Jerome H Powell: Ending "too big to fail"

Speech by Mr Jerome H Powell, Member of the Board of Governors of the Federal Reserve System, at the Institute of International Bankers 2013 Washington Conference, Washington DC, 4 March 2013.

* * *

Today I will discuss "too big to fail" and the ongoing work since the financial crisis to end it.[1] More than three years into this effort, there have been sweeping reforms to the regulation of large financial organizations in the United States and around the world. Substantial proportions of the new rules are designed to end the practice of bailing out such firms with taxpayer money. The too-big-to-fail reform project is massive in scope. In my view, it holds real promise. But the project will take years to complete. Success is not assured.

In the meantime, some urge the adoption of more intrusive reforms, such as a return to Glass-Steagall-style activity limits, more stringent limits on size or systemic footprint, or a requirement that the largest institutions break up into much smaller pieces. I believe that public discussion and evaluation of these ideas is important. At a minimum, we need to thoroughly understand these alternatives in case the existing reform project falters.

It is worth noting that too big to fail is not simply about size. A big institution is "too big" when there is an expectation that government will do whatever it takes to rescue that institution from failure, thus bestowing an effective risk premium subsidy. Reforms to end too big to fail must address the causes of this expectation.

In broad terms, these reforms seek to eliminate the expectation of bailouts in two ways – by significantly reducing the likelihood of systemic firm failures, and by greatly limiting the costs to society of such failures. When failures are unusual and the costs of such a failure are modest, the expectation at the heart of too big to fail will be substantially eliminated. My focus today is principally on the second of these two aspects of reform – containing the costs and systemic risks from failures, a goal being advanced by work to create a credible resolution authority.

I hope you won't mind if I draw today on some of my own experiences over the years with too big to fail, beginning with my service at the Treasury Department during the Administration of President George H.W. Bush. I joined the Administration only a few years after the rescue of Continental Illinois, which is sometimes said to have codified the practice of too big to fail.

In my years at Treasury, we faced a wave of well over 1,000 savings and loan and bank failures. That included the failure of the Bank of New England Corp., then the third largest bank failure in U.S. history.[2] It happened in January 1991, at a time of great stress in the financial system and the broader economy, and only days after 45 depository institutions in the region had been closed and 300,000 deposit accounts frozen.[3] My Treasury colleagues and I joined representatives of the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve Board in a conference room on a Sunday morning. We came to understand that either the FDIC would protect all of the bank's depositors, without regard to deposit

---

[1] The thoughts that follow are my own and do not necessarily reflect the views of my colleagues on the Board of Governors. I am grateful to Felton Booker, Barbara Bouchard, Michael Gibson, John Maggs, and Mark Van Der Weide for numerous helpful conversations and suggestions.

[2] Ranked by total assets at the time of failure, in 1991 Bank of New England Corp. ($21.7 billion) was the largest U.S. bank failure following Continental Illinois National Bank and Trust ($40 billion; 1984) and First Republic Bank ($32.5 billion; 1988).

[3] See Thomas E. Pulkkinen and Eric S. Rosengren (1993), "Lessons from the Rhode Island Banking Crisis (PDF)," Federal Reserve Bank of Boston, *New England Economic Review*, May/June.

insurance limits, or there would likely be a run on all the money center banks the next morning – the first such run since 1933. We chose the first option, without dissent.[4]

In the summer of 1991, we faced the Salomon Brothers crisis. Salomon, a global investment bank, was one of the largest financial institutions in the United States, and the largest dealer in U.S. government securities. The firm came under severe market pressure after some of its traders were caught submitting phony bids in Treasury bond auctions. As recounted in harrowing detail in the book "The Snowball," Salomon came within hours of failure over a weekend in late August.[5] Salomon was clearly understood to be outside the safety net, and I recall no discussion of a government rescue. But the firm's failure would almost certainly have caused massive disruption in the markets. To this day, I am grateful that we resolved that crisis with neither a bailout nor a failure.

Over 20 years later, both these events still frame the too big to fail reform agenda. Faced with the failure of a large commercial bank, we chose to extend the safety net rather than run the very real risk of a systemic depositor run. Our "near miss" with Salomon in 1991 presaged the enormous damage that would result from the failure of Lehman Brothers, another investment bank, in 2008. In fact, the dimension of the problem grew substantially over the years. Since 1991, the ratio of U.S. banking assets to annual gross domestic product in the United States has more than doubled, from 55 percent to 126 percent. Meanwhile, the percentage of those assets held by the largest three institutions has increased from 14 to 32 percent.

