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DOES THE DODD-FRANK ACT END "TOO BIG TO FAIL?"

HEARING

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

OF THE

COMMITTEE ON FINANCIAL SERVICES

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DOES THE DODD-FRANK ACT END "TOO BIG TO FAIL?"

Tuesday, June 14, 2011

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 12:05 p.m., in room 2128, Rayburn House Office Building, Hon. Shelley Moore Capito [chairwoman of the subcommittee] presiding.

Members present: Representatives Capito, Renacci, Royce, Manzullo, Jones, McHenry, Pearce, Westmoreland, Luetkemeyer, Huizenga, Duffy, Canseco, Grimm, Fincher; Maloney, Gutierrez, Watt, McCarthy of New York, Miller of North Carolina, Scott, Meeks, and Carney.

Ex officio present: Representative Frank.

Chairwoman CAPITO. This hearing will come to order. I want to thank everybody for coming this morning. I know there is a lot of interest in the hearing and many members have opening statements, so I will try to limit my remarks in the spirit of expediency. My ranking member, Mrs. Maloney, is on her way so we are going to go forward with our opening statements, and I am sure she will be here shortly.

During the financial crisis of 2008, Federal regulators were faced with the recurring challenge of determining whether or not a financial institution was so interconnected in the financial system that its failure would lead to a ripple effect in the financial markets. Regardless of the outcome for each individual institution, in the months following the crisis, there was considerable agreement that we should end the practice of the government picking winners and losers. The financial regulatory reform debate of 2009 and 2010 provided a forum for this change, but I believe it had a missed opportunity for Congress, the large institutions continue to grow, and I feel that we have done nothing but further embed the idea of an institution being "too big to fail."

I know Mr. Krimminger and his colleagues at the FDIC fervently believe that the Dodd-Frank Act ends "too big to fail," and we will hear his testimony on that. But I am skeptical as to whether or not the markets will share his view. The credit rating agencies, Moody's and Standard & Poor's, have both indicated they are taking into account the prospect of future government support when rating the largest institutions. If these institutions receive a credit rating advantage over smaller competitors because they have been

designated as systemically significant, then we have done nothing to resolve the root cause of the financial crisis. The big institutions will continue to get bigger, and excessive risk-taking will return with the expectation of a government bailout.

I look forward to learning our witnesses' thoughts on the process for designating an institution systemically significant, and unfortunately, I don't think we really know who is systemically significant until the next crisis is upon us, and it will then be up to the new regime set forth for resolving these institutions in Dodd-Frank.

The proponents of the Orderly Liquidation Authority (OLA) now granted to the FDIC argue that the new regime ends government bailouts. What they also fail to mention is that the FDIC has the authority to borrow funds from the Treasury once the FDIC is appointed the receiver of the failed institution.

Even if the money is returned to the taxpayer, this still sends the message that the government will serve as a backstop. I know that Chairman Bair sincerely believes that these new powers effectively end "too big to fail," and I sincerely hope that she is correct. We must all work together to ensure that the message is clear from the corner suites to trading desks, account for risk accordingly, and there will be no government bailout.

I would now like to recognize the ranking minority member, the gentlelady from New York, Mrs. Maloney, for 4 minutes for the purpose of making an opening statement.

Mrs. MALONEY. I thank the gentlelady from West Virginia for granting me the time and for calling this very important hearing.

As the gentlelady said, we faced an incredible financial crisis, and we really, our regulators really had only two options and neither of them were very good. When large complex financial institutions had, or if their financial security was threatened, they could either fail, which happened with Lehman, or they could be bailed out, which happened with AIG. Neither alternative was a good one.

And without the tools to have an orderly wind-down, without these tools, Treasury was unable to protect the economy as a whole. When it became clear that AIG Financial Products was going to fail, there was no choice but a taxpayer-funded bailout, or to just let it fail, which many thought would be too disruptive to our economy.

I think we have forgotten how close we came in late 2008 to a complete financial collapse. Each of the largest financial institutions confronted their own demise in an unprecedented way, and for the most part, the regulators' hands were tied.

With the enactment of Dodd-Frank last year, we changed that. We gave the regulators the tools they need to act swiftly and efficiently if or when there is another crisis.

We created the Financial Stability Oversight Council which fosters collaboration among the banking regulators to spot threats to our financial security before they create systemic risk, and we created an orderly liquidation process similar to what the FDIC already has for the banks it regulates. And by all accounts, the FDIC acted swiftly and effectively in many cases. That will allow a failing institution to wind down and its assets to be distributed to its creditors in a way that does not take down the entire financial system.

FDIC Chairman Sheila Bair testified before the subcommittee at the end of May, as she prepared to leave her position this summer. Her testimony outlined the conditions that the financial system faced leading up to the crisis, including excessive leverage, misaligned incentives in financial markets, gaps in the regulatory structure, and the undermining of market discipline due to "too big to fail."

She further testified that she believes the Dodd-Frank Act, if properly implemented, "will not only reduce the likelihood of future crises, but it will provide effective tools to address large company failures when they do occur without resorting to taxpayer supported bailouts or damaging the financial system input."

And just yesterday, Moody's indicated that it might downgrade the investment ratings of the largest financial institutions because it believes it is clear that the government will no longer bail them out.

I would like to ask unanimous consent to place in the record press statements on Moody's decision.

Chairwoman CAPITO. Without objection, it is so ordered.

Mrs. MALONEY. There is a great deal of work that needs to be done to take the Dodd-Frank tools and build a framework that will be there for the system when the next financial crisis hits. It is very much a work in progress. And as we approach the 1-year anniversary of the signing of the Dodd-Frank Act, I do think it is important to take a look at how far we have come since the financial crisis, but still be aware of the great deal of work that needs to be done.

I thank the chairwoman for calling this hearing, and, of course, I welcome our panelists today and thank you very much for being here.

Chairwoman CAPITO. Thank you. I would like to recognize Mr. Royce for 1 minute for the purpose of an opening statement.

Mr. ROYCE. Thank you, Madam Chairwoman.

This should get our attention, the top 10 financial firms today account for 64 percent of the total assets. That is up from 25 percent in 1990. And because of their implicit government support, or the anticipation of a backstop, many of these firms benefit from lower borrowing costs than they would otherwise have. The FDIC, I think, estimates that at 100 basis points, so it is significant. And by definition, this implicit subsidy is going to continue to erode market discipline until we do something about it, and that is going to further weaken our financial system.

We have a problem with Dodd-Frank. The truth of the matter is, in times of crisis, regulators are always going to err on the side of more intervention and more bailouts. The Orderly Liquidation Authority under Dodd-Frank does little more than facilitate this process. And as a result, "too big to fail" not only lives on, it is further compounded.

So I hope we take steps to correct this failure in the coming months and reinstate market discipline by revisiting this issue. Thank you. I yield back.

Chairwoman CAPITO. Thank you.

I would like to recognize the ranking member of the full committee, Mr. Frank, for 3 minutes.

Mr. FRANK. Thank you, Madam Chairwoman.

For people who do not fully understand what a self-fulfilling prophecy is, pay clear attention to this hearing because you will hear people try to do one. They will argue that we are going to continue to bail out big institutions and then complain that people perceive that we are.

In fact, let's go to the hard record. The argument is that being considered systemically significant confers on a financial institution an advantage that will translate to lower borrowing costs because that institution will be seen as immune from failure.

What do the institutions think? Every single large financial institution thinks that is dead wrong. I have to say, I and some others have been critical of some of our large financial institutions for being a little bit too self-interested at times. But apparently, some of my Republican colleagues think they are the most selfless people in the world, they are 9 Mother Teresas or 10 or 12 or however many. Why? Because according to some of the Republicans, the bill confers on these large financial institutions a great benefit of being considered "too big to fail." And every single one of them is fighting against it.

Apparently, this is a gift that no one wants. The reason, of course, is very clear. Before you would ever get to the point of being faced with dissolution, not resolution, in fact, but dissolution as the bill required before a penny can be spent on your behalf, the firing of the CEO, the wiping out of the shareholders, you are subject to much tougher regulation. And what the financial institutions are saying is the prospect of the tougher regulation that would be mandated by this bill as it is carried out by the regulators who helped write it and who will certainly be carrying it out would do away with any perceived advantage. And it is for that reason, as the gentlewoman from New York the ranking member, noted, that Moody's is now beginning to get one right, not always, I must say, Moody's record, but Moody's is starting to get it right, and they are saying, no, they are not "too big to fail."

And, by the way, those who say there will be a bailout do not seem to me to have been present in the United States Congress in the past few years. Here is what they are predicting. The law says that if one of these institutions cannot meet its obligations despite having been subject to much tougher capital controls etc., then the institution is dissolved. That is where the death panels are. And the shareholders are wiped out, the CEO is fired, and the institution no longer exists, and the regulators may, at that point, the FDIC, pay off some of the debts if it is necessary to prevent a downward spiral, but any penny paid out must be recouped from the large financial institutions.

Some of my colleagues say no, no, that won't happen. Congress will rush in and allow it to be paid out of public money, the people appointed by the President will say oh, no, no, we are going to ignore the law. We are going to violate the law, we are going to give them public money anyway.

In what universe? The fact is, there is now an overwhelming national consensus not to do that.

And the only people who are arguing that despite what happened in the past and despite the statute and despite the views of all the

large financial institutions, they are the ones who are arguing that nothing will change, and that if a large financial institution gets in trouble, the government will step in and bail it out and let it continue, are some of the Republican critics of the bill. They are the ones who are creating that false perception. Reality is overwhelming.

And I close by noting we had every regulator here at a hearing. And we asked—I asked every one of them, has any institution—look, some institutions are automatically, the banks, are going to be covered; some large institutions, some insurance companies, some mutual funds, some others, it is not clear whether they will be covered or not and a lot of factors went into this, not just size, as it should.

I asked if anybody has lobbied to be given the great advantage that my Republican friends say this bill confers on them to be systemically significant. Not one, not one. Have any lobbied not to be? Every one of them.

