Session 4:
How to Cope with the "Too Big to Fail Problem"

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TOO-BIG-TO-FAIL AND THE DODD-FRANK LEGISLATION[1]

1. INTRODUCTION

In 2004, Ron Feldman and I wrote "Too Big To Fail: The Hazards of Bank Bailouts". Published by the Brookings Institution, the book has two principal themes. First, from the perspective of early in the previous decade, we argued that the too-big-to-fail (TBTF) problem had not been addressed effectively and was only getting worse. And the second theme was a set of recommendations explicitly designed to rein in TBTF.

Of course, time has passed since the book first appeared and, while we have been vindicated by events, the public policy challenge of TBTF persists. Importantly, major financial reform legislation, the Dodd Frank (D-F) Act, was passed in the summer of 2010 and is being put into effect. And so a critical question today is: does D-F effectively address TBTF?

The short and direct answer to this question is that we don't know, although we can say with confidence that D-F is sufficiently broad and far reaching to potentially address TBTF. However, as I will explain, the "fate" of TBTF depends on what policy makers, regulators, and supervisors do, and not on what they assert. The balance of this note presents a framework for addressing TBTF and

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identifies those aspects of D-F which require or permit implementation of the framework. Against these criteria, D-F looks promising, and one must hope that financial institution regulators have the courage to get it right.

2. SYSTEMIC FOCUSED SUPERVISION

Several years ago, Ron Feldman and I offered a proposal called "systemic focused supervision" intended to curb TBTF significantly. The name of the proposal is not important, but its key ingredients are. The three components of the systemic focused supervision (SFS) framework are:

- ❖ Preparation
- ❖ Enhanced prompt corrective action
- ❖ Communication.

As previously noted, D-F either permits or mandates all three elements of the SFS framework.

For a number of reasons, preparation is essential to dealing effectively with TBTF, and the component of the D-F legislation most pertinent in this regard is the requirement that systemically important financial institutions (SIFIs) prepare "living wills", or orderly wind-down or resolution plans. Such plans have to be approved by the relevant supervisor and are intended to enable the closure of a troubled SIFI in a timely and orderly way, without significant negative spillover effects on other major financial institutions or markets. In short, the plans are intended to assure that contagion effects, if any, are effectively contained.

This aspect of D-F is constructive but it is critical that wind-down plans are prepared properly. This means, essentially, that the regulators must be intimately involved in their preparation. There are two reasons for this recommendation. The first has to do with incentives. If we ask about the quality and quantity of resources a SIFI is going to devote to preparation for its own demise, the answer I think of is obvious. Thus, the regulators have to be sufficiently involved to assure the quality and comprehensiveness of the plans.

Second, the regulators should be deeply involved so that they "buy in" to the plans and have effectively pre-committed to employ them under the appropriate circumstances. Such a buy in is exceedingly valuable in my experience because in its absence regulators will likely find a plethora of excuses to engage instead in a bail out.

3. ENHANCED PROMPT CORRECTIVE ACTION

Prompt corrective action (PCA) was a major element of the FDICIA financial reform legislation passed in 1991, and at the time many of its proponents asserted that it effectively curtailed TBTF. Feldman and I have been perpetually skeptical, and events have borne us out. Among the shortcomings of PCA were its reliance on book value accounting and failure to include market signals in assessing the condition of what SIFIs essentially are. Thus, when we speak of enhanced PCA, we are specifically advocating market value accounting and incorporation of market data—for example, equity values relative to those of peers, credit default swap pricing, subordinated debt spreads—in evaluating the financial health of SIFIs.

We realize that these proposals are controversial, especially in an environment where expectations of TBTF protection are deeply entrenched. But if the wind-down plans are credible and, make no mistake, credibility is essential, then uninsured creditors should come to understand that they are at risk and market pricing should more accurately reflect risk. Indeed, this is a significant additional benefit of preparation for the failure of SIFIs in that it will serve over time to improve market discipline.

4. COMMUNICATION

The third ingredient of our SFS proposal is communication. Uninsured creditors and other market participants are not mind readers, so they need to be told that regulators are aggressively preparing to make SIFIs "safe to fail" and that creditors will experience losses in the event. The communication should describe fundamental aspects of the wind-down plans and the market data regulators are using to help assess institutions. In short, transparency is essential here so that creditors understand that the regime has changed, that they cannot count on TBTF protection, and that they need to adjust their behavior accordingly.

5. CONCLUSION

In our view, D-F gives financial industry regulators more than enough tools and authority to significantly reduce TBTF protection, and expectations of such protection, of uninsured creditors of SIFIs. This is distinctly positive development but, unfortunately, victory is not yet at hand. At the end of the day the real issue is not whether regulators can take appropriate action but, rather, will they take appropriate action when a SIFI is in trouble?