Testimony of

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Mr. Chairman, and members of the Subcommittee, thank you for inviting me here today. I am very pleased to have the opportunity to speak with you about the need for a resolution authority for systemically significant financial institutions.

For the better part of a year, I have been focused on how best to manage the risk posed by systemically dangerous firms – and, by extension, how to structure our regulatory and legal systems so that no private financial firm is considered “too big to fail.” When several of our country’s largest and most interconnected financial institutions became vulnerable this year and last, our government was left with few options but to assist them, lest their failure and ensuing bankruptcy provoke a dangerous cascade of losses across the financial system. To avoid the need for bailouts in future crises, we must establish a strong resolution mechanism in advance, specially tailored for systemically significant financial firms, in a way that our existing bankruptcy system is not.

For a resolution mechanism to fulfill its promise and serve as a firewall against the need for bailouts, it must manage the twin dangers of systemic risk and moral hazard. First, it must be designed to limit – and certainly not exacerbate – the systemic threat posed by the failure of a very large and highly interconnected financial firm. It is now widely believed that the current bankruptcy system is not well suited for this purpose. At the same time, to prevent the creation of moral hazard (i.e., incentives for excessive risk taking), a resolution mechanism must be sufficiently tough so as not to resemble a bailout itself. It must also be sufficiently credible so that market participants are confident in advance that it will in fact be used (and not dropped in favor of a bailout), even in the midst of a financial crisis. Over the remainder of my testimony, I would like to discuss what a resolution authority that met these objectives might look like.

A strong resolution authority is needed to allow systemically significant firms to fail, without provoking an avalanche of losses in the process.

Although American bankruptcy law has served us extremely well in many different contexts over the past 100-plus years, it was never designed to handle the failure of a large, systemically significant financial institution, particularly at a moment of severe financial turmoil. For one, our bankruptcy procedure may be too slow to deal with the failure of a major financial institution in the midst of a fast moving crisis. Moreover, the preservation of certain claims, even at public expense, may in some special cases be necessary to prevent or limit a broader financial storm.

More concretely, at a moment of financial turmoil or distress, the bankruptcy of a systemically significant financial institution (SSFI) could potentially provoke cascading losses (far beyond the firm and its direct creditors and counterparties) and perhaps even trigger a severe financial panic. Concern about such a chain of events, stemming from the bankruptcy of a large financial firm, existed well before the failure of Lehman

Brothers, but was dramatically confirmed by Lehman's entry into bankruptcy in September 2008 and the financial havoc that followed. Given this, it is very likely that in some future moment of financial turmoil, federal officials would go to great lengths to prevent a systemically significant financial institution from falling into bankruptcy. In fact, with the notable exception of Lehman, this is precisely what happened in the recent crisis (with government-supported rescues of Bear Stearns, Fannie Mae, AIG, and Citigroup, among others).

As a result, the choice we now face may not be between the existing bankruptcy system and a new resolution process, but rather between an ad hoc bailout process (to avoid bankruptcy at a moment of systemic turmoil) on the one hand, and a strong resolution process on the other. Given this choice – and, I'm afraid, this is exactly the choice we face – I prefer the creation of a credible resolution process, specially designed for SSFIs.

The good news it that FDIC has had this authority for years with respect to commercial banks, and it has worked well. What is needed now is a comparable resolution process for all SSFIs, whether they are banks, bank holding companies, or other financial institutions. We need a resolution process that works, so regulators don't have to be afraid to let a systemically significant financial institution fail.

The resolution mechanism must be designed as one component of a comprehensive regulatory plan to eliminate the policy of "too big to fail."

While a resolution mechanism is necessary to help eliminate "too big to fail," it is by no means sufficient. If there is one thing I would like to convey today, it is this: in isolation, a resolution mechanism will not do the trick. Rather, it must exist as part of a larger program to manage systemic risk, or we will likely end up with the very same ad hoc bailout system that we are now trying to eliminate. FDIC's resolution mechanism for commercial banks exists as part of a broader system of regulation and insurance, and so must the new resolution mechanism for SSFIs that we hope to create.[1]

To effectively manage the problem of "too big to fail," we must take four linked steps, designed to reduce the risk of systemically dangerous firms failing in the first place, and to allow such firms to fail if necessary, without causing system-wide damage.[2]

- As a first step, I believe we must publicly identify systemically significant financial institutions (that is, those firms whose failure, whether in normal times or times of financial turmoil, could provoke a cascade of losses in the financial system); and we

[1] See note 4 below.