So, apparently, as I said, we have discovered what many people were looking for, these selfless financial institutions, the institution that says, despite my Republican friends saying this is a great gift, please, we don't want it. We don't want that extra advantage because it is not an extra advantage. It is not a license; it is a red letter. It is a notion that you will be subject to greater regulation. That is what the law says. That is what people perceive. And it is only people who are trying to make political points who are trying to undermine that and create the very perception that they decry.

I thank the gentlewoman for the time.

Chairwoman CAPITO. Thank you. The gentleman from Georgia, Mr. Westmoreland, for 1 minute.

Mr. WESTMORELAND. Thank you, Madam Chairwoman.

One of the biggest problems that I have with the Dodd-Frank Act is that it does codify "too big to fail." The problem in 2008 was that markets were conditioned to expect government bailouts following Bear Stearns. This guarantee was then priced into the market. Unfortunately, Dodd-Frank makes this guarantee. The government will be there for big firms when they are on the brink, just like Bear Stearns and just like TARP.

Regrettably, the American taxpayers and small businesses will always draw the short end of the stick in this arrangement. If your Wall Street firm is teetering on the brink, the Dodd-Frank bill gives the FDIC the ability to finance these companies with taxpayer money up front.

Considering this has not worked with Fannie and Freddie, and taxpayers are still paying for those bailouts, I am not hopeful that the Dodd-Frank bailouts will be repaid either.

Congress must learn from the mistakes of the 2008 bailouts. I urge this committee and the chairwoman to work towards repealing these provisions of Dodd-Frank because the taxpayers cannot afford these perpetual bailouts anymore.

And with that, Madam Chairwoman, I yield back.

Chairwoman CAPITO. Mr. Canseco from Texas for 1 minute.

Mr. CANSECO. Thank you, Madam Chairwoman. A critical factor that has helped to make our economy the strongest in the world is the allowance of failure, unlike other countries that create false

economies and prevent these failures. Companies fail for a variety of reasons: they are poorly managed; the product they offer is obsolete or the entrepreneurial idea fizzles out; or there is a failure to shift in paradigm at the right time.

Failure, no matter how big or how small, is not a sign of a weak economy. Corporate failure allows for the healthy reallocation of capital to more productive companies and sectors that are better positioned to create jobs and contribute to economic growth.

When this natural rebalancing is artificially disrupted, the result is confusion, moral hazard, a damaged economy, and a false economy. No company or industry should ever be considered too big or too important to fail. Unfortunately, there is widespread belief that the Dodd-Frank Act carved into stone the "too-big-to-fail" label on some of our largest financial institutions.

And despite what other Members of Congress may think, you can't legislate failure out of existence. Thank you.

Chairwoman CAPITO. Mr. Grimm from New York for 1 minute.

Mr. GRIMM. Thank you, Chairwoman Capito, for holding this hearing and thank you to the witnesses for testifying today.

I believe that one of the greatest strengths of the United States is our free market system. It made our country the strongest and most prosperous in world history.

However, I am very concerned that system is under attack. It is under attack by overregulation and overbearing government bureaucracy.

It is imperative for our economy that strong firms can thrive and weak ones fail and that new businesses replace those that cannot compete. Therefore, I look forward to hearing the witnesses' comments on whether or not Dodd-Frank allows a capitalist free market system to run its natural course or whether it short circuits it, ending with results that may be favored by some government bureaucrats to the detriment of our economy.

I yield back.

Chairwoman CAPITO. Thank you.

The gentleman from Tennessee, Mr. Fincher, for 1 minute for an opening statement.

Mr. FINCHER. Thank you, Madam Chairwoman.

The issue before us today is whether or not Dodd-Frank adequately addresses the U.S. financial system's vulnerability to future economic crisis. Dodd-Frank created a complex bureaucracy with the goal of solving the problem of "too big to fail." But many in the financial industry are not convinced that it does the job, including the many community bankers and small business owners I represent in Tennessee. They are the heart and soul of our economy and create new jobs. Simply put, what will work on Wall Street will definitely not work on Main Street.

I look forward to hearing the testimony today. I met with community bankers last week in my district, and they are just to the point of, it is very, very bad at home when we are restricting the flow of capital and we are trying to prevent the guys who have been doing this right from doing their jobs.

Many of the community banks in rural America—I don't know about Wall Street, but I know about rural America—are the heart and soul of these rural communities. And we have to make sure

that we are not defeating the purpose of moving our economy forward. So I yield back. Thank you.

Chairwoman CAPITO. Thank you. And that concludes our opening statements. I would like now to go to the first panel and introduce the witnesses for the purpose of giving a 5-minute opening statement.

Our first witness is Mr. Michael Krimminger, General Counsel of the FDIC.

Mr. Krimminger?

STATEMENT OF MICHAEL H. KRIMMINGER, GENERAL COUNSEL, FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC)

Mr. KRIMMINGER. Thank you. Chairwoman Capito, Ranking Member Maloney, and members of the subcommittee, thank you for the opportunity to testify today on behalf of the FDIC on the question of whether the Dodd-Frank Act ends "too big to fail."

During 2008 and 2009, the U.S. financial system suffered its most severe crisis since the Great Depression. This crisis grew from an unevenly regulated and highly leveraged U.S. financial system that proved to be anything but strong and stable.

Regulatory gaps allowed risks to grow in the shadow banking system of securitization trusts, CDOs and nonbank financial companies. Many of our largest financial institutions packaged and sold huge volumes of securities backed by mortgages that could never be repaid.

The market, long before Dodd-Frank, had assumed that the largest financial companies were "too big to fail." These nonbank companies could not be resolved under the FDIC's bank resolution powers which have been used hundreds of times for the orderly resolution of failed banks while imposing losses on creditors and shareholders.

In contrast, nonbank financial companies could only be closed under the Bankruptcy Code, and the market simply assumed this would not happen.

The Lehman Brothers insolvency in the fall of 2008 illustrated the problems in closing a major financial firm under the Bankruptcy Code. As a result, given the options in 2008 of a bankruptcy proceeding during the post-Lehman financial turmoil or providing financial assistance, policymakers in several instances chose to provide financial assistance to prevent even more severe effects on the financial system.

Title I and Title II of the Dodd-Frank Act are products of the realization that this should never be allowed to happen again. In combination, they provide the tools to end "too big to fail" if properly implemented.

Under Title I, the Financial Stability Oversight Council is responsible for designating systemically important financial institutions, or so-called SIFIs, based on criteria that are now being established. Factors to be considered in designating a SIFI include size, leverage, off balance sheet exposures, its importance as a source of credit and the concentration, interconnectedness and mix of its activities. Related to all of these is whether it can be resolved effectively through the Bankruptcy Code without creating systemic consequences. That must be a key consideration.

Once designated, SIFIs will be subject to heightened financial supervision by the Federal Reserve. SIFIs must also develop detailed resolution plans showing they are resolvable under the Bankruptcy Code. Preparation of these plans will require hard thinking about how to achieve a workable set of resolution options. Given SIFIs current complexity, this process should improve shareholder value by improving efficiency as well.

Resolution plans are essential to ending "too big to fail" because they will require a close working relationship between the companies and regulators to achieve workable options and between U.S. and foreign regulators to address the complexities of cross-border operations.

These plans will provide the analysis, information, and advance planning that was lacking in 2008.

Perhaps most importantly, Title II creates an alternative process to be used if bankruptcy would create systemic consequences. This new process, like the FDIC's bank receivership law, allows prompt action to achieve operational continuity through a bridge financial institution or a transfer of operations to another private sector company. This would be critical to avoid a future financial meltdown. But let's be clear. This is no bailout. There is no statutory authority in the Dodd-Frank Act for us to bail out a failed financial institution. The company must be liquidated.

The statute imposes the losses on creditors and shareholders and affirmatively prohibits any loss to taxpayers. It requires removal of management and provides for a claw-back of compensation received by senior executives or directors who were substantially responsible for the failure. Like the bank receivership process, the Dodd-Frank resolution process is a transparent process defined by a specific structure for a payment of creditors that allows access to the courts to decide disputes. Notice in comment rulemaking will guide its application and the FDIC will be subject, as it is today, to Inspector General and congressional oversight.

This insolvency process is an essential tool to ending "too big to fail." Today, credit rating agencies are reassessing the likelihood of Federal support due to this new power. Earlier this month, Moody's placed major financial institutions' debt ratings under review for potential downgrade based on reconsideration of this prior uplift for assumed systemic support. According to Moody's, and I quote, "The U.S. Government's intent under Dodd-Frank is very clear. Going forward, it does not want to bail out even large systemically important banking groups."

In summary, the Dodd-Frank Act creates a new, more effective SIFI resolution authority that will go far toward returning market discipline to our financial system. I will be happy to answer any questions.

[The prepared statement of Mr. Krimminger can be found on page 64 of the appendix.]

Chairwoman CAPITO. Thank you.

Our next witness is Ms. Christy Romero, Acting Special Inspector General, Office of the Special Inspector General for the Troubled Asset Relief Program. Welcome.

STATEMENT OF CHRISTY ROMERO, ACTING SPECIAL INSPECTOR GENERAL, OFFICE OF THE SPECIAL INSPECTOR GENERAL FOR THE TROUBLED ASSET RELIEF PROGRAM (SIGTARP)

Ms. ROMERO. Thank you. Chairwoman Capito, ranking member of the full committee Frank, ranking member of the subcommittee Maloney, and members of the committee, I am honored to appear before you today.

SIGTARP was created to protect the interests of those who funded TARP, the American taxpayers. And an important part of SIGTARP's mission is to bring transparency to decisions that were made in the wake of the financial crisis because there are important implications for the future by examining the past; we can take advantage of lessons learned to better protect taxpayers in the future.

SIGTARP issued a couple of audits in which we determined that Treasury and banking regulators made decisions related to the use of TARP funds in order to bolster investor and consumer confidence in the Nation's financial system. For example, we issued an audit detailing the government's decision to inject $125 billion into 9 of the Nation's largest financial institutions.

