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Can We End Financial Bailouts?

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The views expressed are those of the author and not necessarily those of the FDIC.

Introduction

The goal and hope of the Dodd-Frank Wall Street Reform and Consumer Protection Act, as the name implies, is to make financial bailouts and, thus, too big to fail relics of the past. With the mere passage of the Act, some argue the goal is achieved. However, the accuracy of such a statement lies not in assertions, but in the actions and changes that follow the law's enactment. Titles I and II of Dodd-Frank are the provisions that outline how regulators are to assure an orderly wind down of failing systemically important financial firms when those firms are, in fact, larger and more complex than they were pre-crisis. This is no simple task, and it is on these two provisions that I will focus my remarks today.

What the Law Requires

Dodd-Frank's Title I requires that the largest systemically important financial institutions provide a written resolution plan called a Living Will to the Federal Reserve and FDIC. The Living Will outlines the process by which that institution would complete rapid and orderly resolution relying on bankruptcy law in the event of material financial distress or failure.

Congress intended this provision to be the principle means for resolution. Bankruptcy is a market-based solution that puts non-federally insured creditors on notice that they are not protected because a taxpayer bailout is unavailable in the event of failure. To make this provision enforceable for a firm that does not provide a credible plan, the Federal Reserve and FDIC may increase their supervision and eventually may require these firms to divest assets to facilitate resolution under bankruptcy. I take special note of the word "may" as opposed to "must".

Title II of Dodd-Frank is an alternative to Title I bankruptcy. It is discretionary and triggered when the Secretary of Treasury, with the concurrence of the President, declares that a financial firm is in danger of default and that its failure would be systemic and detrimental to financial stability and harmful to the public. The law provides that the FDIC be appointed receiver to carry out the liquidation of not only the commercial bank but also the financial company.

It is important to note that in bankruptcy, the cost of the resolution goes against the stockholders and uninsured creditors. In a government resolution, costs go against stockholders, some creditors, and eventually to the financial industry through assessments. The taxpayer also plays a role in providing necessary funding during the transition. In my view, this provision has the same consequences of the bailout process we just went through, but with advance notice.

Therefore, regulators must enforce Title I by requiring firms to be positioned so they could be resolved through bankruptcy. Not doing so would fail Congress and the public.

Taking Stock

To comply with the law and use a Title I bankruptcy resolution as the preferred option, we should see changes in these firms' structure and balance sheets that demonstrate they can fail and be placed into bankruptcy without bringing the system down with them. This then begs the questions: 'Have we made progress?,' and 'Where are we today?'

Pre-crisis size, complexity, leverage ratios, and funding mechanisms

Pre-crisis, with the growth in activities among the largest banking firms, the industry became highly concentrated with the eight largest having assets, excluding derivatives, representing the equivalent of 59 percent of the GDP. Their operations became increasingly complex and involved thousands of domestic and global operating subsidiaries. The notional value of derivatives contracts carried by the three largest banking firms averaged a considerable \$47 trillion.

In addition, cross-boarder exposures were significant and no provisions existed to deal with international bankruptcy. The firms were highly interdependent in wholesale funding markets -- relying on money market funds and tri-party repos, for example -- and they had created major exposures as counter-parties to one another in the derivatives market. Finally, there was a desperate lack of tangible capital to absorb losses. The leverage ratios that once were below 15 to 1 were allowed to exceed, on average, 30 to 1 and in some instances 40 to 1.

When the crisis emerged full force, bankruptcy was set aside as it was believed that the consequences of failure were too great and that the largest financial firms had to be bailed out. This included bank holding companies with direct access to the safety net, and shadow-banks and money market funds that relied on short-term, deposit-like instruments to fund long-term assets. Most importantly, the Lehman Brothers failure seemed to validate worst fears about the impracticality of using bankruptcy to resolve these largest financial companies.

Post-crisis size, complexity, leverage ratios and funding mechanisms

Compared to 2008, the largest financial firms today are in most instances larger, more complicated, and more interconnected. The eight largest banking firms have assets that are the equivalent to 65 percent of GDP. The average notional value of derivatives for the three largest U.S. banking firms at year-end 2013 exceeded \$60 trillion, a 30 percent increase over their level at the start of the crisis.

The largest banking firms also have tended to increase their complexity. They have used the safety net subsidy to support their expansion across the globe¹. They have further combined commercial, investment banking, and broker-dealer activities. There have been no fundamental changes in the wholesale funding markets, on the reliance of bank-like money market funds, or on the use of repos, which all are major sources of volatility in times of financial stress.

While these largest firms highlight that they have added capital to strengthen their balance sheet, they remain excessively leveraged with ratios, on average, of nearly 22 to 1. The remainder of the industry averages below 12 to 1. Thus, the margin for error for the largest, most systemically important financial firms is nearly half of that of other far less systemically important commercial banks and financial firms.