[2] For a fuller description, see David Moss, "An Ounce of Prevention: Financial Regulation, Moral Hazard, and the End of 'Too Big to Fail'," *Harvard Magazine*, September-October 2009 (http://harvardmagazine.com/2009/09/financial-risk-management-plan).

must develop and maintain this public list of SSFIs on an ongoing basis, before crisis strikes.

- Second, to reduce the risk that such institutions will fail, and to give them an incentive to slim down, we should impose heightened regulation on the systemically significant firms on the list. This heightened regulation should include, at a minimum, tough leverage and liquidity requirements, limits on the proportion of short-term debt on these firms' balance sheets, and restrictions on their off-balance sheet activity. A maximum leverage ratio for SSFIs might even be written directly into the statute.

- Third, to prepare in advance for the possibility of system-wide disturbance and to help make the resolution mechanism credible, we should create an explicit – but strictly limited – stabilization fund, which would trigger only in periods of severe systemic distress. The fund would require regular fees or premiums (ex ante) and would provide pre-specified (and temporary) capital infusions to all viable SSFIs to help stabilize the broader financial sector in the midst of a crisis. I'll return to this stabilization-fund proposal later in my testimony.

- Fourth and finally, we should develop an effective resolution mechanism – as I have mentioned – to ensure that no institution is seen as too big, or to systemic, to fail.

The resolution authority must be sufficiently tough and credible so as not to create moral hazard.

A resolution mechanism, placed within the broader regulatory program just described, would allow systemically dangerous financial firms to fail without the type of systemic damage a bankruptcy could create. However, as I mentioned in my introductory remarks, the resolution authority must not only prevent systemic damage, it must also avoid the danger of moral hazard. I see two potential scenarios in which a resolution mechanism could fail, leaving us with a de facto bailout policy – and the associated moral hazard.

First, in designing a resolution authority that would avoid the systemic damage engendered by bankruptcy, we must take care not to build in so much support for claims against the failing firm that the resolution is essentially a bailout itself. If the resolution process is not sufficiently tough – that is, if it is tantamount to a bailout – the market will still consider systemic firms government-guaranteed. Shareholders must be wiped out, and creditors must be converted into new shareholders (starting with the most junior creditors, and working up). Counterparties may require some protection, but even here there should be significant haircuts to avoid the perception of an implicit guarantee and the moral hazard that goes along with it.

Second, and most important, a resolution mechanism must be credible in order to eliminate implicit guarantees and reduce moral hazard. Market participants must believe that the mechanism will in fact be used to take down a failing financial firm, whether in normal times or in times of financial turmoil, and that public officials will not instead (and at the last minute) resort to an ad hoc bailout.

The problem is that in the event of a severe systemic disturbance that threatened to take down all (or at least many) of the nation's largest financial firms simultaneously, it would probably not be either feasible or desirable for the government to put every major financial institution into receivership at the same time. Nor could it credibly make this threat ex ante. Consequently, the danger exists that if we faced a broad financial crisis, in which numerous SSFIs were at risk of collapse, public officials might feel compelled to circumvent the resolution mechanism by providing direct (and open-ended) financial support to these firms, to prevent them from failing. If market participants perceived this bailout option to be inevitable in a crisis, the resolution mechanism would be far less effective than it should be in reducing (or, ideally, eliminating) implicit guarantees and the associated moral hazard.

As a result, while a resolution mechanism for SSFIs would play an important role in combating perceptions of "too big to fail," we should prepare in advance for a situation in which a systemic disturbance leaves many such firms vulnerable at the same time. To address this problem, we should create a stabilization mechanism that would provide a strictly limited infusion of funds to all *viable* SSFIs at a time of severe systemic turmoil.[3] Such an infusion (which would likely involve the purchase of preferred shares) would be available only to pre-designated systemically significant firms and would be designed to stabilize fundamentally healthy institutions. Weaker firms, whose failure was deemed imminent, would not receive the infusion and would face resolution immediately. Firms that received a capital infusion but neared failure in any case would also be forced into resolution.