Bailouts may have been more tolerable in the early 1990s when they were rare and their use for a failing bank was uncertain. That is no longer the case. Recent years have seen large and numerous bailouts as a result of the financial crisis. The public, the regulatory community, and large financial institutions themselves all agree now that too big to fail must end.

As I said earlier, reforms to end too big to fail must wage the fight on two fronts. First, we need enhanced regulation to make large financial institution failures much less likely. Second, we need a credible mechanism to manage the failure of even the largest firms, without causing or amplifying a systemic crisis.

Let's survey what has been proposed and implemented thus far in that two-front war on too big to fail.

The U.S. and global efforts to address too big to fail

Reducing the probability of default of systemic financial firms

Much has been done since the crisis to strengthen the regulation of large banking organizations. The highlights would begin with the Basel III capital and liquidity reforms, including the graduated risk-based capital surcharges for globally systemic financial firms. These reforms are in the process of implementation in the United States and elsewhere. In addition, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) imposes on the largest financial institutions enhanced prudential standards and also requires central clearing of derivatives. And banking regulators have implemented enhanced supervisory measures such as stress testing and recovery planning.

While these measures are not the primary focus of my remarks today, I believe that they collectively constitute a broad and well-structured agenda to strengthen the resilience of the

---

[4] See FDIC (1997), "Bank of New England Corp. (PDF)," in *Managing the Crisis: The FDIC and RTC Experience,* Part II.

[5] Alice Schroeder (2008), *The Snowball: Warren Buffett and the Business of Life* (New York: Bantam Books).

financial system. The Federal Reserve and the rest of the regulatory community are working diligently to implement that agenda.

Today, risk-based capital and leverage ratios for banks of all sizes have improved materially since 2009 and are significantly above their levels in the years preceding the crisis. The banking sector overall also has substantially improved its liquidity position over the past few years. The system is undeniably stronger than before the crisis.[6]

Reducing the systemwide loss given default of systemic financial firms

It is neither possible nor desirable to regulate large financial institutions so that they literally cannot fail. But regulation can limit the systemwide impact of such a failure. Let's review what has been done since the crisis to reduce the damage to the system from the failure of one of the very largest firms.

Under Dodd-Frank, nearly all financial institution failures, including those of large, complex institutions, will continue to be addressed as they were before passage of the new law. The holding company will be resolved in bankruptcy. Operating subsidiary failures will continue to be treated either under bankruptcy or, where applicable, under specialized resolution schemes, including the Federal Deposit Insurance Act for banks and the Securities Investor Protection Act for securities firms.

Dodd-Frank eliminated the authority used by the Federal Reserve and other regulators to bail out individual institutions during the crisis, including Bear Stearns, Citicorp, Bank of America and AIG. But Congress also recognized that there may be rare instances in which the failure of a large financial firm could threaten the financial stability of the United States. To empower regulators to handle such a failure without destabilizing the financial system or exposing taxpayers to loss, Dodd-Frank created two important new regulatory tools.

First, the Act requires large bank holding companies and nonbank financial firms designated by the Financial Stability Oversight Council to submit a resolution plan or "living will" for their rapid and orderly resolution under the Bankruptcy Code. Second, the Act created a new Orderly Liquidation Authority (OLA) as a backup to resolution in an ordinary bankruptcy.

The largest bank holding companies submitted their first annual "living wills" to the Federal Reserve and the FDIC last summer. The initial round has yielded valuable information that is being used to identify and assess key challenges to resolvability under the Bankruptcy Code (Title I plans). The Title I plans will help to focus firm efforts to mitigate those challenges so that bankruptcy may be a viable resolution strategy for large institutions. These plans will also support development of the FDIC's backup resolution plans under OLA (Title II plans).

The resolution plan process is iterative by design. There is still much work to be done by firms, domestic and foreign regulators, and national governments. We remain committed to ensuring that this work is done quickly but responsibly in the coming years.

That brings us to the question of special resolution regimes. In October 2011, immediately before I was nominated to the Federal Reserve Board, I helped design a public simulation of the failure of a large financial institution under OLA. The cast included former senior government officials as well as leading experts from the private sector. The FDIC, the Federal Reserve, and the industry offered their assistance as we developed the simulation.

From the outset, my earlier experience had led me to be skeptical about the possibility of resolving one of the largest financial companies without destabilizing the financial system. Today's global financial institutions are of staggering size and complexity. I believed that an attempt to resolve one of these firms – a firm with multiple business lines carried out through

---

[6] See Ben S. Bernanke (2012), "Banks and Bank Lending: The State of Play," speech delivered at the 48th Annual Conference on Bank Structure and Competition, Chicago, Illinois (via satellite), May 10.

countless legal entities, across many jurisdictions and different legal systems – could easily spin out of control. The result could be greatly increased uncertainty for creditors and counterparties, which could trigger or accelerate a run on the failed institution that could quickly spread and destabilize the whole system.

