STATEMENT

OF

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on

"Who is Too Big to Fail: Does Title II of the Dodd-Frank Act Enshrine Taxpayer Funded Bail-outs?"

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Chairman McHenry, Ranking Member Green, and members of the Subcommittee, thank you for the opportunity to testify today. The topic for today's hearing is "Who is Too Big to Fail: Does Title II of the Dodd-Frank Act Enshrine Taxpayer Funded Bail-outs?"

Too Big to Fail did not begin with the recent financial crisis or with Dodd-Frank. It is the product of the long-time expectation by the market that some institutions are so critical to the functioning of the financial system and economy that the government will act to prevent their insolvency and resolution. This expectation over many years has distorted market pricing for debt and equity, and limited the incentives that should be provided by market discipline. The recent financial crisis transformed the expectation of a bail-out into a proven reality in 2008 because the regulators had no option other than bankruptcy to resolve the largest non-bank financial companies and, as a result, had to take several difficult steps to prevent greater chaos.

To be succinct in response to the question posed for today's hearing, Title II of Dodd-Frank does not enshrine Too Big to Fail. Title II provides an alternative to the Bankruptcy Code to ensure that the tools are available in a crisis to close the largest financial companies and to impose the losses on their shareholders and creditors, while mitigating the potential for more widespread dislocations in the financial system and economy. These tools are based on those long used by the Federal Deposit Insurance Corporation to resolve failed insured banks. I think it beyond dispute that we our statutory framework in 2008 did not have all of the tools necessary. Title II provides that statutory framework.

Any consideration of Title II has to examine why it was created and the alternatives. In a properly functioning market economy there will be winners and losers, and some firms will become insolvent and should fail. Actions that prevent firms from failing ultimately distort market mechanisms, including the market's incentive to monitor the actions of similarly situated firms. Title II was a reaction to the fact that in 2008 the regulators did not have the legal authority to close the largest financial holding companies, impose losses on their shareholders and creditors, and resolve them. In 2008, the only alternative was the Bankruptcy Code and no one wanted to replicate the experience of the Lehman Brothers' bankruptcy.

One explanation for the market reaction to the Lehman failure was that it shocked investors because, following Bear Stearns, they had assumed Lehman was too big to fail and its creditors would garner government support. Others feel that the bankruptcy process itself had a destabilizing effect on markets and investor confidence. While the underlying causes of the market disruption that followed the Lehman failure will likely be debated for years to come, both explanations pointed to the need for a new resolutions process for systemically important non-bank financial institutions.

It was clear in the United States and internationally that some alternative to impose shareholder and creditor discipline through an insolvency process without the consequences of widespread economic dislocation was necessary. Title II was designed to provide that alternative in the rare cases where the Bankruptcy Code could not meet those needs.

I served with the Federal Deposit Insurance Corporation for more than twenty-one years, and represented the FDIC on the Financial Stability Board's Resolutions Steering Group after the financial crisis began in 2008. During this time, it became obvious to virtually everyone in the international arena that you could not close a complex financial company operating internationally under then-existing U.S. or foreign laws without creating havoc in national and international markets with potentially devastating consequences for the citizens of those countries. In the absence of the essential legal tools, such as those in Title II, other countries like the United States opted for bail-outs in 2008 because the consequences of a disorderly collapse were too dire.

The universality of the recognition that certain statutory tools are essential to resolve a complex financial company is reflected in the Key Attributes of Effective Resolution Regimes for Financial Institutions adopted by the G-20 heads of state in 2011. The Key Attributes incorporate virtually all of the powers contained in Title II, which itself was based on the long-standing authority used by the FDIC to resolved failed banks. The Financial Stability Board is now regularly evaluating the progress of member countries in implementing those authorities. The insolvency tools included in Title II are now being incorporated into law in the European Union, the United Kingdom and other jurisdictions because those tools are basic building blocks to resolve large, complex financial companies. It is no exaggeration to say that Title II is, in fact, the international standard.

The Role of Bankruptcy

Bankruptcy has a long and honored history under U.S. law. For the vast majority of the business bankruptcies in the United States, the current system has worked very well. In fact, the U.S. bankruptcy process is aptly considered a strength of our commercial and economic system. Many thousands of businesses have been successfully reorganized or liquidated under the Bankruptcy Code. The bankruptcy process has even been an effective tool for restructuring large commercial companies, such as General Motors and Chrysler.