And what we found were that these first TARP recipients were chosen for their perceived importance to the greater financial system. We also issued an audit detailing the decision by the government to step in and provide additional assistance to one of the nine, to Citigroup, and to deem Citigroup to be too systemically significant to be allowed to fail. The government gave that assistance to assure the world that the government would not let Citigroup fail. There are several lessons to be learned from the Citigroup bailout. Although the government restored market confidence in Citigroup, the decision that Citigroup had to be saved was strikingly ad hoc. The consensus that Citigroup was systemically significance was one based more on gut instinct and fear of the unknown as opposed to objective criteria. The absence of objective criteria for that conclusion raised concerns as to whether there was selective creativity being exercised in who was systemic and who was not. In addition, the government's actions with respect to Citigroup also undoubtedly increased moral hazard.

The mere enactment of the Dodd-Frank Act did not end the concept of "too big to fail" in the market's eyes. The market still gives the largest financial institutions competitive advantages over their smaller counterparts. The Dodd-Frank Act provides for regulators to designate institutions as systemically significant and for requiring additional supervision and heightened standards and requiring them to have living wills for their orderly liquidation. Whether or not this determination will provide a competitive advantage for those institutions ultimately may be dependent upon the market's perception of whether the government will step in again and stand behind these companies. But as long as the financial institutions themselves, their counterparties, and their rating agencies believe there will be future bailouts, competitive advantages that are associated with "too-big-to-fail" institutions will almost certainly persist and market discipline will be reduced.

It is too early to tell whether Dodd-Frank will ultimately be successful in ending "too big to fail" and that success will be dependent on the market's perception of the effectiveness of the actions that are taken by Treasury and the regulators now. And as we observed with Citigroup stabilizing after the government announced additional assistance, the market will react to the words and actions that are taken by the regulators.

In order to end "too big to fail," the regulators must take effective action using the tools that have been given them under the Dodd-Frank Act.

Regulators have a benefit now that was missing during the financial crisis, and that is the benefit of time. It is vital that regulators use this time when the Nation is not in a financial crisis to promulgate rules, and develop objective criteria and a solid framework for applying that criteria so that should the Nation face another potential financial crisis, the road map is in place along with all the needed sign posts.

Rules, however, are only as effective as their application. And in order to convince the markets, the promise of the regulators and Treasury that to end "too big to fail" must be matched with actions, actions that signal with certainty that the government will not make future bailouts. The markets will watch to see what a designation of "systemically significant" means. The markets will watch to see the level and type of enhanced supervision that comes with that designation. The markets will watch to see whether these companies are restructured and simplified. Regulators have the authority to shape the living wills of these companies and to compel substantial changes to their structure and their activities.

These actions rely on the courage of the regulators to protect our Nation's broader financial system against any institution whose demise could potentially trigger another financial crisis. Chairwoman Capito, Ranking Member Maloney, and members of the subcommittee, thank you again for the opportunity to appear before you. I would be pleased to respond to any questions you may have.

[The prepared statement of Ms. Romero can be found on page 86 of the appendix.]

Chairwoman CAPITO. Thank you.

I want to thank you both and I will start the questioning.

Ms. Romero, in your statement, you talk about the process of whether or not Citigroup was "too big to fail," and therefore, in need of a rescue as ad hoc. Then you went on to say that whether this would continue into the future may be a perception that the government would be willing to step in.

I am not sure if you are aware that we argued pretty vociferously during "too big to fail" to have an enhanced bankruptcy where there could be no perception that the government could step in.

I guess what I am interested in is these both sound like more esoteric terms, "ad hoc" and "perception," and not a definitive statement that a government bailout could not occur. Do you see it that way?

Ms. ROMERO. SIGTARP, when we did our audits and we went and looked at the past actions of the government during the financial crisis, what we found was that a lot of the decisions that were being made were being made to address the markets. Citigroup

itself said that it was healthy at the time that it ended up needing the additional government assistance. But there was devastated investor confidence in Citigroup which was shown by a dramatic drop in its stock price and in a widening of its credit default spreads.

So what we found in looking at the past so you can determine the implications for the future is that what the market perceives has an effect, and has an effect as to whether the company is in trouble and whether that company will trigger another financial crisis and what the interconnectedness is with that company.

And so, ultimately, you do have to take into account the market's perception.

Now, the market's perception could be affected by what happens going forward. It could be affected in the case of if there was going to be an enhanced bankruptcy proceeding under the prior proposed legislation, the market could see that. The market could see what is here with Dodd-Frank. But Dodd-Frank just sets up the rules and the tools. It is ultimately going to be up to the regulators and the strength with which they use those tools and the objective criteria that they set out. Right now, the market just does not know what it means to be systemically significant.

Chairwoman CAPITO. So building on what you say then with Mr. Krimminger as the regulator, let's take the Citigroup example that she used. Citigroup said they were healthy at the time. So now we are going to ask them, assuming they will be systemically significant, which I think is a pretty good assumption, they are going to be asked what they are doing right now, creating a living will, which lets them predetermine what their fate is going to be, that is what a living will is for individuals, so their perception of themselves is different from the perception of the market or the perception of the regulator, and then I think we end up back to this ad hoc sort of esoteric feel.

How does this Orderly Liquidation Authority that you now have—will that eliminate that in your mind? I would like your comments on that.

Mr. KRIMMINGER. Thank you very much.

I think one of the things to remember is that I have never met a financial institution that thought that it was in as bad a condition as it actually is in.

So Citigroup's impression of where they were in the fall of 2008 might be a bit misleading. I think one of the key things of Dodd-Frank is in Title I and that is in section 165(d), which provides for the resolution planning process, as you referenced. I think that is not something where Citigroup will have the ability to predetermine its own fate. The statute actually is very clear. Citigroup has to show they have a credible plan for a rapid and orderly resolution under the Bankruptcy Code, which seems to me to be totally appropriate since the Bankruptcy Code, even after Dodd-Frank, will fully remain the primary option for resolving any financial company.

I think one of the key things about that standard that is set in the statute is it will require some really hard thinking by the firms in order to develop resolution plans that show that they could be resolved under the Bankruptcy Code without creating systemic consequences. That is going to be a tough standard because they won't have access to bridge financial institutions or bridge banks that we

use under the FDIC Act, so they will have to come up with some real hard thinking about what type of structures they will use, what types of liquidity support they should rely on, and what types of processes they should put in place in order to resolve themselves.

Chairwoman CAPITO. The other thing I would add is, and my time is running short here, that they also wouldn't have the ability to go into the Orderly—if they go into the Orderly Liquidation Authority, the FDIC has the ability to access taxpayer dollars, and I know Sheila Bair testified 2 weeks ago that the first payback is those Treasury dollars, but that is a big distinction between a bankruptcy and the Orderly Liquidation Authority that I think does lend itself more towards a reliance on the Federal taxpayer to begin this authority and end the authority, and I am going to go to my ranking member now.

Mrs. MALONEY. To be clear, the Wall Street Reform Act absolutely requires that a company whose failure threatens the entire system be liquidated so that there cannot be a bailout. It provides tools for regulators to stabilize the broader system and specifically protects taxpayers.

So the Dodd-Frank bill ends "too big to fail." It ends government bailouts.

I would like to ask the panelists, do you interpret the recent announcement that Moody's is considering downgrading the largest banking entities to be based on reconsideration of the extent to which they receive government support?

Do you see this as an indication that the market views the Wall Street Reform Act as ending "too big to fail?"

I would like both panelists to answer, starting with you, Mr. Krimminger.

Mr. KRIMMINGER. I will put it this way: We think that it is important, as Ms. Romero just mentioned, that we look to how the market is going to ultimately perceive this. The statutory provisions are very clear that the firm has to be liquidated, there can be no taxpayer losses, and that any losses in the resolution have to be paid back first from the firm, and then from an assessment against the industry if necessary.

I think the key thing is looking at how the credit rating agencies will consider this. And in my discussions with several of the credit rating agencies, I have asked them this question pointedly. Is there any authority under Title II of Dodd-Frank for there to be a bailout of the institution or to prop the institution up, and they said "No, any uplift that we are providing to date for the credit ratings for these institutions is based upon the idea that the law could be changed in the future." So the law today, the rating agencies are telling me, confirms that they can't be bailed out.

Mrs. MALONEY. Thank you. Ms. Romero?

Ms. ROMERO. I think that the actions and the statements by the government in late 2008 and early 2009 made this explicit "too big to fail" statement to the markets and Dodd-Frank came in and there is an opportunity here depending upon the actions taken by regulators in putting in strong heightened supervision and strong requirements on these companies where there would be an opportunity to send a strong message to the market.

I think the credit rating agencies and their view of things can be one indication of that.

Mrs. MALONEY. The fact that they are downgrading it shows that they think "too big to fail" has been ended. It is my understanding that large institutions, complex, nonbank financial companies, that they think that they possibly could be designated as "too big to fail" are lobbying the Financial Stability Oversight Council and other regulators not to designate them. They don't want to be designated in that category.

And doesn't that directly contradict the notion that the financial industry perceives a funding advantage or a "guaranteed bailout" that some of my friends on the other side of the aisle seem to claim that there even though it clearly states in Dodd-Frank that there will be no bailouts, that there will be an orderly liquidation, doesn't that show that these large and complex companies that are subject to stricter regulation that they don't want it, they don't want to be a part of it, doesn't it show that they realized that they will not be bailed out? Mr. Krimminger?

Mr. KRIMMINGER. I would just comment that I am not aware of any of the companies seeking to be designated as systemically important. The bank holding companies over $50 billion in size are designated by the statute so they are already designated.

Mrs. MALONEY. But aren't they lobbying to get out of the designation?

Mr. KRIMMINGER. They are required to be within the designation by statute—

Mrs. MALONEY. I have read press reports and I have had people come to me who don't want to be designated.

Mr. KRIMMINGER. I would agree. I am not aware of any company that is not automatically designated seeking to be designated.

