Ending Too Big to Fail
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I. Introduction

Over two years ago, the United States and the global economy faced the worst economic crisis since the Great Depression. The crisis was rooted in years of unconstrained excess on Wall Street, and prolonged complacency in Washington and in major financial capitals around the world. The crisis made painfully clear what we should have always known--that finance cannot be left to regulate itself; that consumer markets permitted to profit on the basis of tricks and traps rather than to compete on the basis of price and quality will, ultimately, put us all at risk; that financial markets function best where there are clear rules, transparency and accountability; and that markets break down, sometimes catastrophically, where there are not.

For many years, a core strength of the U.S. financial system had been a regulatory structure that sought a careful balance between incentives for innovation and competition, on the one hand, and protections from abuse and excessive risk-taking, on the other. When that balance was properly struck, the U.S. financial system worked at its best. The American financial system often surpassed other major developed economies in innovation and productivity growth. It was generally good at directing investment towards the companies and industries where the returns would be the highest. Its regulatory checks and balances helped create a remarkably long period of relative economic stability which, in turn, gave rise to extraordinary national wealth. And it did so while providing investors and consumers with strong protections. It endured crises and recessions, including the costly bank and thrift failures of the late 1980s and early 1990s; these, however, did not threaten the foundations of the financial system.

Over time those great strengths were undermined. The careful mix of protections we created eventually eroded with the development of new products and markets for which those protections had not been designed. And our regulatory system found itself outgrown and outmaneuvered by the institutions and markets it was responsible for regulating and constraining.

In particular, the growth of the "shadow banking" system permitted financial institutions to engage in maturity transformation with too little transparency, capital, or oversight. The years leading up to the recent crisis saw the significant growth of large, short-funded, and substantially interconnected financial firms. Huge amounts of risk moved outside the more regulated parts of the banking system to where it was easier to increase leverage. Legal loopholes and regulatory gaps allowed large parts of the financial industry to operate without oversight, transparency, or

[1] Organizations provided for affiliation purposes only. Testimony is solely on my behalf.

restraint. Entities performing the same market functions as banks escaped meaningful regulation on the basis of their corporate form, and banks could move activities off balance sheet and outside the reach of more stringent regulation. Derivatives were traded in the shadows with insufficient capital to back the trades. "Repo" markets became riskier as collateral shifted from Treasuries to poorer quality asset-backed securities. The lack of transparency in securitization hid the growing wedge in incentives facing different players in the system and failed to require sufficient responsibility or risk retention from those who made loans, or packaged them into complex instruments to be sold to investors. Synthetic products multiplied risks in the securitization system. The financial sector, under the guise of innovation, piled ill-considered risk upon risk.

As the shadow banking system grew, our system failed to require real transparency, sufficient capital or meaningful oversight. Rapid growth in key markets hid misaligned incentives and underlying risk. Financial innovation often outpaced the capacity of managers, regulators and markets to understand new risks and adjust. Throughout our system we had increasingly inadequate capital buffers – as both market participants and regulators failed to account for new risks appropriately. Short-term rewards in new financial products and rapidly growing markets overwhelmed or blinded private sector gatekeepers, and swamped those parts of the system that were supposed to mitigate risk. Consumer and investor protections were weakened and households took on risks that they often did not fully understand and could ill-afford.

Rising home and other asset prices had helped to feed the financial system's rapid growth, and to hide declining underwriting standards and other underlying problems in the origination and securitization of mortgage loans. When home prices began to flatten, and then to decline, fault lines were revealed. The asset implosion in housing led to cascades throughout the financial system, and then to contagion from weaker firms to stronger ones. Failures in the shadow banking system fed failures in the more regulated parts of the banking system. And then, in the fall of 2008, credit markets froze. The over-reliance on short-term financing, opaque markets and excessive-risk taking that had been the source of significant profit on Wall Street and in financial capitals globally, fanned a panic that nearly collapsed the global financial system.