However, experience has shown that an alternative is necessary as a back-up for dealing with the resolution of some financial institutions during periods of financial crisis. During those rare cases where the Bankruptcy Code could create a potential for wider systemic consequences, we need an alternative to address several key issues. In a crisis, immediate action may be necessary that is more difficult under the current Bankruptcy Code. It is essential that someone have the power to act immediately after failure to take over the business, preserve critical financial operations, establish an operating institution – such as a so-called bridge institution, and provide continuity for those critical operations. During the uncertainty of a market crisis threatening a spiral of market dislocations, a response to an insolvency that can stabilize the failed operations quickly allows the markets, both domestic and international, to make investment, pricing and liquidity decisions with greater certainty and reduce the likelihood of market disruptions.

In addition, it is important to have features in the applicable insolvency law – such as bridge financial companies and the ability to transfer financial contracts without immediate termination – that are essential to the continuity of the business of a large, complex financial company. Continuity is critical in order to maximize value for the creditors of large financial companies and to avoid potential systemic consequences. Both the Bankruptcy Code's automatic stay and the immediate termination of financial contracts can make this more difficult. The option of a bridge financial institution, such as available in bank receiverships, allows the receiver to transfer assets and contracts from the failed firm to the bridge institution in order to retain franchise value and to avoid dumping financial contracts on the markets. The Bankruptcy Code also allows counterparties to certain financial contracts to terminate the contracts and retain net collateral immediately after initiation of the bankruptcy. While this protection can be important to protect financial markets in normal times, it can create a rapid unraveling of the failed company, and broader problems for the financial markets, during the failure of larger financial companies. The bridge financial institution also can maintain other systemically significant functions such as payments processing, securities lending, and the continuity of ongoing government securities or other transactions.

An effective insolvency process for complex financial companies that can be subject to market runs may also require a ready source of liquidity. The Bankruptcy Code currently lacks access to such a source and, during a crisis, it has so far proven difficult to arrange adequate financing under the existing "debtor-in-possession" framework. This is particularly crucial because in virtually all cases large financial companies fail because they lack sufficient liquidity. While work to improve the availability of debtor-in-possession financing should be pursued, this remains a significant challenge in financial bankruptcies.

Finally, a resolution of the most complex financial firms requires pre-planning. An essential element in this advance planning is consideration of what steps are necessary to protect the public interest. The bankruptcy process focuses on resolving creditor claims and not protection of the broader public interest. For almost all insolvencies, this is the appropriate focus, but in extraordinary cases it may be necessary to consider the consequences for the broader economy.

An essential element in the FDIC's process for resolving failed insured banks is extensive pre-planning of the resolution and the ability to develop expertise in quickly implementing a resolution that preserves critical financial operations once the bank is closed. As a useful comparison, without the ability to pre-plan for the closure of an insured bank, the FDIC could not achieve success in giving insured depositors virtually immediate access to their deposits. This factor, so critical to preserving liquidity for even the smallest failed bank, is self-evidently indispensable to avoid broader market and economic disarray in the resolution of the largest financial firms in a crisis.

The Bankruptcy Code can be improved and provide a much more effective tool to address the insolvency of large financial companies. There are certain discrete improvements that can be made to substantially improve the ability of the Bankruptcy Code to address the failure of financial companies. However, in my view, we will always need the tools in Title II for some insolvencies because of the foregoing inherent limitations of the Bankruptcy Code.

The Title II Process

In examining whether Title II enshrines Too Big to Fail, it is worth recognizing that the powers provided to the FDIC are drawn from those used for many for decades to manage receiverships of failed banks – and include many parallels to those in the Bankruptcy Code. In fact, the provisions in Title II specifically follow the Bankruptcy Code wherever possible with the differences focused on those provisions essential to address the missing elements noted previously. The reason is simply that since Title II is a back-up option for those extraordinary circumstances where bankruptcy appears likely to lead to systemic consequences, it should mimic bankruptcy except in those areas needed to address systemic risks. As a result, Title II is structured so that the market evaluation of debt or equity issued by a company potentially subject to Title II should not differ in substance from their evaluation in a bankruptcy scenario. Of course, because Title II will rarely be invoked, it is critically important for both markets and non-U.S. regulators that the FDIC provide as much transparency as possible – in advance – about its preferred course of action for this type of resolution. I understand that the FDIC is preparing a statement of policy to better describe this process. To be helpful, this statement must be sufficiently detailed to provide market participants with clear direction on the expected steps and the parameters for action. Application of Title II is not an area for vague and uncertain standards.