Mrs. MALONEY. Ms. Romero, could you comment?

Ms. ROMERO. Yes. No one knows right now what will happen once someone is designated as systemically significant. And so I think it is not surprising that companies who are being told that they would be subjected to heightened supervision and heightened requirements without even knowing what these requirements are going to be would want to lobby against that. And I think those institutions, as well as the markets, are looking to see what happens, and so they are looking to see what is going to be the heightened capital requirements, the heightened liquidity requirements, and so you are certainly seeing companies not wanting to be given a designation what they don't know the outcome is.

Mrs. MALONEY. I would say it shows that they don't see a funding advantage or a guaranteed bailout that they realize they are not going to be bailed out so there is no advantage, they want to get out of it. Anyway, my time has expired.

Chairwoman CAPITO. Thank you. Mr. Renacci for 5 minutes for questions.

Mr. RENACCI. Thank you, Madam Chairwoman.

My colleagues on the other side, I believe, have said two or three times now that Dodd-Frank ends "too big to fail." If I look at your testimony, first, Mr. Krimminger, you say the three basic elements of the Dodd-Frank Act together help end "too big to fail." You say it helped end "too big to fail." Are the power to designate the sub-

jects as SIFIs to heighten prudential supervision by the Federal Reserve Board, the power to collect information necessary to plan and prepare for or to avoid the necessity of the resolution of SIFI including the requirement for SIFI to prepare detailed resolution plans and the orderly resolution authority to ensure that if necessary a SIFI can be resolved without course to bailout.

So you have a tremendous amount of "subject to's," especially the prepared detailed resolution plans which I want to come back to.

Ms. Romero, in your testimony, you say it is too early to tell whether Dodd-Frank will be ultimately be successful in ending "too big to fail" and its success will be dependent on the market's perception of the effectiveness of the actions taken by regulatory and Treasury. You also say rules, however, are only as effective as their application in order to convince market promises of regulations to end "too big to fail" must be matched with actions that signal with certainty that the government will not make future bailouts.

Just a simple yes or no, in your opinion, Mr. Krimminger, does the Dodd-Frank bill end "too big to fail?"

Mr. KRIMMINGER. There is no authority—yes, because there is no authority to do a bailout as there was in 2008.

Mr. RENACCI. But there are a lot of, if you will agree, "subject to's" in your testimony.

Mr. KRIMMINGER. If I may elaborate. Certainly, my point being on those "subject to's" is that Title I includes a lot of authority to provide for resolution plans, the regulations are still out for notice and comment, and we will be finalizing those requirements very shortly. There are also the standards for the heightened supervision and the capital requirements. Those still need to be put in place, but as I said in my testimony, Dodd-Frank provides the tools to end "too big to fail."

The key thing in our perspective is that Title II for Orderly Liquidation Authority precludes bailing out a firm and requires it to go into liquidation and resolution.

Mr. RENACCI. Again, "subject to." And these detailed resolution plans, again, I am a CPA; I have actually been hired to go through bankruptcy filings. It is going to be interesting how easy it will be to get detailed resolution plans.

Ms. Romero, you say, again, your comments, do you believe Dodd-Frank ends "too big to fail?"

Ms. ROMERO. It is too early to tell. The mere enactment of the Dodd-Frank Act wasn't enough to take away the competitive advantage that these large institutions realize now. But going forward, what happens with the regulators in using the tools and implementing some objective criteria and a sold framework for applying that, that will be determinative of whether it ends "too big to fail."

Mr. RENACCI. Now, let me add the question, if there were stipulations that there was a guaranteed no bailout and bankruptcy was the alternative, wouldn't that bring the free market system in and ultimately end "too big to fail," Mr. Krimminger?

Mr. KRIMMINGER. That is what we had in 2008. The Bankruptcy Code was the only resolution authority for these large, nonbank financial institutions. And so the Treasury sought additional author-

ity from Congress to provide additional inputs of funding in at the capital level, so I think that—

Mr. RENACCI. I don't mean to interrupt you, but I did say if there was no bailout and bankruptcy was the alternative, would that end "too big to fail?"

Mr. KRIMMINGER. There is a no-bailout provision of Dodd-Frank today. If bankruptcy is the only option, based upon the experience in other countries where bankruptcy is the only option, I don't believe it would because there would be an incredible pressure to do something other than bankruptcy.

Mr. RENACCI. But, again, I will go back to, I will go to Ms. Romero, if those two options were there, would it end, if you bring the private market back in with bankruptcy and you had no bailouts, would "too big to fail" end?

Ms. ROMERO. I think the only way to end "too big to fail" is to ultimately have institutions that are not so interconnected that their demise takes down the entire financial system. So whether that is the situation that those institutions are restructured and simplified so they are not so interconnected or whether it is a situation where they are, it is with certainty that they will have to suffer the consequences of their own excessive risk-taking, that is what is needed to end "too big to fail."

Mr. RENACCI. Again, that is bankruptcy, but thank you.

Chairwoman CAPITO. Thank you. Mr. Frank for 5 minutes.

Mr. FRANK. First of all, we have to draw a distinction. The bill deals with the failure of large institutions in two ways, first of all by significantly increasing the regulators' ability to stop this from happening or make it less likely, for example, by the regulation of derivatives, totally unregulated derivatives without any requirement of margin or capital, that was contributory. The bill outlaws the kind of mortgages that were made that many of us tried to outlaw earlier. So we don't simply wait as to whether or not there is failure. There is a lot in here that prevents failure.

Secondly, in terms of bailouts, people haven't mentioned one of the major things this law does that ends the bailout, the largest single bailout per institution was of AIG. AIG was bailed out by the Federal Reserve under statutory authority to dating from the 1930s which the law abolished. Section 13-3 of the Act, of the Federal Reserve Act, allowed the Federal Reserve to advance all that money to AIG. We abolished that. That was one very big example of bailout authority that no longer exists.

Then the question is, and my colleague who spoke previously asked for a yes-or-no answer, and he got a yes and he didn't like it. I guess we now have not just a self-fulfilling prophecy but an example of not taking yes for an answer. Yes, our witness from the FDIC, does it end "too big to fail," he said yes. How does it do it? By making it illegal for regulators to do this.

Now let's be very clear, under the law, no Federal official may extend money to a large institution that is failing. It can, after abolishing that institution, wiping it out, spend some money on some of the debts.

So the question then is okay, it doesn't end "too big to fail." Do we assume that Federal regulators will then violate Federal law and give money despite the law saying they can't and keep the in-

stitution going? Or is it that Congress will say oh, well, we didn't really mean it; we are going to vote the money.

Neither one is likely. People ask the question. I don't know what they mean. The law clearly says you cannot extend the money in those circumstances, and you can't do what the Federal Reserve did, they can no longer do it because we explicitly took that away. Now, the dilemma is the question, can bankruptcy handle everything? It was Henry Paulson, George Bush's Secretary of the Treasury, who first told the Congress in 2008 in the spring that the law was inadequate, that having to choose—and this is Secretary's Paulson's argument at the time—between bankruptcy and intervention that kept the institution going was an inadequate set of choices. And that is what happened in 2008. Lehman was allowed to go bankrupt with, they thought, negative consequences.

It was the Bush Administration that came to Congress in September 2008 and said, we have a disaster on our hands because Lehman failed, and then AIG was about to fail. So one option was bankruptcy, Lehman Brothers. The other option was let the Federal Reserve give $80 billion right away without any congressional involvement to AIG. What Secretary Paulson said was, I have been begging you, give us an alternative. This is the alternative. The alternative is—there are three aspects.

First of all, you regulate beforehand. You say, you are a particularly important institution because you are so interconnected, not just big, and I appreciate the Inspector General mentioning it, it is the interconnection that makes it particularly problematic. So we are going to give you a higher capital charge because you have people complaining about a higher capital charge. That is what makes it less likely to fail. We are going to regulate derivatives in ways they weren't before. We are not going to let you get all these credit default swap obligations and not have the money to pay it back like AIG. We are not going allow those kinds of mortgages to be made and packaged and securitized with no risk retention. All of those things go forward.

If, despite all of that, there is a failure, then the regulators are told under Federal law that the institution is gone. It is dead. They are fired. No more board of directors, no more shareholder equity. At that point we may decide, this is what Hank Paulson said, if it is bankruptcy, then if it was an institution that was so interconnected and there is no way to pay any of the debts, things may get worse.

By the way, this is not untested. It is what the FDIC has been doing for years. That is why the FDIC is the authority here. They step in, they get rid of the bank that has failed, and they pay some of the debts to make it not get worse. So that is what we are talking about.

And the only thing that is keeping alive the perception that "too big to fail" is still there are Republicans who are trying to make political points by denying the reality.

And again, I do want to emphasize, if you ask the financial institutions that are the alleged beneficiaries of a "too big to fail" designation that will allow them to get cheaper capital, they all don't want it. They all say no, that is not true. All this does for us is subject us to greater regulation.

And those institutions that have an option, the large banks, the large financial houses don't, but those institutions that have an option not to be covered want desperately not to be covered, are lobbying us not to be covered, as The New York Times mentioned on Sunday, because this is not a license to get cheaper money; it is an eligibility for much tougher regulation.

Chairwoman CAPITO. Thank you. Mr. Royce for 5 minutes.

Mr. ROYCE. I think one of the questions here is regardless of what authority we give and what assurances we give in this committee about whether or not that authority will be used by the next FDIC regulator, I am just thinking back to a debate on the Floor in 2008, I think it was July of 2008 as we were debating the Housing and Economic Recovery Act, and the issue then was, the authority is in the bill in theory to bail out Fannie Mae and Freddie Mac, but no, argued those putting forward that legislation, that will never be used. That authority will never be used.

Let's examine some of the assertions that are being made here right now. And I would like to go, if I could, to Mr. James Wigand, I want to quote somebody from your shop, he is the head of the FDIC's Office of Complex Financial Institutions. And here is what he says.

He views the liquidation, in his words, that is a bit of a misnomer. For him, the most important part of the FDIC's new authority isn't liquidating failed firms. He views it as preserving their franchise value so they can be sold to other firms.