As we developed the simulation, however, I came around to the view that it is possible to resolve a large, global financial institution. What changed my mind was the FDIC's innovative "single-point-of-entry" approach, which was just coming into focus in 2011. This approach is a classic simplifier, making theoretically possible something that seemed impossibly complex.

Under single point of entry, the FDIC will be appointed receiver of only the top-tier parent holding company of the failed financial group. Promptly after the parent holding company is placed into receivership, the FDIC will transfer the assets of the parent company (primarily its investments in subsidiaries) to a bridge holding company. Equity claims of the failed parent company's shareholders will be wiped out, and claims of its unsecured debt holders will be written down as necessary to reflect any losses in the receivership that the shareholders cannot cover. To capitalize the bridge holding company and the operating subsidiaries, and to permit transfer of ownership and control of the bridge company back to private hands, the FDIC will exchange the remaining claims of unsecured creditors of the parent for equity and/or debt claims of the bridge company. If necessary, the FDIC would provide temporary liquidity to the bridge company until the "bail-in" of the failed parent company's creditors can be accomplished.

It is crucial to recognize how this approach addresses the problem of runs. Single point of entry is designed to focus losses on the shareholders and long-term debt holders of the failed parent and to produce a well-capitalized bridge holding company in place of the failed parent. The critical operating subsidiaries would be well capitalized, and would remain open for business. There would be much reduced incentives for creditors or customers of the operating subsidiaries to pull away, or for regulators to ring-fence or take other extraordinary measures. If the process can be fully worked out and understood by market participants, regulators, and the general public, it should work to resolve even the biggest institution without starting or accelerating a run, and without exposing taxpayers to loss.

Single point of entry has important features in common with Chapter 11 bankruptcy reorganization. The principal differences in favor of OLA are the greater speed at which a firm can be placed into a resolution process and stabilized, the ability to avoid disruptive creditor actions, and the availability of temporary backup liquidity support to continue critical operations.

Some have proposed changes to adapt the Bankruptcy Code to the purpose of handling the failure of a large financial institution – for example, to allow the government to provide debtor in possession (DIP) financing, or to allow a firm's primary regulator to initiate a bankruptcy filing.[7] At a minimum, these proposals would further limit the need for OLA to the rarest of cases.

As the development of the single-point-of-entry approach continues, it is important to continue to reduce the uncertainties that creditors and other market participants would face in connection with their potential treatment in OLA. Questions remain about how the FDIC will apply its broad statutory discretion. For example: How will the FDIC exercise its discretion to dissimilarly treat creditors of the same class? How will a creditor's "minimum right of recovery" be determined? And how will the FDIC value the failed firm? Stability

[7] See Kenneth E. Scott and John B. Taylor, eds. (2012), *Bankruptcy Not Bailout: A Special Chapter 14* (Stanford, Calif.: Hoover Institution Press).

demands that market participants have a reasonable degree of certainty about their treatment in OLA *ex ante*. This is an important concern.

To reduce uncertainty, the FDIC is working to provide market participants as much clarity as is feasible regarding its contemplated approach to the failure of a systemic U.S. firm. Regulators will always need to maintain some degree of flexibility to manage the evolving failure of a systemic financial firm. But greater clarity would increase the predictability of this new process, and thus reduce the likelihood that creditors, counterparties, and customers would pull away from even a well-capitalized institution in OLA. I strongly support these efforts to provide more clarity to market participants.

Two remaining challenges loom large: ensuring that all systemic financial firms have sufficient unsecured long-term debt at the parent level to recapitalize a bridge holding company in OLA; and mitigating cross-border impediments to resolution of a multinational financial firm.

In consultation with the FDIC, the Federal Reserve is considering the pros and cons of a regulatory requirement that systemic U.S. financial firms maintain a minimum amount of long-term unsecured debt. Such a requirement would help ensure that equity and long-term debt holders of a systemic firm can bear potential future losses at the firm and sufficiently capitalize a bridge holding company.