The major U.S. investment banks merged, failed, or sought a life-line from the Federal Reserve as newly converted bank holding companies. The federal government injected capital into major commercial banks shaken in the aftermath of the collapse of Lehman Brothers. The FDIC put in place guarantees across the entire banking system. The Federal Reserve pumped liquidity into the financial system to halt further economic collapse. A dangerous run on money market mutual funds was halted by guarantee and liquidity programs set up by Treasury and the Federal Reserve. Congress enacted a major stimulus plan to keep the economy from cratering.

Yet stabilizing the financial sector did not address the failures that led to the crisis. Further action was necessary to restore discipline to our financial markets, adequate protections to consumers and investors, and the market's long-term ability to generate economic growth for future generations of Americans. The test of whether a financial system works is whether it does a reasonable job of channeling savings to finance future innovation and growth. The test is whether it protects consumers and investors. And the test is also whether it can do so while supporting, not harming, the economy. In the lead up to 2008, our system failed that test.

II. Ending Too Big to Fail Through Enhanced Supervision, Higher Capital Levels, and Market Reforms

That is why comprehensive reform was essential. One year ago, President Obama signed into law the Dodd-Frank Act—the most sweeping reform of financial regulation since the New Deal. The Act provides for supervision of major firms based on what they do, rather than their corporate form. Shadow banking—through large, interconnected financial firms, OTC derivatives, "repo" funding markets, hedge funds, and securitization—is brought into the regulatory daylight. The largest financial firms will be required to build up their capital and liquidity buffers, constrain their relative size, and place restrictions on the riskiest financial activities. The Act comprehensively regulates derivatives markets with new rules for exchange trading, central clearing, transparency, anti-abuse provisions, and capital and margin requirements. The Act provides for data collection and transparency so that in no corner of the financial markets can risk build unnoticed. The Act creates an essential mechanism for the government to orderly liquidate failing financial firms without putting taxpayers at risk. The Act creates a new Consumer Financial Protection Bureau and provides for consumer and investor protections. In sum, the Act provides a strong foundation on which the U.S. must now carefully build a more stable and balanced regulatory system--a system that protects consumers and investors, that rewards innovation and that is able to adapt and evolve with changes in financial markets.

Before Dodd-Frank, if an entity were a bank, then it had tougher regulation, more stringent capital requirements, and more robust supervision. But if an entity were an investment bank engaged in the same activities, then it was able to abide by different rules. For example, when U.S. investment banks needed to find a "consolidated holding company regulator" in order to meet European Union standards for doing business in Europe, the Securities and Exchange Commission set up a "voluntary" Consolidated Supervised Entity program with little oversight. The SEC was not established as a prudential regulator, did not have clear regulatory oversight for investment bank holding companies, and had little experience and few trained examiners. Moreover, the leverage requirement that served as a backstop for capital requirements on banks was not applied to these investment banks. In effect, the system allowed large financial institutions to choose the regulator that would offer the least restrictive supervision.

The Federal Reserve did not have any authority to set and enforce capital requirements on the major institutions that operated businesses outside of bank holding companies. That meant it had no supervision over investment banks, diversified financial institutions like AIG or the nonbank financial companies competing with banks in the mortgage, consumer credit and business lending markets. The Office of Thrift Supervision viewed its role as supervising thrifts, not their holding companies (such as AIG). And regulators permitted banks and thrifts themselves to engage in risky mortgage lending, stepping in with guidance only when it was too late.

Today, Dodd-Frank has provided authority for clear, strong and consolidated supervision and regulation by the Federal Reserve of any financial firm--regardless of legal form--whose failure could pose a threat to financial stability. We will have a single point of accountability for tougher and more consistent supervision of the largest and most interconnected financial firms.

All bank holding companies will be supervised by the Fed, and the largest ones will be subject to heightened standards. The Office of Thrift Supervision has been abolished, and all Savings & Loan Holding Companies will be supervised by the Fed. Non-bank financial institutions designated by the Financial Stability Oversight Council will also be Fed-supervised. The voluntary investment bank holding company regime has ended.