The Orderly Liquidation Authority includes the elements that are needed to deal with a rapidly changing environment surrounding a large, complex financial company. This new process is only initiated in extraordinary circumstances, under specific standards, by a process requiring the recommendation of a super majority of the Board of Governors and the FDIC Board, or alternatively the Securities and Exchange Commission or Director of the Federal Insurance Office in the case of a broker and dealer or insurance company, respectively. It is designed to be a rarely used option and only as a last resort.

Once the FDIC is appointed as receiver, it can move immediately to transfer operations to other financial companies or to a bridge financial company to preserve value and mitigate systemic consequences. This allows the immediate authority to act decisively that is essential to respond to the vagaries of a rapidly changing financial environment. The FDIC would have the authority to sell or transfer operations to a buyer or newly created bridge financial company so that synergistic value and critical operations can be maintained. While there are important due process rights to which creditors are entitled, those rights are fully protected by the ability to sue the FDIC as receiver for damages after the fact – Title II preserves this important protection by providing for jurisdiction in the federal courts for claims against the receiver.

Crucial to the ability to preserve value and prevent systemic consequences, as noted previously, is having statutory authority to continue the financial company’s systemically important operations. Naturally, as noted above, a precondition to doing this is to prevent the immediate termination of market-based contracts once the receiver is appointed, while providing for the continuation of those contracts in a purchasing company or in a bridge financial company.

Equally vital is the ability to address the fundamental reason the financial company failed in the first place – the evaporation of liquidity. Title II does this by providing a source of temporary liquidity funding if private market funding is not available that the FDIC may obtain from the Treasury Department in order to lend to the failed company. This temporary government funding cannot be used as a taxpayer bailout in disguise, because the statute flatly prohibits the use of this funding as a means to shift losses of the failed institution to taxpayers.

In addition, Title II expressly precludes any use of this liquidity source in order to prevent the closing and resolution of any entity.

Title II includes important safeguards to ensure that taxpayers never sustain losses from such funding. First, any money that the Treasury makes available must be repaid from the sale of the failed company's assets before any other creditors recover a dime. This alone should be more than adequate to ensure repayment of any loans made by the FDIC in nearly all circumstances. Second, the amount of money that Treasury can provide is capped at less than the value of the company's assets – further supporting repayment by the sale of those assets. Third, no money can be made available without a specific plan and repayment schedule for full repayment between the Secretary of the Treasury and the FDIC based on the resources available to repay the amounts requested. Fourth, in the highly unlikely event that the assets of the failed company prove inadequate to fully repay the temporary funding, the FDIC can "clawback" certain monies from creditors. Finally, in the even more unlikely event that the proceeds from the assets and the clawback payments are insufficient to fully repay the amounts outstanding, the FDIC must recover the balance due through risk-based assessments on the large, complex financial institutions subject to special Board of Governors' oversight.

Another key element in Title II is the ability, coupled with the living wills requirement in Title I and the additional supervisory authorities granted to the Board of Governors, to undertake advance planning. Advance planning is particularly critical to develop the framework for resolution of the cross-border operations of a large, complex company. Past experience leads to the conclusion that U.S. and foreign regulators are unlikely to cooperate in a way that will achieve a cooperative resolution of a cross-border financial company. The failed cooperation involving Lehman Brothers, the sub-optimal resolution of Fortis Bank between the Netherlands and Belgium, and the problematic issues created by the collapse of several Icelandic banks are simply recent examples. The Financial Stability Board, during and after my service, has recognized these problems – as have all national regulators. They have also recognized that, in a world without an international insolvency process, cooperation in a crisis by national supervisory and resolution authorities must be based on common statutory powers, extensive pre-crisis information sharing and planning cooperation, and by a sober appreciation that cooperation in a crisis can only be reliable when each countries' domestic interests are promoted by doing so. These foundational elements revolve around regular and detailed pre-planning both to test approaches and to test confidence. Title II is the first U.S. law to provide the basis for this pre-planning by creating the statutory framework to resolve banks and complex non-bank financial companies. In this way, the authorities in Title II – along with the planning requirements in Title I – are essential to improved international cooperation.