So I would ask you a question. Does Mr. Wigand's view represent that of the FDIC that the Orderly Liquidation Authority is not, in fact, a death panel as has been asserted here, but, in fact, a form of life support so that these firms can be sold off with taxpayer support presumably to other firms just like the Federal Reserve did with Bear Stearns?

Mr. KRIMMINGER. Congressman, the FDIC's position, as the law requires, is that the institution, the company that fails is put into a liquidation process. What Mr. Wigand is referring to is that in any liquidation process or any resolution process, you are selling the assets and operations of that firm to other private companies. That is how those assets are recirculated into or recycled into the private sector. So if you can sell them while they are operating in a functioning way rather than in a pure liquidation, which is what can occur in a Chapter 7 bankruptcy, they will have more value. That is what he means by franchise value. That is exactly the same thing we do with failed banks today.

Mr. ROYCE. And your assumption here is that the taxpayers will be made whole. But I am going to go back to another issue which assumes that we will go back and get the money, get any excess payments from these now weakened institutions which we didn't put through a normal bankruptcy process, and following up on the Chair's comments, the problem with the Orderly Liquidation Authority is that it encourages regulators to err on the side of more bailouts with the assumption that they are going to go back and they are going to recover anything in excess of what creditors would have received in bankruptcy.

I have laid out these arguments during the debate over Dodd-Frank and in the conference with the Senate. I am sharing with

you, going back and getting that money will be a very difficult task given that those creditors will also likely be other "too-big-to-fail" banks. And that goes to the issue of why there is this assumption that these institutions are going to come out of this better the way we have structured this than they would if they had to go through a bankruptcy?

So the question is, is there a way to overcompensate for the error?

The amendment that I brought up that was defeated was to have the FDIC, to have you estimate the likely payment under bankruptcy, then take a haircut, take 20 percent off of that, thus minimizing the potential for bailouts and encouraging market discipline by putting them on the same status as their smaller, "too-small-to-save" competitors out there in the market.

I have yet to get any acknowledgement of what economists are arguing here. And I would like just like to ask your opinion and very quickly, Ms. Romero's opinion on that kind of an offset in order to kind of at least try to mimic market discipline in this.

Mr. KRIMMINGER. Congressman, there is a minimum payment today that a creditor receives that is limited by the Chapter 7 liquidation value. What we are talking about doing in Dodd-Frank, as I said, is nothing more than we do with smaller institutions today. The creditors receive payments based upon whatever the sale of the assets will recoup. So that the amount that the creditors in a Dodd-Frank resolution would receive is based upon the sale of, the value of the sale of, the assets.

Mr. ROYCE. Ms. Romero?

Ms. ROMERO. No, I think what has to happen is that market discipline has to be restored. What we have to have happen is that to the extent that these institutions who took excessive risk before and put our greater financial system at risk and ended up having a bailout, that has to end. So market discipline has to come back in so that the due diligence that takes place by counterparties, the access to capital, the terms of the credit, needs to equal the amount of risk.

What is the best way to bring back that market discipline? The best way to bring it back is to make it very clear that these institutions are not going to be allowed to be so interconnected, so large, that they will take down the entire broader financial system.

As to what is the best way to do that and whether it is through your amendment, I haven't studied your amendment and so I am not sure.

Mr. ROYCE. But clearly, the counterparties believe they would be worse off under the amendment that I am proposing here than they would be under this scenario, and that would help drive it in that direction.

Chairwoman CAPITO. The gentleman's time is expired.

Mr. Gutierrez?

Mr. GUTIERREZ. Thank you very much, and thank you to the witnesses. I didn't know we are in a legislative session making amendments to Frank-Dodd, maybe Dodd-Frank, we do that later on. Maybe I was mistaken.

So here is what we have to believe. We have to believe that the Congress of the United States would appropriate billions of dollars

in order to bail out our financial institutions that are significant and would pose a significant risk to the entire system. Yet no one on that side will do it, because you have all said you wouldn't do it. There isn't a Republican who said they would step up and do it. I haven't heard anybody from this side say they would do it, but we are all afraid of something that everybody says no one will do.

I think my friends in the Republican Party should just be very clear, they have always said they are the friends of big business and financial institutions and they say they don't want any regulations and they—

Mr. ROYCE. Will the gentleman yield because we, in fact, say none of that.

Mr. GUTIERREZ. No. Please don't interrupt.

Chairwoman CAPITO. It is the gentleman's time.

Mr. GUTIERREZ. Thank you. And that is what they say. So they should just be very, very clear about it. The fact they get upset that I say it and repeat their mantra shouldn't really bother them that much. They say they are the friends. How do I arrive at that conclusion? Because you are always saying we are the enemy. So if we are the enemy, you must be the friend of the financial institutions.

And you should just be very clear. The fact is that a Republican President came in before this Congress and a Republican Treasury Secretary came before this Congress, and a host of other big-time Republican Wall Street big shots came before this Congress and said, "Bail us out. The system is going down." That is what happened; those are the facts.

And now, who gave the most votes to do that? The Democrats did. But now you come back and say, oh, well, this Dodd-Frank, let's just get rid of that.

Let's go back to bankruptcy. Gentlemen, did you miss the point of the failure of the fall of 2008 that bankruptcy didn't work? That we brought our financial system to the precipice of disaster and that we had to take action?

So why would you want to go back to something that didn't work? I know why you want to go back to something that didn't work: so that you can try to finagle another bailout once again, after you take all the rules and all the regulations and everything away from the financial institutions that have been put in place by Frank-Dodd so that we can bail them out again.

Because there isn't an institution out there—I challenge my friends on the other side of the aisle to tell me a major financial institution that is "too big to fail" that wants and supports the Dodd-Frank bill. Just name me one that sends lobbyists here in order to get support.

I know what they come here to do. I think we should all be transparent and clear with one another. They come here, the financial institutions, after they had gotten bailed out, to do one thing and one thing only, and that is to go back to the old course of business that they were involved in before, and that is no regulation whatsoever, so that they can get extreme profits with virtually no risk, because then in the end they will be "too big to fail" and cause a systemic risk.

That is what you want to do. I get it. You cashed in on the one end, and you are trying to cash in on the other. But guess what?

There are going to be people here who are going to defend the consumers and the small—and then they come and tell us, "Oh, I met with my community bankers. They told me this was so bad." This is not about your community bankers. 'Fess up. This is about the big titans on Wall Street that you want to come here to defend, trying to act as though you are here for the people on Main Street. That hasn't been the case.

Mrs. MALONEY. Will the gentleman yield?

Mr. GUTIERREZ. I certainly will.

Mrs. MALONEY. And on the bankruptcy deal, the bankruptcy has no specific taxpayer protections. Bankruptcy allows a bailout. And bankruptcy does not have systemic effects and a systemic impact on the industry.

You are doing a great job.

Mr. GUTIERREZ. No, wait a minute. It is just, it seems as though everybody just forgot. I just want to make one last point.

In the Dodd-Frank bill, I put in an amendment—many of us supported it—that said that, much like the FDIC, all those "too-big-to-fail" institutions had to put money in a kitty. In case one of them went errant, all of them would help pay so that the taxpayers wouldn't be there. And guess what my colleagues in the Republican Party said? Oh, no, we don't want to do that to those big financial institutions.

No, your little banker and your little community financial institutions have to pay the FDIC, but you don't want the Wall Street titans to have to pay when they come and threaten our economic system. I think it is wrong. And you should just tell people you are for big banks and make it clear and simple.

Chairwoman CAPITO. The gentleman from New Mexico, Mr. Pearce.

Mr. PEARCE. Thank you, Madam Chairwoman. I am still trying to get my breath after that.

If I could get the chairwoman to put up a chart there I think that might be loaded in, I would like to make the point.

This is the government interpretation of how we would administer health care. And Mr. Krimminger, on page 9, would have us believe that the same government that developed that organizational structure could bring a rational organizational structure to private companies. I find that sort of incredulous, that the government is going to work any differently than it has in this chart here and give us that rational organizational structure in firms that they are sitting inside the rooms with, not participating.

So that is one of the disbeliefs that we on this side have, at least this person on this side has, that government can bring anything rational.

We are also being asked to believe that we are going to bring financial stability and financial believability to the firms in the financial institution, and the operational structure is going to be provided by a government that, itself, is in the process of having its debt downgraded. If the government can manage the debt and the organizational structure of the banks and the financial institutions, maybe it should start with its own business first, because it is in the process of being downgraded. And so I, for one, believe that the government structures that are created here and that are being so

eloquently supported by Mr. Krimminger maybe are going to fall somewhat short of their task.

I think, as I am going through the discussions today and listening to them, I am thinking of a banking system, a financial regulatory system that is going to be subject to things that our other companies already do. I think, for example, of the Shell Oil Company and the Alaska oil fields that did a $4 billion study in order to provide an EIS, an environmental impact statement. And I am going to see the government develop these same sort of studies that are required before they allow the institutions to move forward. And the government just said, "Well, I am sorry, you left a paragraph out of that, and we are going to turn down the whole $4 billion thing."

Mr. Krimminger, when these resolution plans are not presented, what is going to happen to the institution? In other words, you say through here many times we got these resolution plans. You simply shut their doors? You stop them from operating? Tell me a little bit about that, if you would?

Mr. KRIMMINGER. Congressman, the statutory provision, section 165(d) of Dodd-Frank provides that the firms, themselves, develop their resolution plans. I can't comment on—

Mr. PEARCE. No, I am saying, let's say that a firm does not get that. Let's say that they don't have a resolution plan that you consider adequate. So what is the penalty? Do you shut them down? Do you stop them from expanding? Do you begin to pull sections away from them, make them distribute part of their assets?

Tell me a little bit about how you perceive it. You obviously were on the inside of the room, planning this.