Dodd-Frank provides for more stringent prudential standards for these major bank and nonbank firms. The Fed is charged with putting in place stronger requirements for capital and liquidity. Annual stress tests will be conducted on these firms. There are enhanced rules on affiliate transactions, lending limits, and counterparty credit exposures. The Fed is required to use macro-prudential supervision, which takes into account not only the risks within the institution, but the risks that the institution poses to the financial system as a whole. Major firms will be subject to a concentration limit that generally prohibits a financial company from engaging in mergers or acquisitions that would result in the firm's liabilities—including wholesale funding and off-balance sheet exposures—exceeding 10 percent of the liabilities of financial companies as a whole. These enhanced prudential measures for major financial firms are likely to reduce risk in the financial system and reduce any "too big to fail" distortions.

Before Dodd-Frank, no regulator or supervisor had the legal authority or responsibility to look across the full sweep of the financial system and take action when there was a threat. Our financial markets have suffered for the lack of an effective system for monitoring and responding to systemic risks or threats to financial stability as they arise. Today the Financial Stability Oversight Council (FSOC) is accountable to identify threats to financial stability and to address them. The FSOC will have access to information across the financial services marketplace. A new Office of Financial Research is empowered to collect data from any financial firm, and to develop and enforce standardization for data collection.

Before Dodd-Frank, the OTC derivatives market--with a notional amount of $700 trillion at its peak--grew up in the shadows, with little oversight. Enormous risks built up in these markets – without effective constraints or any robust monitoring by regulators. Credit derivatives, which were supposed to diffuse risk, instead concentrated it. Synthetic securitization with embedded derivatives magnified failures in the real securitization market. Major financial firms used derivatives to increase their credit exposure to each other, rather than decrease it. We should never again face a situation – such as AIG's $2 trillion derivatives portfolio – where the potential failure of a virtually unregulated, capital deficient major player in the derivatives market can impose devastating risks on the entire system. The opacity of this market meant that the government and market participants did not have enough information about the location of risk exposures in the system or the extent of the mutual interconnections among large firms. So, when the crisis began, regulators, financial firms, and investors had an insufficient understanding of the degree to which trouble at one firm spelled trouble for another. This lack of information magnified contagion as the crisis intensified, causing a damaging wave of margin increases, deleveraging, and credit market breakdowns. Lack of transparency, insufficient supervision, and inadequate capital left our financial system vulnerable to concentrations of risk, and to abuse.

Today, regulators are putting in place the tools to comprehensively regulate the OTC derivatives market for the first time. The Act provides for regulation and transparency for transactions in this market. It provides for strong prudential, capital, and business conduct regulation of all dealers and other major participants in the derivatives markets. And it provides for regulatory and enforcement tools to go after manipulation, fraud, and other abuses in these markets.

The Act requires all standardized derivatives to be centrally cleared, which will substantially reduce the build-up of bilateral counterparty credit risk between major financial firms. Central clearing parties would be subject to strong prudential supervision. Such derivatives would be traded on exchanges or alternative swap execution facilities, which would improve pre- and post-trade price transparency. Exchange trading will help to improve price competition as well as to improve safety and soundness in the derivatives system, as market participants and regulators will have full access to current prices in the event of system disruptions. Even non-centrally cleared OTC derivatives would be reported to a trade repository, making the market far more transparent. The Act provides for prudential regulation of all OTC dealers and all other major players in the OTC markets, so that adequate capital, business conduct rules, and prudential supervision will apply to all market participants. The Act provides for robust capital and initial margin requirements for derivative transactions that are not centrally cleared, providing a strong incentive to use central clearing and a bigger buffer should problems arise in the OTC markets.

At the same time as the Act reforms derivatives markets, it provides a new framework for regulation of financial market utilities and critical payment, clearing, and settlement activities, including not only those in the derivatives markets but also the wholesale funding "repo" markets that are critical to the shadow banking system. In the lead up to the financial crisis, major financial firms became increasingly funded not by traditional bank deposits, or even longer-term funding in the commercial markets, but rather by overnight funding in the repo markets. And these markets became increasingly concentrated in only two major clearing banks. As the market became more concentrated, it also became riskier because counterparties came to accept not only Treasury securities as collateral, but also highly rated asset-backed securities. And these securities, in turn, became riskier, as credit rating agencies became increasingly willing to label as safe assets that were lower quality—including pools of securities backed only by poorly underwritten subprime and Alt-A mortgages. When the financial crisis hit, the repo markets froze, causing a massive contraction in available credit.