The FDIC has been engaged in an ongoing domestic and international planning process for some time, but much remains to be done. The largest financial companies, and the largest insured banks now prepare living wills under regulations required by Title I of the Dodd-Frank Act. The requirement of a detailed, *credible* resolution plan for each financial company with assets greater than $50 billion is a major undertaking and the financial companies themselves have devoted enormous resources to meeting the requirements. The FDIC and the Board of Governors, as well as individual Federal Reserve Banks, have likewise focused significant resources on evaluating these plans and working with the companies to improve them. This is a critical step forward. After all, the court-appointed trustee overseeing the liquidation of Lehman Brothers Inc. found that the lack of a disaster plan "contributed to the chaos" of the Lehman bankruptcy, the loss of billions of dollars in value, and the liquidation of its U.S. broker-dealer.

When a large, complex financial institution gets into trouble, time is the enemy. The larger, more complex, and more interconnected a financial company is, the longer it takes to assemble a full and accurate picture of its operations and develop a resolution strategy. By requiring detailed resolution plans in advance, the Dodd-Frank Act gives the FDIC and the Board of Governors information that will allow for extensive advance planning both by regulators and by the companies themselves.

Today, the FDIC is working with other regulators and the financial services industry to actively evaluate how to resolve the most complex financial companies. The FDIC's "single point of entry" approach offers significant advantages in addressing a number of the major challenges in the resolution of the largest financial companies. This work is an important step forward, but it must continue to be strengthened and deepened. The FDIC must convince the marketplace that its plans will, in fact, allow it to resolve a systemically important financial institution without creating widespread financial and economic disruptions. Only if the marketplace, and the public, are convinced that a Title II resolution is realistic will market discipline operate more effectively on financial companies of all sizes. This is the real question. The FDIC has done an admirable job of explaining its plans and how its process will work. But, the job it not complete because questions and doubts remain. To complete the job will require a much more explicit and detailed public statement of how the resolution will be conducted.

Today, market participants generally understand the fact that Title II does not allow the FDIC, or any other regulator, to simply keep a financial company open and bail-out its shareholders. What they question is whether the Title II process will be invoked or whether the laws will be changed to allow another bailout in the next crisis.

Where Do We Go From Here?

While Title II is a vital foundation, it is not sufficient to end Too Big to Fail. The expectation of a government bail-out will end only when the market fully incorporates into its pricing and other interactions an expectation that in the next crisis the largest institutions will be closed and resolved. While Title II provides a legal framework for the resolution of a large, complex financial company, more must be done. We must continue ongoing efforts to achieve greater international coordination and we must continue the ongoing resolution planning that the large U.S. financial companies and the FDIC and Board of Governors are pursuing.

The history of the recent crisis is replete with examples of missed opportunities to sell or recapitalize troubled institutions before they failed. The market cannot operate effectively unless bailout is kept off the table by providing a statutory framework for a resolution that imposes the costs on shareholders and creditors. Bailout is now off the table by legislative decision. It must remain off the table. Removing Title II might be read many market observers as simply signaling that the next crisis is more likely to return to past practice and bailout the largest financial companies. We need to support market discipline by ensuring that we have insolvency procedures that are effective for all scenarios. Market discipline, if allowed to act, can prevent failures by incentivizing action by management and creditors alike. We need a Title II process to help market discipline make its mark.

Conclusion

Too Big to Fail should be eliminated because of its distortion of market discipline and market practices, and ultimately its negative consequences for the real economy. However, Too Big to Fail was not created or enshrined by the Dodd-Frank Act. Too Big to Fail simply reflects the expectation that the government will step in to prevent the insolvency of the largest financial companies. In 2008, this expectation became a proven reality. Title II of the Dodd-Frank Act directly prohibits such a bailout. In fact, the statutory insolvency tools provided by Title II helps support other insolvency tools by serving as a back-up to ensure that market discipline will be effective even in the extraordinary cases. However, the elimination of Too Big to Fail is a work in progress. Much work remains to be done.