The cross-border activities of large institutions present another set of challenges to an orderly resolution. OLA is limited in its applicability to U.S.-chartered entities. Subsidiaries and bank branches of a U.S.-based systemic firm chartered in other countries could be ring-fenced or wound down separately under the insolvency laws of those countries, if foreign authorities did not have full confidence that local interests would be protected. Certain OLA stabilization mechanisms, including the one-day stay provision with respect to over-the-counter derivatives and other qualified financial contracts, may not apply outside the United States. Accordingly, counterparties to qualified financial contracts with the foreign subsidiaries and branches of a U.S. firm may have contractual rights and substantial economic incentives to terminate their transactions as soon as the U.S. parent enters an OLA resolution. Today, regulators and the industry are focused on the potential for addressing this concern through modifications to contractual cross-default practices and other means.

Further progress on these cross-border challenges will require significant coordination among U.S. regulators and the key foreign central banks and supervisors for the largest financial firms. For example, the FDIC and the Bank of England are deeply engaged in this important work, as recently described in their joint paper applying the single-point-of-entry framework to the resolution of a globally active, U.S. – or U.K.-headquartered banking firm.[8] The FDIC also has an active dialogue with the European Commission. These challenges will also require foreign jurisdictions to have national resolution regimes consistent with the Financial Stability Board's "Key Attributes."[9]

Assessing progress on too big to fail

It seems to me that efforts by U.S. and global regulators to fight too big to fail are generally on the right track. The Basel III and Dodd-Frank reforms designed to reduce the probability of failure of large banking firms are sensible and, for the most part, targeted at the causes of

---

[8] Federal Deposit Insurance Corporation and the Bank of England (2012), "Resolving Globally Active, Systemically Important, Financial Institutions (PDF)" (December 10).

[9] The Key Attributes of Effective Resolution Regimes for Financial Institutions (PDF) (Key Attributes) were adopted by the Financial Stability Board in November 2011 as a new international standard that sets out the core elements of an effective special resolution regime for systemically significant financial firms.

the crisis. They are being implemented thoughtfully and effectively. And I believe that those Financial Stability Board and Dodd-Frank reforms designed to permit the resolution of systemic firms without taxpayer exposure or undue disruption are very promising. That said, much of the work lies ahead.

The critics also deserve a fair hearing.

Criticism of the current U.S. and global anti-too-big-to-fail policies generally takes one of two tacks. Some of the criticism argues that Dodd-Frank – particularly the OLA mechanism – enshrines taxpayer bailouts. I do not believe that it does. OLA requires by its terms that the losses of any financial company placed into FDIC receivership be borne by the private sector stockholders and creditors of the firm. Single point of entry can work without exposing taxpayers to loss.

Although the FDIC has authority to provide temporary liquidity to a failed firm, any costs incurred by the FDIC in resolving the firm must be recovered completely from either the assets of the firm or assessments on the financial industry. The failed firm's investors, and, if necessary, other large financial firms, will bear any costs. That is "bail-in," not "bailout."

Another strand of criticism argues that reforms do not go far enough and calls for more activity limits on banking firms, for limiting their size or systemic footprint, or for simply breaking them up.

Activity limits

Some have urged the resurrection of the 1930s-era Glass-Steagall prohibitions – that is, preventing the affiliation of commercial banks with investment banks. This proposal seems neither directly related to the causes of the financial crisis, nor likely to help end too big to fail. The systemic run that led to the financial crisis began with traditional investment banks, such as Bear Stearns and Lehman Brothers. The activities of these firms were, of course, not affected by the repeal of Glass-Steagall. Commercial banking firms now engage in activities traditionally associated with investment banking, such as securities underwriting. The combination of these activities under a single corporate umbrella did not contribute meaningfully to the financial crisis. In my view, losses at the commercial banks were more importantly a consequence of bad credit underwriting and the failure of risk management systems to keep up with innovation and the explosive growth in securitization – developments that were not fundamentally driven by the repeal of Glass-Steagall.

Size limits

There are also calls to further limit the size or systemic footprint of financial firms. Limits of this nature require, and deserve, careful analysis.

Two provisions of existing law already impose size caps on U.S. banking firms. One limits acquisitions of banks by any bank holding company that controls more than 10 percent of the total insured deposits in the United States, and a second, added by Dodd-Frank, forbids acquisitions by any financial firm that controls more than 10 percent of the total liabilities of financial firms in the United States. In addition, Dodd-Frank added a new requirement that banking regulators consider "risk to the stability of the U.S. banking or financial system" in evaluating any proposed merger or acquisition by a bank or bank holding company. Critics argue that these restrictions are inadequate and subject to exceptions that continue to allow even the largest firms to grow, both organically and through acquisitions.