The Dodd-Frank Act fundamentally reforms the wholesale funding markets by providing strong authority for the Federal Reserve to regulate financial market utilities and critical payment, clearing, and settlement activities; to set new rules for capital, collateral and margin requirements; and to establish uniform prudential standards across the market. These reforms are coupled with basic changes to liquidity requirements for major financial firms under the Basel III rules, liquidity concentration limits under the Act, and reforms to the deposit insurance system that will encompass all depository liabilities. These reforms will have the effect of taxing short-term liabilities and forcing firms to internalize more of the costs of this funding system. At the same time, SEC changes to regulations of money market mutual funds under Rule 2a-7 will mean that such funds have stronger liquidity positions.

The Act also fundamentally transforms regulation of the last major element of the shadow banking system—securitization. The Act requires deep transparency into the structure of securitizations, including information about the assets and originators. Securitization sponsors must generally retain risk in the securitizations they sponsor, so that incentives are better aligned among participants in the system. Capital rules will better account for actual risk. Parallel changes in accounting rules will now bring the most common forms of securitizations onto the balance sheet. Credit rating agencies will be subject to comprehensive oversight by the SEC, including policing of ratings shopping and conflicts of interest; ratings themselves will be more transparent—including key information on rating methodology, compliance with methodology, underlying qualitative and quantitative data, due diligence, and other protections.

Before Dodd-Frank, consumer protection regulation was fragmented over seven federal regulators, most of which chose to focus their energies in areas other than protecting consumers. Regulators lacked mission focus, market-wide coverage, and consolidated authority. Nonbanks could avoid federal supervision. Banks could choose the least restrictive consumer approach among several different banking agencies. Federal regulators preempted state consumer protections laws without adequately replacing these important safeguards. Fragmentation of rule writing, supervision and enforcement led to finger-pointing in place of effective action.

Today, the Consumer Financial Protection Bureau has market-wide coverage. The Bureau will focus on more effective regulation and supervision. The CFPB will set high and uniform standards across the market. It will focus on improving financial literacy for all Americans. And it will help to end profits based on misleading sales pitches and hidden traps; rather, banks and nonbanks can compete vigorously for consumers on the basis of price and quality.

III. Ending Too Big to Fail Through the Orderly Liquidation Authority

Before Dodd-Frank, the government did not have the authority to unwind large, highly leveraged, and substantially interconnected financial firms that failed – such as Bear Stearns, Lehman Brothers, and AIG – without disrupting the broader financial system. Firms benefited from the perception that they were "too-big-to-fail"-- a presumption that they would receive government assistance in the event of failure. Such a presumption reduced market discipline and encouraged excessive risk-taking by firms. It provided an artificial incentive for large firms to grow even larger. It created an unlevel playing field with smaller firms. And when the financial crisis hit, it left the government with the untenable choice between taxpayer-funded bailouts and financial collapse.

Today, major financial firms will now be subject to heightened prudential standards, including higher capital and liquidity requirements, stress tests, and “living wills.” Major financial firms will be required by these standards to internalize the costs that they impose on the system, which will give them incentives to shrink and reduce their complexity, leverage, and interconnections. And should such a firm fail, there will be a bigger capital buffer to absorb losses.

These measures will help to reduce risks in and among the largest financial institutions. In the event that such an institution fails, these actions will minimize the risk that any individual firm's failure will pose a danger to the stability of the financial system. Thus, bankruptcy proceedings will remain the dominant option for handling the failure of a non-bank financial institution.

The crisis, however, showed that the U.S. government simply did not have the tools to respond effectively when the failure of one or more major financial institution threatened financial stability. As Lehman's collapse showed quite starkly, there are times when the existing options under the Bankruptcy Code are simply not adequate to deal with the insolvency of large, complex and interconnected financial institutions in times of severe crisis.