In contrast to the current bailout approach, where open-ended government support is provided disproportionately to the weakest firms, the system described here would – in a crisis – separate SSFIs into two groups: strong firms, for which a limited (and temporary) capital infusion would be sufficient to ensure survival through the crisis; and weak firms where even the promise of a limited capital infusion would not be sufficient to ensure

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[3] Specifically, I am recommending the creation of a stabilization fund for systemically significant financial institutions (SSFIs), which would require these firms to pay fees (or premiums) on an ongoing basis. At a moment of severe systemic turmoil – and only at such a moment – the fund would have the authority to borrow from the Treasury to undertake pre-specified (i.e., not open ended) capital infusions to all viable, pre-designated SSFIs. Once the crisis had passed, surviving recipient firms would be required to repurchase the government shares from the stabilization fund, and the fund would then repay the Treasury. Any losses to the fund would be covered by the previously collected fees (premiums). These fees might also be used to finance resolution operations, as necessary.

survival. Under the proposed system, strong firms would be stabilized until the turmoil dissipated, whereas weak firms on the verge of failure would be credibly forced into the resolution mechanism.

Importantly, the proposed stabilization fund would not create a new guarantee. Rather, it would transform an open-ended implicit guarantee, which already exists (and is by far the most dangerous kind of guarantee), into the possibility of explicit support that was well-defined, carefully limited in scope, effectively funded through premiums or fees, and reserved only for rare moments of systemic turmoil. In the period after the systemic disturbance, all surviving SSFIs would be required to repay the federal government (most likely by repurchasing the preferred shares that the government had acquired). Consequently, the only loss to the fund would be the amount provided to firms that ultimately failed, despite receiving stabilization assistance. This loss would be covered by fees (or premiums) paid into the fund by all SSFIs, ex ante.

Such a system would ensure that resolution remained a credible option for taking down systemically significant financial institutions, even in the midst of a severe financial crisis.[4]

Conclusion

Particularly given the string of bailouts that we just lived through, it is critically important that we develop a credible resolution mechanism for dealing with systemically significant financial firms in the future. No private entity should ever be "too big to fail." However, it is also essential not to deceive ourselves by creating a resolution mechanism that looks good on the surface but would in fact fail to reduce the implicit guarantee that these institutions now enjoy – either because the mechanism was so weak as to constitute a de facto bailout, or because it was not credible, with market participants doubtful that it would be used in a crisis. In either case, the unfortunate result would be a virtual continuation of the current policy of "too big to fail" and the severe moral hazard that goes along with it.

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[4] Proponents of a resolution mechanism for SSFIs commonly put forth as a model the FDIC's resolution process for commercial banks, which is widely regarded as effective. It is worth remembering, however, that the FDIC resolution process is part of a broader program of bank supervision that includes not only prudential regulation but also federal deposit insurance. Without the insurance component, officials at the FDIC might be reluctant to put a large bank into receivership, lest depositors at other banks become nervous and commence bank runs or even start a general panic. Just as FDIC's resolution process for commercial banks would be far less effective (and credible) without the existence of federal deposit insurance, so too a new resolution process for SSFIs would be unlikely to be very effective (or credible) without the existence of a stabilization fund.

For the resolution mechanism to be effective, the process of winding up a financial firm must be streamlined and the receiver must have some discretion to avoid triggering systemic losses; but the process must never coddle the creditors, counterparties, or management of failing financial firms simply because those firms are systemically significant. To be credible, the resolution mechanism must be accompanied by a stabilization fund to safeguard strong financial institutions in times of crisis and to allow the weak ones to be put into resolution. Together with heightened prudential regulation of systemically significant financial firms (to reduce the risk of failure), a stabilization fund and a resolution authority would enable the government to credibly take down weak institutions, preserve stronger ones, and dramatically reduce the problem of moral hazard by rendering obsolete the existing policy of "too big to fail."