Mr. KRIMMINGER. The statutory provisions, Congressman, provide that if the resolution plan is not credible to provide for a rapid and orderly resolution under the Bankruptcy Code, then the firm would go back and try again. And if it tries again or fails to submit a plan, then the Federal Reserve, working with the FDIC, in discussion with the Council, could require additional capital requirements, additional liquidity requirements, because the firm has shown that it can't be resolved under the Bankruptcy Code.

And then if the firm still, after another 2 years, fails to provide a credible resolution plan with the additional capital and liquidity requirements in place, then the FDIC and the Federal Reserve, in consultation with the Financial Stability Oversight Council, can require the firm to take some actions, including selling some assets, if necessary, in order to make itself more simple and more resolvable.

That is the statutory provision.

Mr. PEARCE. And you feel like that is a plan that is going to work?

Is the FDIC overseeing any part of the Lehman Brothers distribution?

Mr. KRIMMINGER. No. That is a bankruptcy resolution.

Mr. PEARCE. Are you kind of watching it? Are you proving up your concepts there? Are you taking a look at what all is required? Are you all watching that closely?

It is a fairly complex institution that is being broken up. It is a place for you to do a dry run. Are you all doing a dry run with all of your concepts?

Mr. KRIMMINGER. We take a very careful look at the Lehman bankruptcy proceedings. We just released a paper a couple of months ago, looking at how Lehman could have perhaps been resolved under the Dodd-Frank provisions. So we obviously are monitoring it because it is a very good—

Mr. PEARCE. And you believe that your findings would have stopped Lehman Brothers if they had been implemented?

Mr. KRIMMINGER. I believe that the Dodd-Frank authorities would have allowed Lehman Brothers to be resolved in a less disruptive way to the financial system, yes.

Chairwoman CAPITO. The gentleman's time has expired.

Mr. Miller?

Mr. MILLER OF NORTH CAROLINA. Thank you, Madam Chairwoman.

Serving on this committee is a strange experience. Hearing all of the statements on the other side, it sounds like Republicans really pushed to make Dodd-Frank or make a financial reform bill a really tough bill and Democrats watered it down. That is completely at odds with what actually happened in the last couple of years, where I think every provision that would have made the bill tougher, that would have, as Ms. Romero said, made for smaller, less interconnected firms that were less of a risk to pull the whole economy down with them if they collapsed, all of those provisions were unanimously opposed by Republicans.

So, Senator Kaufman introduced an amendment on the Senate side that failed, which would have limited the overall size of banks to 2 percent of the GDP. That is still, like, a $300 billion company. That is a pretty big bank, big enough to do pretty much anything. But it would have required that the 6 biggest firms be broken up into more than 30 banks. No Republican support for that at all. I introduced the idea on the House side, but the fight was really over in the Senate side.

Mr. Gutierrez mentioned the idea of an up-front resolution fund funded by the industry to make sure that taxpayers really were not on the hook. It was absolutely opposed by the industry and by Republicans, who pretty much said exactly the same thing the industry said.

One of the issues in the last couple years, it was dimly understood at the time of the crisis, was that there was—Mr. Krimminger mentioned the shadow banking system, and there are a lot of things that are considered to be part of the shadow banking system. One is what is called the repo market, which is an interbank, inter-financial-institution lending system that was pretty much completely unregulated. And what happened in the fall of 2008 was that there was a run in the repo system that almost looked like the run in, "It's a Wonderful Life," where everyone went down and took their money out and the whole system froze up.

Chairman Bair did propose a solution to that to create some market discipline. I introduced it with Mr. Moore on this side. It went to the Senate, somewhat watered down. It then came back as a study. And the study will apparently come out this summer.

Mr. Krimminger, what is the current status of the repo market and the vulnerability of the repo market to another run like what we had?

And we are talking about a lot of money here. I think Bear Stearns was getting $70 billion a night in overnight lending from the repo market. And when that dried up and went away, it collapsed. Pretty much the same thing happened to Lehman Brothers.

What is the current status of that?

Mr. KRIMMINGER. Congressman, I would have to get back to you with the statistics on the current repo market.

The repo market certainly has stabilized dramatically from the fall of 2008. But you are correct that one of the characteristics of the fall of 2008, following the Lehman bankruptcy, was a dramatic shutdown of the commercial paper and repo market at that time. And Chairman Bair and the FDIC had expressed concern about an overreliance by some financial institutions in the past on short-term secured financing.

While the study will come out this year, I think that is an issue that we need to all look very carefully at, because that can have the same effects as a deposit run without deposit insurance. And neither I nor anyone else around would want to have insurance for repos, for sure. So we need to find a way of making sure that a repo run would be less likely in the future.

Mr. MILLER OF NORTH CAROLINA. Before the FDIC, we really haven't had a deposit run in 75 years, in three-quarters of a century since the FDIC. Now, of course, at the time, the banks pronounced that if the FDIC went into effect and there was deposit insurance and safety and soundness regulation, no one would ever put their money in a bank. And of course the opposite happened because people realized they could put their money in the bank and they would be able to get it back.

But before that, there were runs every few years. There were crises in the financial system every few years. Is there any reason to think that there won't be again?

Ms. Romero?

Ms. ROMERO. Again, as we looked at Citigroup and AIG and other things that we examined sort of what happened, it was runs that ended up causing the government to step in and do the bailout.

So, the government before has taken action in response to this lack of investor and consumer confidence, whatever the run may be. And so it is really up to the regulators now in what they do with these plans—they have authority to shape these plans—and what they do with setting their requirements.

The markets are going to watch that. And they are not just going to watch the words or the promises that the Dodd-Frank Act ends "too big to fail." It has to be matched up with actions—actions that say for certain that the government is not going to step in.

And that is the way—what you want to do is get into a situation where, if there is a run on one of these companies, that run does not cause—doesn't trigger the next financial crisis. And that is going to be key.

Chairwoman CAPITO. The gentleman's time has expired.

Mr. Westmoreland?

Mr. WESTMORELAND. Thank you, Madam Chairwoman.

And I would like to remind our colleague from North Carolina, at the time Dodd-Frank passed, I believe the Senate had a 59–41 advantage and the House had a 252–183 advantage. So I believe they could have passed anything that they would have liked.

Mr. Krimminger, in your testimony, you say, "Given the absence of a nonbankruptcy auction to prevent a disruptive collapse, government assistance was necessary to prevent the effects of these failures from cascading through the financial system, freezing financial markets"—and I am assuming that is credit—"and stopping the economy in its tracks."

Is that not what has happened?

Mr. KRIMMINGER. I was describing, Congressman, in my testimony that we believe, in the fall of 2008, since there were no other options other than additional destabilizing and disruptive bankruptcy proceedings involving the largest financial institutions, that, without another option, the government assistance was necessary to prevent further and even more severe disruption of the financial markets.

There is no question that the fall of 2008 was a very dire time for the financial markets and the financial system as a whole.

Mr. WESTMORELAND. Did Lehman Brothers not go through bankruptcy?

Mr. KRIMMINGER. Yes, it is in a bankruptcy proceeding today.

Mr. WESTMORELAND. Yes. So it was an orderly process.

Mr. KRIMMINGER. I don't know that I—it followed the Bankruptcy Code. It was a very disruptive process, because even Alvarez & Marsal, who have been doing the liquidation, have testified that the bankruptcy process probably cost over $75 billion in losses that could have been recouped had there been the ability to continue some level of transactions in order to achieve a better value for the creditors.

Mr. WESTMORELAND. Who were those losses to?

Mr. KRIMMINGER. Those losses would be to all the creditors. To date, there have been unsecured creditors in Lehman who have not received a distribution.

Mr. WESTMORELAND. Okay.

Now, as you might know, Georgia has had 63 bank failures. Do you believe that the same government assistance should be extended by the FDIC to the community banks?

And let me explain. When you talk about cascading through the financial system, it saved all the big banks, but when it got down to the small banks, it spread out and has caused more small banks to fail. So I guess "too small to save." And what has happened is, that is real money that is sucked out of these communities.

What is being done to try to save some of these community banks rather than putting the pedal to the metal and making them go faster? Is there anything that the FDIC is doing to look at these smaller institutions?

Mr. KRIMMINGER. Congressman, we certainly participate, with the Georgia Department of Financial Institutions, in examinations of the State non-member banks. And other regulators, of course, are the primary Federal regulators for other types of banks in Georgia.

We are not trying to accelerate the closing of banks. We certainly are trying to make sure we follow the law very scrupulously. If a bank goes below the critically undercapitalized level, then the statute requires us to give them 90 days to correct that, and if they can't, then they have to be closed.

We certainly agree with you that it was unfortunate that the largest institutions benefited from a level of support that the smaller institutions did not. That was a demonstration of a long-held perception of "too big to fail." That is why, however, that we think we should never be put in the position again where we don't have an option that will make sure we can close the largest institutions while making the shareholders and creditors bear the losses just as the small banks do.

Mr. WESTMORELAND. But it is the communities that it is getting sucked out of. And, you say that these—

Mrs. MALONEY. Will the gentleman yield? Because I support your position completely.

Mr. WESTMORELAND. Sure.

Mrs. MALONEY. I support his position completely. A great number of small institutions that are serving communities and are really the heart of these communities have been closed.

So I would like the gentleman to consider asking the question, is there any leeway on the 90 days? This is a financial crisis time, and these smaller banks need a little more time to try to get the capital to keep their doors open. Is there any leeway to allow them past the 90 days if they don't meet your criteria to stay open?

I yield back.

Mr. KRIMMINGER. There is certainly an opportunity to extend the 90-day period if there can be a demonstration. And, usually, it would be us working with the State regulator if it is a State nonmember, or the Federal regulator if it is a Federal regulator, to extend the period if there is a demonstration that there is a plan in place to provide the additional capital. I can assure you, we have tried to work very closely with institutions to try to make sure they have an opportunity to raise capital, to do a private-sector merger and acquisition.

And I would just say, from the FDIC's perspective, we certainly are not eager to close banks. We certainly would like to see the banks get recapitalized and continue on to serve those communities. I think there is a grave risk to the community banks in the United States. They, unfortunately, have—some have a substantial number of bad assets on their balance sheet, which is making it impossible for them to merge and avoid a failure. But we certainly agree on the importance of community banks to the U.S. financial system.