That is why the Dodd-Frank Act permits the government, in limited circumstances, to resolve the largest and most interconnected financial companies outside of the traditional bankruptcy regime and consistent with the approach long taken for bank failures. This is the final step in addressing the problem of moral hazard. To make sure that we have the capacity – as we do now for banks and thrifts – to break apart or unwind major non-bank financial firms in an orderly fashion that limits collateral damage to the system. Under the orderly liquidation authority, the FDIC is provided with the tools to wind down a major financial firm on the brink of failure. Shareholders and other providers of regulatory capital to the firm will be forced to absorb any losses. Management of the firm culpable for its losses will be terminated. Critical assets and liabilities of the firm can be transferred to a bridge institution, while any remainder is left in the receivership estate. Any required funding for liquidity can be obtained through Treasury borrowing that is automatically repaid from the assets of the failed firm, or, if necessary, from an ex post assessment on the largest financial firms. In that manner, the resolution authority allows the government to impose losses on shareholders and creditors without exposing the system to a sudden, disorderly failure that puts the financial sector as a whole at risk.

The objectives of the resolution regime differ from those of the Bankruptcy Code. The purpose of the Bankruptcy Code is to reorganize or liquidate a failing firm "for the benefit of its creditors". The resolution authority is structured to manage the failure of a financial firm in a manner that protects taxpayers and the broader economy and promotes stability in the financial system. This purpose is explicitly different than the purposes of the Bankruptcy Code, but that is why the Act is narrowly tailored to situations in which there are exceptional threats to financial stability.

The Dodd-Frank approach is modeled on the long standing regime for bank failure. There are significant and tested safeguards in the Act modeled on the bank failure law to protect creditor rights. In addition, creditors in the resolution process are protected by the same system of judicial review that has existed for the FDIC (and its predecessors) for its receivership and conservatorship authorities for more than 75 years. The Act seeks to respect the Bankruptcy Code's fundamental principles of fairness and equity among similarly situated stakeholders. As is the case under the Bankruptcy Code's best-interests test and under the model in place for bank resolution, in the limited circumstances where the Act permits deviation from those principles, the Act expressly guarantees that stakeholders will be made no worse off by a regulator's use of resolution authority than would be the case in a liquidation under Chapter 7 of the Bankruptcy Code. The Act also maintains the right of an affected company to seek judicial review following the appointment of a receiver or conservator and a claimant's right to challenge a regulator's disallowance of its claim.

As with any new authority, the first and most central questions are: how would this work? How would it be different than what is possible today? What would happen if the U.S. government were once again faced with situations like those of September 2008?

Major financial institutions would have prepared a "living will" embodying a liquidation strategy and, in most cases, a supervisory recovery plan to map out contingencies for how the firm would respond to avoid failure during a period of severe financial distress or instability. Such firms would have larger capital buffers in the event of economic stress, and stringent conditions imposed on the use of "hot" money funding, including liquidity requirements over one month and one year time frames. Regulators would have the authority to supervise the firm for system-wide risks and to impose tough prudential measures. As a firm faced capital or liquidity problems, regulators would order early remediation. But we need to have some humility about the future and our ability to predict and prevent every systemic failure of a major financial firm.

In a severe crisis, if one or more major financial firms fail, and prudential measures, remedial action, and capital buffers prove inadequate, special resolution should be available. The Dodd-Frank Act builds in important safeguards for the use of such authority, including by requiring concurrence of the Treasury Secretary, two-thirds of the Board of the Federal Reserve, and two-thirds of the Board of the FDIC (or the Securities and Exchange Commission in the case of a broker-dealer). If the financial firm's board does not consent, prompt judicial review is required.

A receivership under this authority would have three essential elements that would improve execution and outcomes relative to the tools that were available in the fall of 2008: First, the FDIC could swiftly replace the board and senior management with new managers. Second, a temporary stay of counterparty termination and netting rights, during which the FDIC could transfer qualified financial contracts to a third party or bridge institution without counterparty consent or court approval. Third, the ability to set up a bridge bank with secured financing from the FDIC to fund liquidity and capital needs, in order to mitigate the "knock on" effects of any firm's failure; to fund its operations, pending its sale or winding down; and to preserve the business franchise, and protect viable assets of stronger subsidiaries pending their sale. This would have the potential to end the firm – wind it down – without contributing to system-wide failure.