Private or Public Resolution

In a recent FDIC Advisory Meeting it was noted that given these largest firms' continued complexity, interdependence, and reliance on volatile funding, it would be unrealistic to presume that in bankruptcy private parties would provide liquidity under debtor-in-possession financing. At the moment of panic, private sector lenders would be unable to determine the availability or reliability of the collateral necessary to secure massive amounts of short-term borrowed funds. Thus, even in bankruptcy, the only source of liquidity for these firms would be the government.²

In addition, despite improved and on-going efforts at international cooperation, there are no international bankruptcy laws sufficient to sort out cross-border creditor rights and no mechanism to assure the reliability of the enormous cross-border flow of funds of just one of these firms. "Ring fencing" assets will be the norm rather than the exception. Under such circumstances, it would be foolish to ignore the fact that countries will protect their domestic creditors and stop outflows of funds when crisis threatens.

In considering these circumstances, a view is being nurtured by some, unfortunately, that bankruptcy for the largest firms is impractical because current bankruptcy laws won't work. Rather than require that these most complicated firms be made bankruptcy compliant through the strict use of the Living Will process, it has been argued that the government can rely on Title II to most successfully resolve any systemically important firm that fails.³ This view serves us poorly, delaying changes needed to assert market

¹ Literature review of studies documenting the TBTF subsidy the largest financial firms receive: <http://www.fdic.gov/news/news/speeches/literature-review.pdf>

² Professor Barry E. Adler, New York University, highlighted this issue at the FDIC Advisory Committee on Systemic Resolution, December 11, 2013. (http://www.fdic.gov/about/srac/2013/2013_12_11_minutes.pdf)

³ For example, see Bipartisan Policy Center, "Too Big to Fail: The Path to a Solution," May 14, 2013. Also, see "Report on the Orderly Liquidation Authority Resolution Symposium and Simulations," The Clearing House Association (2013), where it argues that Title II Ends TBTF.

discipline and reduce systemic risk, and it undermines bankruptcy as a viable option for resolving these firms.

While Title II drives toward resolution and requires that stockholders and some long-term debt holders lose their investment, it requires public assistance to make it work. Unlike in bankruptcy, the Treasury is empowered to fund short-term creditors who, for example, would avoid becoming general creditors as they exit at the firm's operating units -- broker dealers, insurance companies, finance companies, trading companies that remain open. This only serves to perpetuate too big to fail, incentivizing creditors to redirect their investment from the holding company to the affiliates, where they will be "safe".⁴

The industry clearly prefers the Title II solution because it requires nothing fundamentally transformational to its operations. Taxpayers are assured that any loss to the Treasury would be recovered through assessments against the industry, but I would caution that this would occur only after the fact, and only after political pressure and intrigue designed to avoid such assessment have had their effects. As I noted earlier, this process has a strikingly familiar ring to it.

Ending Bailouts

For the market to serve as disciplinarian and for bankruptcy to be a viable means for resolving systemically important financial firms, these largest most complicated firms must become eligible for bankruptcy. Ending bailouts using the tools authorized in Dodd-Frank requires that the Living Will process be vigorously implemented. Each systemically important financial firm must provide a credible plan for orderly resolution through bankruptcy. Any institution that fails to do so should receive increased supervisory oversight and enhanced prudential standards. Ultimately, if a credible plan is not produced, supervisors should be prepared to require an institution to sell assets and simplify operations until it shows itself to be bankruptcy compliant.

In advocating this approach, it is critical to also recognize and address its challenges. For example, Living Wills are prepared on an individual institution basis. Each firm's plan is judged separately and is dependent on assumptions regarding individual structure and business activities. To generalize and implement this process and to assure that bankruptcy can be executed uniformly across the industry is problematic. If the process is subject to extensive political maneuvering, there is greater risk of inconsistent application of divestiture requirements and uneven outcomes. We gain a sense of this challenge from our experience with the Volcker Rule. It was resisted from the outset and continues to be challenged after the final rules have been adopted.⁵

⁴ Hoenig statement on the FDIC Single Point of Entry Strategy, December 2013.
<http://www.fdic.gov/about/learn/board/hoenig/statement20131210b.html>

⁵ Another example is Section 5(e) of the Bank Holding Company Act. It has been in effect since 1978 giving regulators the authority to separate problem affiliates to prevent them from endangering a commercial bank. However, it has never been used.

To be sure, having regulatory agencies rather than legislators define the nation's financial structure and business activities is less than ideal. In the end, legislating the separation of highly subsidized commercial banks from non-bank trading and similar activities might be the better choice. However, among the array of hard choices, it is better to work through such difficulties than to endure another severe crisis and bailout due to lack of resolve to make bankruptcy work as required by the law.

Conclusion

To solve a problem, the first step is to acknowledge that one exists. Dodd-Frank sets a law in place, but it does not solve the problem of bailout so long as firms remain too large, too leveraged, too complicated, and too interconnected to be placed into bankruptcy when they fail.

In the meantime, regional and community banks are smothering under layers of new regulations even though they are not too big to fail, and even though they hold significantly higher levels of capital than the largest banking and financial firms.⁶

Changing outcomes for the public means enforcing the law to address root causes of instability in the financial system, rather than maintaining the status quo. Our goal should be to create a fair, competitive environment where financial firms can thrive or fail based on the forces of the free market, regardless of size and complexity.

In theory, Title I provisions to resolve these firms make the system safer. In practice, it will be the industry and its regulators that make the law work.

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⁶ Global Capital Index: <http://www.fdic.gov/about/learn/board/hoenig/capitalizationratios4q13.pdf>

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