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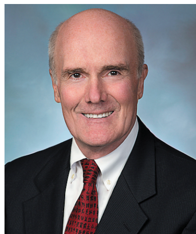
REGULATORY POLICY

Systemic Risk

Recognizing Realities, Reshaping the Too-Big-to-Fail Debate



BY CHARLES M. HORN

Few issues in financial reform have stirred up as much argument as too-big-to-fail (TBTF). Not because there is any argument over whether TBTF is ''bad'' - virtually everyone agrees that our financial system should not be exposed to the risk of financial institutions that are so large and so interconnected that their failure cannot be allowed. But the arguments revolve around whether the Dodd-Frank Act has ended TBTF, whether additional legislation is needed to cure TBTF, and how the negative financial and social effects of TBTF (''too big to jail,'' ''too big to manage,'' and so forth) can be controlled.

Debating whether TBTF can be ended, however, is the wrong discussion for several reasons. If the goal of regulatory reform is to end TBTF, that goal cannot be achieved. Further, an excessive focus on trying to attain an unreachable goal diverts valuable attention and resources away from what is a challenging but eminently realizable objective. And, that objective is the management of TBTF risk down to acceptable levels and ensuring that we have the right tools in place to manage TBTF in an effective manner.

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Why is it impossible to end TBTF? First, as appealing as it is to say that our regulatory apparatus should allow any financial firm to fail, our banks and other financial institutions play a unique and critical role in facilitating the flow of capital resources in the U.S. and global economies. In turn, if the failure of a particular financial institution threatens a serious disruption of the domestic economy, the U.S. Government will, and should take whatever measures are lawfully necessary to prevent that outcome. If those measures include government or taxpayer support, logic would dictate that the government should provide that support if not doing so risks a financial meltdown or severe damage to the U.S. economy. Unfortunately, legislation to prohibit taxpayer subsidies for financial firm rescues, or ring-fence banking from nonbanking businesses, may do little more than tie the hands of regulators and deprive them of valuable options in a time of financial emergency.

Second, the alternative approach to ending TBTF, which is ''downsizing'' our largest financial institutions to a size where they are no longer systemically important, suffers from serious practical shortcomings. The downsizing approach may be fine in principle, but the problem lies in defining what ''too big'' means in a way that satisfactorily solves the problem without material and adverse consequences. For example, there have been proposals to define TBTF banks by reference to a benchmark asset or deposit size, but attempting to determine what that asset or deposit level may be is highly arbitrary and very likely to fall wide of the mark. It is easy to imagine a real-world balance sheet of a very large bank where the bank's failure would result in little or no systemic disruption due to the nature and character of its business lines and counterparty relationships. By the same token, a smaller financial institution's counterparty relationships and commitments may be

such that the financial institution's failure may pose a serious risk to the financial system, a phenomenon that was in full view in 2008. Further, systemic risk also arises out of correlated product risk (subprime mortgages in 2007 and 2008 are an excellent example) in which the financial collapse of a product line may jeopardize wide swaths of the banking industry, not just the large banks.

Difficult to Define, Quantify TBTF

In short, systemic risk is a function of many factors, size being just one of them. In turn, it is very difficult to create workable or effective quantitative or even qualitative standards to define whether a particular financial institution is TBTF. Would the price of stripping U.S. financial institutions of the economies of scale and depth of financial relationships needed to conduct a global financial services business, in terms of negative effects on U.S. competitiveness and the efficiency and creativity of the U.S. financial economy, be worth the questionable benefits of forced downsizing?

So, if TBTF is with us to stay, the best solution is to reduce, to the extent reasonably possible, its impact on the financial and political economies, and minimize its adverse financial and social effects. That solution first requires an understanding of the environment in which TBTF is apt to manifest itself in its most undesirable form — a straight U.S. Government bailout of a large bank or nonbank financial institution — and then doing what is necessary to minimize the likelihood of those environmental circumstances coming to pass.

The experience of the recent financial crisis demonstrates that the failure of a systemically important financial institution likely would occur very rapidly and be triggered by an abrupt withdrawal of wholesale short-term funding sources resulting from the loss of confidence by the financial institution's wholesale counterparties – in other words, the 21st century version of a run on the bank. We witnessed this phenomenon in the case of the firms that needed assistance in 2008, as well as more generally in the money market mutual fund industry when a major money market mutual fund ''broke a dollar.'' If this loss of counterparty confidence occurs, which could create a risk of contagion adversely affecting other financial intermediaries, then the only solution is to restore that confidence, and do so quickly.