In sum, the nation would no longer have to make the untenable choice between taxpayer bailouts and market chaos. Instead, the Dodd-Frank reforms provide the FDIC with the authority to wind down any firm whose failure would pose substantial risks to our financial system, in a way that will protect the economy while ensuring that the failed firm, and if necessary other large financial firms – not taxpayers – bear any costs.

To be sure, the creation of a domestic resolution authority is not enough. Large financial institutions operate globally. Resolution of a major firm will require international cooperation among regulators participating in existing supervisory colleges which monitor the largest financial firms.. That is why it is so critical that other nations develop and implement special resolution regimes with similar tools and authorities, which is the essential first step to being able to resolve such global firms.

IV. Ending Too Big to Fail through International Reforms

While the United States is implementing the Dodd-Frank Act, it is critical that global reforms proceed as well. In particular, the United States should continue to press for progress on raising the quality and quantity of capital; reducing the moral hazard of systemically important financial institutions; and imposing new rules for capital, margin, exchange trading, central clearing, transparency and oversight of the OTC derivatives market.

Much progress has been made through the Basel Committee on Banking Supervision to raise global capital standards. In Basel III, minimum capital ratios are set at a level that will represent a significant increase in firms' requirements. These new requirements include the creation of a capital conservation buffer above the minimums, which if breached will restrict firms' ability to pay dividends or buy back stock. Such restrictions will help shore up a firm's capital base before it reaches a point of no return. Basel is now at work on how to implement a capital surcharge for the largest, most interconnected financial firms. The Basel Committee is also examining how to use new contingent capital instruments—in which debt transforms into equity under specified circumstances—to force firms to internalize the costs of their own failure.

Not only is Basel raising the ratios, but just as importantly, it is also raising the quality of capital that underlie them. The new capital requirements will focus on common equity, excluding other liabilities that did not act as a buffer to absorb losses in the crisis. There will be strict limits in the capital calculation on counting minority interests, as well as on the aggregate contribution of investments in other financial institutions, mortgage servicing rights and deferred tax assets.

Moreover, Basel is increasing the capital required for banks' riskiest activities, such as trading positions and counterparty credit exposures. Capital calculations for trading exposures will be based on stressed market conditions, and the charges for securitization exposures will be increased substantially. In both derivatives and secured lending transactions, firms will be subject to a capital charge for deterioration in the credit worthiness of counterparties. For the first time, Basel III will also be introducing a new, internationally applied, leverage ratio requirement that includes firms' off balance sheet commitments and exposures.

Furthermore, Basel III will be instituting explicit quantitative liquidity requirements for the first time, to ensure that financial firms are better prepared for liquidity strains. Under the new rules, firms will have to hold enough highly liquid assets to meet potential net cash outflows over a 30 day stress scenario. Basel will also require a minimum amount of stable funding over a one year time period, relative to a firm's assets, commitments and obligations. These liquidity requirements will be crucial in helping to mitigate severe strains like those that we saw on the financial sector at the time of the collapse of Bear Stearns and Lehman Brothers during 2008.

In addition, countries must implement the resolution recommendations agreed by G-20 Leaders, which are a necessary prerequisite for effective cross-border resolution of systemically important financial institutions. While many in Europe are focused on using contingent capital as a means to improve resolution, these efforts are not enough. Contingent capital will not be sufficient on its own to permit the resolution of a major financial firm without wide-scale harm to the markets, and must not be used as an excuse to avoid legislating strong resolution regimes internationally.

Both our financial system and this crisis have been global in scope. So solutions have been and must continue to be global. The U.S. has not waited for the international community to act before building a new foundation in the Dodd-Frank Act, and there must not be an international race to the bottom on regulatory standards.

V. Conclusion

The United States had an urgent obligation to fix the failures that threatened our financial system and helped trigger the worst global economic crisis since the Great Depression, and a recession that has cost American families and American businesses so dearly. The Dodd-Frank Act puts in place the key reforms that were necessary to end the perception of “too big to fail,” and to establish a firm foundation for financial stability and economic growth in the decades ahead.

United States House of Representatives
Committee on Financial Services

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Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	2. Organization or organizations you are representing:
Michael S. Barr	None

3. Business Address and telephone number:

[redacted]

4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?
☐ Yes ☑ No	☐ Yes ☑ No

6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.

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