

On the Resolution of Large Financial Institutions

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Chairman Frank, Ranking Member Bachus, and members of the committee: I am grateful for the opportunity to talk to you today.

Big Picture

This crisis was not an isolated event. We are in a cycle of ever larger risk-taking, punctuated by ever larger failures and ever larger bailouts. This cycle cannot go on.

We cannot afford it. This crisis strained our government's borrowing ability. There remains worry of a flight from the dollar, and government default through inflation. The next, larger, crisis may lead to that calamity.

Moreover, the bailout cycle is making the financial system much more fragile. Financial market participants expect what they have seen and been told: no large institution will be allowed to fail. They are reacting predictably. Banks are becoming bigger, more global, more integrated, more "systemic," more "interconnected" and more opaque. They want regulators to fear bankruptcy as much as possible.

We need the exact opposite. We, and Wall Street, need to reconstruct the financial system so that as much of it as possible can fail, without government help, with pain to the interested parties, but not to the system.

Policy

There are two competing visions of policy to achieve this goal. In the first, large integrated financial institutions will be allowed to continue and expand, with the implicit or explicit guarantee of government help if they get in trouble, but with the hope that more aggressive supervision will contain the obvious incentive to take greater risks.

In the second, we think carefully about the minimal set of activities that cannot be allowed to fail and must be guaranteed. We commit *not* to bail out the rest. Private parties must prepare for their failure. We name, diagnose, and fix whatever problems with bankruptcy law cause systemic fears.

I think the second approach is more likely to work. The financial and legal engineering used to avoid regulation and capital controls last time were child's play. Too large to fail must become too large to exist.

Resolution Authority

A “resolution authority” offers some advantages in this effort. It allows the government to quickly impose some of the economic effects of failure -- shareholders and debtholders lose money -- without legal bankruptcy.

But nothing comes without a price. First, regulators “systemic” fear is often *exactly* that counterparties will lose money. So, it's not obvious they will use this most important provision, rather than continue to bail out counterparties. Second, people buy debt in the first place because they know they can seize assets in the event of default. Rather than gauge the value of assets, debt now becomes a game of guessing – and lobbying for -- what you can get out of the resolution authority.

The FDIC is a useful model, for its *limitations* as well as the *rights*, which constrain moral hazard and keep it from becoming a huge piggybank for Wall Street losses.

- The FDIC applies only to banks. A “resolution authority” must come with a similar clear statement of who is subject to its authority – and who is not, and therefore *will fail*.
- Deposit insurance and FDIC resolution come with serious restriction of activities. An FDIC insured bank can't run a hedge fund. Protection, “resolution” and government resources must similarly be limited to “systemic” activities and the minimum which must accompany them.
- Deposit insurance and FDIC resolution address a clearly defined “systemic” problem – bank runs. A “resolution authority” must similarly be clearly aimed at specific, defined, and understood “systemic” problems.
- The FDIC intervenes with clear triggers.

The Administration proposal needs improvement especially on the last two items. It only requires that the Secretary and President announce their fear of “serious adverse effects.” This is an invitation to panic, frantic lobbying, and gamesmanship to make one's failure as costly as possible.

Fix Bankruptcy

Before designing a new system, we must ask, *what exactly are the “systemic” effects of bankruptcy that we are trying to fix, anyway?*

If you ask, you find fixable technical problems. The runs on Lehman and Bear Stearns' brokerages, collateral stuck in foreign bankruptcy courts, and the run on money market funds, can all be fixed with changes to legal and accounting rules.

Resolution does not avoid these questions. *Someone* has to decide who gets what. If Citi is too complex for us to do this now, how is the poor Treasury secretary going to make it up at 2 AM on a Sunday night? The Administration's proposal substitutes huge power for any rules, but this does not avoid the need to make these complex decisions.

The most common and persuasive argument against bankruptcy is psychological not technical: Markets expected the government to bail everybody out. Lehman's failure made them reconsider whether the government would bail out Citigroup. But the right answer to *this* problem is to limit and clearly define the presumption that everyone will be bailed out, not to expand it and leave it vague. Markets that are always guessing what the government will and won't do are prone to panic.

More broadly, the key of the crisis was a run in short-term debt. We need to focus on this, truly "systemic," and difficult problem, without losing ourselves in a contentious reregulation of every corner of the financial system, most of which had little to do with this crisis.