Explicit government financial support for the afflicted institution is the most obvious solution to restore short-term confidence, as was again shown during the 2008 crisis, but this is precisely the solution that most want to avoid. The government, however, cannot responsibly withhold financial support for a large failing financial institution without clear and workable alternatives in place, as the Lehman Brothers failure so dramatically showed. In turn, if the goal is confidence restoration, the alternative is to have in place a mechanism that provides for the orderly continuation of a failing bank's core business lines while it is being reorganized or liquidated. By doing so, parties doing business with the bank have reasonable assurances that their financial exposures to the institution will not be frozen or materially disrupted. And, by preserving the bank's ability to conduct its key businesses without significant interruption, counterparty confidence in the financial institution is preserved and the need for explicit governmental support becomes correspondingly less.

This is where the orderly liquidation authority (OLA) of the Dodd-Frank Act (Title II) comes into play. The primary goal of OLA is to prevent a ''disorderly resolution'' of the sort that occurred when Lehman Brothers failed in September 2008 and the U.S. Government, much to the dismay of the financial markets, did not provide financial support to the failing enterprise. To accomplish this objective, OLA provides for the resolution of a large, failing financial institution by the Federal Deposit Insurance Corporation (FDIC) in a manner that seeks to preserve without substantial interruption its critical business lines and operations. In addition, OLA allows the FDIC to impose failure-related losses on the financial institution's shareholders and creditors, and prohibits the use of taxpayer resources to fund any resolution subject to OLA, although temporary advances to fund the FDIC's short-term resolution activities are allowed. OLA is complemented by the resolution plan, or ''living will,'' provisions of the Dodd-Frank Act (Title I), which require covered banks and covered nonbank financial institutions to develop a detailed ''road map'' for a Bankruptcy Code-based resolution of the financial institution. In turn, this road map will be available to the financial institution's receiver (the FDIC) to guide it in its resolution activities, if it so chooses.

OLA's Strengths, Shortcomings

OLA creates a resolution mechanism that can be activated very quickly and employed over a very short time frame by a single receiver that is highly experienced in financial institution resolution activities, and which can take any initial measures needed to stabilize the failure of a large financial institution. Whether these measures include transferring the financial institution's critical operations to a bridge institution, providing short-term liquidity to enable the successor to these critical operations to meet its short-term obligations, temporarily staying the self-help rights of the financial institution's counterparties, or other measures, will depend on the specific facts and circumstances of a particular resolution.

OLA has its share of critics in the public, private and academic sectors who variously charge that OLA preserves the perception that some large financial institutions will not be allowed to fail, and that its ''special treatment'' of covered financial institutions continues the implicit funding subsidies and other distortions that the largest banks reportedly enjoy in the financial marketplace. Critics also note that OLA gives the FDIC excessive discretion to protect certain ''favored'' creditor classes at the expense of others; that the U.S. bankruptcy framework is better suited to prioritize and protect financial institution creditor interests; and that the mechanics of the OLA framework are too opaque to enable financial institutions and their counterparties to understand and have confidence in how OLA may affect their interests.

Some of these criticisms may have merit, and may make a case for changes in the structure and specifics of OLA as well as for complementary changes to the U.S. Bankruptcy Code. In addition, OLA is very much a work in progress, as the FDIC, building on its single-point-of-entry approach, continues its efforts to develop the architecture necessary to maximize OLA's effectiveness and market credibility. On balance, however, the

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presence of a credible financial institutions-specific resolution mechanism that allows for quick and decisive action when time is of the essence may outweigh any of OLA's present flaws.

That being said, OLA does suffer from two material inherent shortcomings - first, it is untested, and second, its efficacy in resolving a large financial institution with extensive international operations currently is unknown. There is nothing that can be done at the present time to address the first deficiency to anyone's complete satisfaction, although the FDIC's successful track record in managing depository institution failures, and the large bank failure simulation exercise reported by The Clearing House in early 2013, among other activities, can be helpful in assessing the potential efficacy of OLA and the challenges in its implementation. The second shortcoming — how OLA would function in the context of a cross-border resolution — is a more serious issue that will only be resolved through meaningful international actions to create an effective international resolution framework. While progress is being made at the international level to create a workable framework for global resolutions, this is not an issue that the United States can fix all by itself. Hence, until this issue is suitably addressed in the international financial community, the systemic risks currently presented by the failure of a global financial institution will continue to be undesirably high.

It is one thing to say that OLA can be improved, and another matter altogether to claim that because it does not end TBTF, OLA should be discarded. In fact, any legislative or regulatory solution that materially reduces TBTF without harming the competitiveness and efficiency of the U.S. financial industry is worth considering, and U.S. policymakers would be well-advised to avoid the trap of trying to legislate or regulate the ''perfect'' solution to a problem that cannot be altogether eliminated.