Mr. WESTMORELAND. Let me make just one brief comment.

The reason they have some of these bad assets is because some of these banks that were given TARP money went in and did fire sales in these communities that undercut the values of the assets that these banks were holding and, with the mark-to-market, had to immediately write them down. This was through no fault of their own. This was the fact that the government had given these big banks the money to go in and fire-sell assets of these banks that they had taken over. These acquiring banks had plenty of

money. They had the loss-share agreements that gave them no incentive to save those loans.

And I will tell you that I have counties in my district that used to have three banks and now do not even have one community bank. This is systemically significant to my district and to rural districts all across this country. And I hope that the FDIC will recognize this and try do something with it to save some of these small lending institutions.

I yield back.

Chairwoman CAPITO. Thank you.

Mr. Meeks?

Mr. MEEKS. Thank you, Madam Chairwoman.

And, okay, you hear it? Democrats and Republicans can agree. And I think that is really where we need to head on this.

I came down, and I have heard both sides, and I think that there are just some basic philosophies that both sides have to agree to. I think that the Republican Party has been known for a long period of time as being the party of deregulation. I think there was a joke that one of President Reagan's chief economic advisors reputedly had said back in 1981, "Don't just stand there. Deregulate something." And I think that the Democratic Party is the party that has been known probably to overregulate. And people will say that then hampers the opportunity to be competitive, etc.

So the key for us is to try to find out where that middle of the road is. Because I think that we can agree that if you do no regulation, if you are talking about deregulating everything, then we are in big trouble. And I think that the flip side of that is also true, that if you overregulate and you stranglehold, then even the smallest of banks—because I have talked to some of the community banks, and they are concerned about, they can't continue to exist because of what the costs would be for overregulation. So we have to try to figure out as adults how we get this thing right.

One of the things that I know that we can't do is to repeat what took place a few years ago, which created the need for Dodd-Frank in the first place. What took place? We went from one swing to the other, and we began to have mass deregulation, and we lost some transparency. And, as a result of it, banks bought other banks and got bigger and bigger and bigger. And then, we had a panic here in Congress, because when a bank began to fail, once we bailed out one—and then, because it wasn't politically expedient, we didn't bail out the other. And so, Lehman Brothers went down and went into bankruptcy. And the markets started going, and everybody panicked up here.

Then, we decided that we are going to try to save this institution. We hated to spend the taxpayers' money, but we decided that was the best thing to do. But we also resolved that we would never do it again. We didn't want it to happen so that somebody becomes so big that it could systemically put everything, our whole economic system, at risk. So we had do something.

And what we tried to do, and I think we did a good job of it, of coming up with something that ends "too big to fail," so that we don't get back to where we are. And the best way that I can see that we could end "too big to fail," which Dodd-Frank does, is by requiring risky firms to create, basically, living wills, and sub-

jecting them to periodic stress-testing, with all of the information made public—that is transparency—arming investors with vital transparency and greater decision-making power.

It also explicitly ban bailouts. Nobody wants to see bailouts again. Taxpayers don't want to do it. And it gives the FDIC the power to wind down failing firms in an orderly manner to avoid the chaos of the court-run bankruptcy system.

There is going to be chaos, because I can tell you, I am still getting calls from people in New York and some who are constituents about the perils of the system because the bankruptcy with Lehman Brothers is still going on today. Their money is tied up. Some of them have university endowments. I am getting calls now, "Help, save me. I have to get my money out of that." So I don't want that system, where I am still getting people today telling me their money is tied up in the British system, and we have some problems there. So we don't want do that again. We have to fix the system.

And so, I think everybody should oppose bailouts. And if you oppose bailouts, then it seems to me that Dodd-Frank is the best way to go because it prevents bailouts in the future, and we make sure that we are not taken under by any huge and risky enterprise that gets too big.

Let me quickly just ask some simple questions to the FDIC, and they revolve around the allegation that "too big to fail" is perpetuated by designating a firm as a systemically important financial institution, or SIFI, which claims increases the likelihood of a bailout.

My first question is, if this is just for big firms, getting bailed out, I haven't heard of any big firm—you can correct me if I am wrong—that is lobbying to be classified SIFI. Do you know of any firms that have lobbied to be classified SIFI?

Mr. KRIMMINGER. I am not aware of any, Congressman.

Mr. MEEKS. And I see that I am out of time. So, all right, I will yield back.

Chairwoman CAPITO. Thank you.

Mr. Canseco for 5 minutes.

Mr. CANSECO. Thank you, Madam Chairwoman.

Mr. Krimminger, one of the major issues surrounding the FDIC's new resolution authority is the requirement that the Treasury Secretary appoint the FDIC as receiver should it be determined that a bank is on the brink of failure and could bring down the whole system.

If we go back to 2008, for a period of several months, there was denial from bank executives and from regulators and from politicians that a number of firms in the financial sector were on the brink of collapse. If the next crisis were to happen 10 or 15 years from now, we don't know who the Treasury Secretary will be and how he or she will react during a market crisis. My point is that the FDIC's authority has no chance of being successful if the Treasury Secretary either continuously denies to appoint them as a receiver or appoints them either too late or too early.

This presents a problem. Unless the timing from the Treasury Secretary is perfect—and there is no guarantee that the FDIC receivership would then actually work if it is, or if it were—the mar-

ket will likely panic as a result. If the Secretary waits too long or doesn't act at all, the problems of the troubled financial institution will only grow. And if the Secretary acts too early, he risks taking over financial institutions that had a chance of surviving on their own. This would destroy confidence in the markets and would prevent private deals from being made for other firms that are in trouble. And the resulting confusion would have everyone asking, who is next?

So my question to you is, is the FDIC's resolution authority an end to "too big to fail" just because it exists? Or is it an instrument that can only work if actual problems in the financial system are relatively contained and then perfectly orchestrated, well-timed, and are taken by regulators at the right time?

Mr. KRIMMINGER. I think the answer is that, under Title II, there is not the ability, there is no statutory power to bail out the firm, so the firm would either have to go into bankruptcy, which is the default option, or it would be placed into an FDIC receivership under Title II.

You also have to go back to Title I, because it is not just the Treasury Secretary's action at a particular point in time that is the key thing. That is why the designation of a particular institution for heightened supervision under Title I is pretty critical, because that then triggers the obligation of that firm to prepare resolution plans, which will go into the analytical structures of the firm and how it could be resolved under the Bankruptcy Code.

Our hope and our goal—because we have no interest in being appointed the receiver for one of the largest firms if it can be resolved under the Bankruptcy Code. But what Title II does is provide an option so that, if the firm is at the edge of the bankruptcy, and it may be going into bankruptcy, that the Treasury Secretary, based upon the recommendation by the Federal Reserve Board and our board, could recommend to the President a decision that it would be placed into a Title II resolution.

So a critical thing is to look at the relationship between Title I and Title II as providing a solution.

Mr. CANSECO. Thank you.

Failure of systemically important financial institutions rarely happens in isolation. The FDIC's report on Lehman Brothers assumes that Lehman was the only trouble spot back in the industry back then. And even if the FDIC had the authority to properly wind down Lehman back then, wouldn't the agency have been distracted by Citigroup, Wachovia, Washington Mutual, and other depository institutions that are the FDIC's primary focus?

Mr. KRIMMINGER. The FDIC has the responsibility of dealing with insured depository institutions. We have set up a separate office to look at the resolution and risk-monitoring characteristics of the largest institutions.

But to get back to your initial premise for the question, our paper was not based upon the idea that Lehman was a simple blot on an otherwise clear canvas. It was based upon the facts and based upon the evaluation and the valuations prepared of the Lehman assets by those who actually were doing due diligence at the time in 2008 based upon the circumstances then. And the reality is that there was a bidder for part of the broker-dealer assets both

in the United States and England at the time of the Lehman failure, but that bidder decided not to participate pre-bankruptcy or pre-insolvency because of the fact that the holding company itself was burdened with a substantial amount of bad assets.

Structuring a resolution where you have a failure that can be structured into a good-bank/bad-bank structure will allow you to deal with the bad assets and can help solve that problem.

Mr. CANSECO. Thank you, Mr. Krimminger.

My time has expired.

Chairwoman CAPITO. Mr. Carney, for 5 minutes.

Mr. CARNEY. Thank you, Madam Chairwoman.

Thank you to the witnesses for coming.

The title of this hearing is really pretty simple and straightforward, "Does the Dodd-Frank Act End 'Too Big to Fail'?" I think I have heard each of you answer that question.

Mr. Krimminger, you said, pretty simply, "yes."

And, Ms. Romero, you said, it depends, maybe, depends on what the regulators do.

Is that an accurate summary of your answer to the question?

Mr. KRIMMINGER. I will answer first.

I think I would agree, yes. But also I think it is important to note that it is important what the regulators do going forward with the resolution planning process and the SIFI designation process and the supervision and capital requirements.

Ms. ROMERO. And just to clarify my answer, the mere enactment of the Dodd-Frank Act was not enough to end "too big to fail."

Mr. CARNEY. So, not enough. So there were things in Dodd-Frank that changed the tools, changed the playing field, really changed the circumstances considerably or somewhat or—

Ms. ROMERO. Absolutely. There are a number of tools there. I think the point is, just the mere enactment by itself was not enough to end "too big to fail." So it does provide regulators the tools that the regulators said that they would have liked to have pre-crisis.

Mr. CARNEY. Necessary tools that were suggested by regulators that they didn't have when the crisis presented itself in 2008?

Ms. ROMERO. That is right. And so then, it is up to the regulators to use those tools and put it into action.

Mr. CARNEY. Right. So we have answered the question up here on the dais, yes, it does; no, it doesn't; yes, it does; no, it doesn't; yes, it does; no, it doesn't—both sides, not a very intelligent kind of debate about that.

