too big to fail" institutions. The idea is that so-called "Tier 1" financial holding companies will be subject to more stringent capital rules that will simultaneously reduce the amount of risk they can take and create a disincentive to become a Tier 1 FHC in the first place.

[1] This point is made in detail in Gary H. Stern & Ron J. Feldman, *Too Big to Fail: The Hazards of Bank Bailouts* (Washington, DC, Brookings Institution 2004).

I believe that these disincentives are insufficient and implementation of the plan would increase, not decrease, the concentration of risk. Once a firm has been designated a Tier 1 FHC, other financial institutions will view it as having an implicit government guarantee, as they did Fannie Mae and Freddie Mac. The theory behind the Administration's proposal is that this advantage will be offset by stricter capital requirements and other regulatory costs that will, on balance, make the cost of capital higher, not lower, for Tier 1 FHCs.

Such a system would put greater demands on the Federal Reserve than any regulator could reasonably meet. Having an implicit government guarantee, Tier 1 FHCs will be extremely attractive counterparties because risk transferred to a Tier 1 FHC will be in effect transferred to the federal government. Tier 1 FHCs will have a valuable asset (the implicit guarantee) that they can sell in quantities limited only by the Fed's oversight. They will have powerful incentives to find mechanisms—new financial products and creative off-balance-sheet devices—to evade any limits on the risks they can purchase from the remainder of the financial sector. And banks that are not Tier 1 FHCs will have similarly strong incentives to grow to the point that they become Tier 1 FHCs in order to guarantee access to bailout money. The fastest way to grow larger, of course, is to take bigger risks. Any institution that can keep its gains while transferring catastrophic losses to the government will find a way to engage in excessive risk-taking and expansion, and the financial system as a whole will suffer more frequent financial crises

This analysis is not meant to suggest that the current bankruptcy process cannot be improved or that it should work exactly the same for financial holding companies as it does for industrial corporations. Substantively, however, the resolution of financial holding companies should follow the same fundamental principle that creditors take losses in order of their contractual priorities. The Lehman Brothers bankruptcy proceeding will undoubtedly provide lessons for resolving financial institutions more efficiently in the future. But a credible threat that failure will lead to a resolution proceeding in which the marginal loss will fall on creditors, not taxpayers, will do a better job of disciplining risk-taking than the combination of oversight and an implicit government guarantee.