The simplest forms of this idea would put a further absolute limit on the amount of balance sheet assets or liabilities, or on the risk-weighted assets of a financial firm. Capping the size or systemic footprint of each financial firm would limit the adverse systemic effects of the failure of any single firm. Smaller, simpler financial firms should be easier to manage and supervise in life, and easier to resolve in death. One option would be to impose a cap on a large U.S. banking firm's short-term non-deposit liabilities as a fraction of U.S. GDP. This

form of proposal would allow such a firm to continue to increase assets and diversify its activities to achieve potentially available economies of scale and scope, so long as the firm finances expansion through more stable forms of funding.[10]

Any new size limits should be designed to limit systemic footprint while minimizing costs to efficiency. This will be a challenging task. The question of whether the benefits of further size limits would exceed any losses in scale economies and other efficiencies is the subject of ongoing research and debate.[11]

Break-up

Some critics want to get right to the business of breaking up the big banks into smaller, more manageable, more easily resolvable pieces.[12] At the heart of this proposal is the thought that no financial institution should be so large or complex that it cannot be allowed to fail, like any other private business, with losses to its equity holders and creditors, and consequences for senior management. If the largest institutions were too big to fail during the financial crisis, why not make them smaller?

Today, the market still appears to provide a subsidy, of changing and uncertain amount, to very large banks to account for the possibility of a government bailout in the event of failure.[13] This subsidy, in the form of lower funding costs, may encourage "too-bigness." There would be substantial externalities to a large bank failure as well.

The market needs to believe – and it needs to be the case – that every private financial institution can fail and be resolved under our laws without imposing undue costs on society. The current reform agenda is designed to accomplish just that, through two channels. *First,* it is intended to substantially reduce the likelihood of failure through a broad range of stronger regulation, including higher capital and liquidity standards, stress tests and recovery planning among other reforms. *Second,* it is intended to minimize the externalities from failure by making it possible to resolve a large financial institution without taxpayer exposure and without uncontainable disruption. If these reforms achieve their purpose, in my view they would be preferable to a government-imposed break-up, which would likely involve arbitrary judgments, efficiency losses, and a difficult transition.

---

[10] See Daniel K. Tarullo (2012), "Industry Structure and Systemic Risk Regulation," speech delivered at the Brookings Institution Conference on Structuring the Financial Industry to Enhance Economic Growth and Stability, Washington, D.C., December 4.

[11] See Joseph P. Hughes and Loretta J. Mester (2011), "Who Said Large Banks Don't Experience Scale Economies? Evidence from a Risk-Return-Driven Cost Function (PDF)," Working Paper 11–27 (Philadelphia: Federal Reserve Bank of Philadelphia); Richard Davies and Belinda Tracey (2012), "Too Big to be Efficient? The Impact of Implicit Funding Subsidies on Scale Economies in Banking (PDF)," Bank of England, June; David C. Wheelock and Paul W. Wilson (2009), "Do Large Banks have Lower Costs? New Estimates of Returns to Scale for U.S. Banks," Working Paper Series 2009-054E (St. Louis: Federal Reserve Bank of St. Louis, October); Andrew G. Haldane (2012), "On Being the Right Size (PDF)," speech delivered at the Institute of Economic Affairs' 22nd Annual Series, The Beesley Lectures, London, October 25.

[12] See Dean Baker (2010), "Why We Must Break Up the Banks," *The Guardian*, April 7; and Bruno J. Navarro (2012), "Neil Barofsky: Breaking Up Big Banks 'Necessary' (http://www.cnbc.com/id/48328948/Neil_Barofsky_Breaking_Up_Big_Banks_lsquoNecessaryrsquo)," CNBC, July 25 (accessed September 11, 2012). See also, Richard W. Fisher (2013), "Ending 'Too Big to Fail': A Proposal for Reform Before it's Too Late (With Reference to Patrick Henry, Complexity and Reality)," speech delivered to the Committee for the Republic, Washington, D.C., January 16, which sets forth a proposal to limit banks to traditional commercial banking activities, restrict access to the Federal safety net to banks, and require affiliates of a bank to disclose to their customers that they are outside the Federal safety net.

[13] See Joseph Noss and Rhiannon Sowerbutts (2012), "The Implicit Subsidy of Banks (PDF)," Bank of England Financial Stability Paper No. 15.

Conclusion

Today, few ideas can be less controversial than ending too big to fail. The question is "How?", and there are differing opinions on that. In Titles I and II of Dodd-Frank, Congress has given the regulators a game plan for ending too big to fail. The regulators, including the Federal Reserve, are forcefully implementing the plan we have been given.

My own view is that the framework of current reforms is promising, and should be given time to work. In any case, too big to fail must end, even if more intrusive measures prove necessary in the end.

Thank you very much.