The question for me really is—and I think the other side—or I heard the other side say, why don't we just let failing institutions go through the normal bankruptcy process? And I have heard the answer several times, "Well, that is all we had in 2008, and that is what led to big bailouts."

Is that an accurate summary of those answers?

Mr. KRIMMINGER. I would just respond for myself that, certainly, being, if you will, living through 2008 and the decisions that were being made, the conclusion was that bankruptcy alone—we could not take the risk of bankruptcy alone in the fall of 2008. Certainly, we had great trepidation about some of the actions that were taken, but those actions were necessary. It is important to have an

additional option that can provide for a more orderly resolution and liquidation of a financial institution.

One thing I would want to note on that point is that the reality is that the same types of powers we have in the Dodd-Frank provisions for these institutions, with bankruptcy, again, being the primary way you resolve financial firms—and that is just the systemic ones we are talking about—that has really become the international standard that other countries are looking at. And it has actually placed the United States in a leadership role by having those authorities in Dodd-Frank. We are pushing very aggressively for other countries to adopt similar types of powers. And it will take some time, but there is progress being made.

Mr. CARNEY. So it would be accurate to say that it is a more orderly, controlled bankruptcy process that might avoid, I heard somebody say, $75 billion of extra losses in the Lehman Brothers bankruptcy, that might avoid that kind of—and protect creditors better?

Mr. KRIMMINGER. The critical thing, from our perspective, is that it would allow for mitigation of the systemic consequences of the failure. It will have the additional effect, we believe, of increasing value for creditors. But the key thing is to make sure that we are able to address the systemic consequences that we did not have the statutory authority to address in the fall of 2008.

Mr. CARNEY. Ms. Romero, would you like to add anything to that?

Ms. ROMERO. When we examined the past bailouts, we definitely saw that the regulators felt like bankruptcy was not an option. And so, looking forward, one of the things, when we interviewed Secretary Geithner, he said to us—and this was in relation to our audit that we did of the bailout of Citigroup—"In the future, we may have to do exceptional things again." And you don't know what is systemic until you know what the nature of the shock is.

Mr. CARNEY. So that is a good way of asking my last question. I am sorry for cutting you off; I am watching my clock. So are we better off to address—or are the taxpayers better protected? Because, really, that is what is underneath the question of whether Dodd-Frank has addressed "too big to fail."

Ms. ROMERO. I think more needs to be done than just having the tools there. The tools have to be implemented.

Mr. CARNEY. Sure.

Ms. ROMERO. To say—

Mr. CARNEY. And that process is under way. There are some people who would want to curtail or hold that process up, stop it, change it. That is not a good thing, to change it, to allow that process to go forward and to do the additional things that need to be done to really prevent "too big to fail." Is that—

Ms. ROMERO. The concept of "too big to fail" still exists in the form of competitive advantages for the largest institutions, who are now—the top 5 are 20 percent larger than they were pre-crisis. So something has to change.

Mr. CARNEY. Thank you very much.

Chairwoman CAPITO. Mr. Luetkemeyer, for 5 minutes.

Mr. LUETKEMEYER. Thank you, Madam Chairwoman.

I would like to follow up on your last comments there, Ms. Romero, from the standpoint that we continue to encourage our institutions to get bigger and bigger and bigger, and with that size comes more risk. I think that we are winding up getting into a position where we have more and more concentration, and, as a result, whenever one of those institutions becomes systemically interconnected with everybody else and is in big trouble, then we are talking about how do we wind it down.

What happens when the whole group of all of these half a dozen or dozen institutions now are all in trouble? How are you going to wind them all down? This is the situation we were in 2008. This bill does not solve that problem. How do you respond to that?

Ms. ROMERO. I certainly think that the concentration that has happened in the banking industry puts our greater financial system at risk.

Mr. LUETKEMEYER. How do we solve that concentration problem?

Ms. ROMERO. The only way to solve the concentration problem—there are two ways: one, they have to be simplified, whether they do it by themselves or whether they do it by regulation; or two, there has to be a situation where if they suffer financial distress, they are left to suffer the consequences of the distress.

The problem is, if they are so interconnected with the greater financial system, then them suffering financial distress automatically puts the greater financial system in stress. And so that is what needs to be addressed.

Mr. LUETKEMEYER. The problem is, if you have one of these big institutions that is in trouble, and you have narrowed it down to just half a dozen, and they all are interconnected, one infects the rest. So now, instead of one institution, you have half a dozen in trouble. How do you solve that problem?

Because that is where we are going to be in 1 year, 2 years, 5 years from now. Because we continue to have more and more of these institutions absorb the smaller institutions, and you wind up with fewer and fewer institutions holding more and more of the assets. And now, when one is sick, they are all sick.

And if one can't be wound down in a reasonable amount of time, what is going to happen? How are you going to react if a September 2008 situation occurs again, where you have to be able to make something within a few days' time of judgment to get things going? You are talking here of 90 days to do something on some of these institutions. You are not going to have 90 days. If they are all infected with the same disease, you are going to have about a week to solve this problem or the whole thing collapses. How are you going to solve that problem?

Mr. Krimminger?

Mr. KRIMMINGER. I think that is why we are doing advance planning. That is why the resolution planning process is so very important, for a couple of reasons. First of all—

Mr. LUETKEMEYER. Mr. Krimminger, with all due respect, you won't have time to resolve this problem, you won't have time to resolve this process, because you are going to have about a week to make the decision on how you rescue the institutions.

Mr. KRIMMINGER. The resolution planning process is created long before that week. The resolution planning process is created for ba-

sically the bank holding companies now over $50 billion, it is in effect now. We are finalizing the regulation very shortly to do that.

The second point about the resolution planning process is that, ultimately, it is going to require the firms themselves to look at simplification. There are parts of Dodd-Frank that can require simplification. It is going to be important to move forward with those, so that actually occurs. Because I would fully agree with the Inspector General that simplification and reducing concentration is important to the system, and we need to move forward with doing that.

Mr. LUETKEMEYER. Okay. How are you going to do the simplification? Are you going to require them to sell assets off, reduce size? Are you going to put a cap on deposits? What is your suggestion for doing that?

Mr. KRIMMINGER. That is going to depend upon how the resolution plans for these firms come forward. If they can show that they can be resolved under bankruptcy, then they can show that, and that would be a very good thing. If they can't show that, then they are going to have to take some hard decisions about what steps next to take in order to address that simplification issue.

Similarly, Title I of Dodd-Frank can impose, and should impose, additional capital and leverage requirements on the largest financial institutions so that they would have an incentive then to not be so large and complex.

Mr. LUETKEMEYER. You keep talking about the resolution of the problem. I am trying to get to the problem before it happens. Because my concern is, if we don't find a way to get these banks capitalized or deconnected or be in less risky positions, we are going to wind up with the whole system being in a position where we can't save it unless you do another huge bailout. And the bailout of 2008 is going to look like a little bitty one compared to what is going to happen if we don't do this right this time.

Mr. KRIMMINGER. I would fully agree that higher capital levels—in fact, that is part of the Basel III standard, to have higher capital for the largest financial institutions.

I also fully agree that we need to take steps—the steps I am talking about are far in advance of any resolution. The planning process would be starting now, not waiting until there is a resolution—

Mr. LUETKEMEYER. My concern is, we are not going to have time to do all this planning whenever the 2008 bomb hits us again. I think we are being very shortsighted instead of being long-sighted.

And if the Chair would just indulge me for 1 second, there is a new movie out called "Too Big to Fail." Have either one of you seen it yet?

Ms. ROMERO. I have.

Mr. KRIMMINGER. I have seen parts of it, yes.

Mr. LUETKEMEYER. Is it a pretty accurate reflection of what happened in 2008, in your opinion?

Mr. KRIMMINGER. It is a fictionalized version.

Mr. LUETKEMEYER. Ms. Romero?

Ms. ROMERO. I think it is a pretty sensationalized version, but a lot of the same players and things that happened matched up with what we audited.

Mr. LUETKEMEYER. Okay. Just curious. Thank you very much.

Thank you, Madam Chairwoman.

Chairwoman CAPITO. Thank you.

Mr. Huizenga?

Mr. HUIZENGA. Thank you, Madam Chairwoman.

And just a general comment. I am shocked—shocked—that anything would be sensationalized out of Washington or out of Hollywood. So I am sure that is news to everybody.

But I have a general question. And I appreciate—and I have to tell you, I have the utmost respect for my friend from Missouri here, and his knowledge and background in it. And I struggle to find anything more intelligent or as intelligent to ask. But it seems to me that he is right, as we are heading down this path of trying to make sure this never happens again.

I am curious if either of you believe that the notion, just the notion of "too big to fail" has really been driven out of the marketplace?

Mr. KRIMMINGER. Not yet. Certainly, to date, the largest financial firms do have something of an "uplift," as it is called in credit rating parlance, for the fact that they have this expected potential future government support.

And as I mentioned earlier in my testimony or in response to questions, the credit rating agencies have told me that it is not based upon any statutory authority today, because they agree that the statutory authority to provide a bailout doesn't exist today. Their only concern is what could happen under a future law adopted by a future Congress in a crisis?

That is why I think it is critical that we move forward aggressively to try to provide that simplification and to provide a more resilient and stable financial system through higher capital and other measures.

Mr. HUIZENGA. Ms. Romero?

Ms. ROMERO. Absolutely not. These large firms are definitely still "too big to fail." They enjoy all the competitive advantages: the enhanced credit ratings by Standard & Poor's and by Moody's; cheaper access to credit that doesn't take into account all the risk; the ability to raise capital. These are all things that they currently enjoy. And, also, there is a reduced market discipline.

Mr. HUIZENGA. Isn't that somewhat counter to what you were saying earlier?

Ms. ROMERO. No, no, I believe it is the same thing. I am saying, the enactment of Dodd-Frank itself did not change "too big to fail."

Mr. HUIZENGA. Okay. And it seems to me—this was brought up earlier by our colleagues on the side that is now empty—that, in many ways, the unknown is worse than the known. And this might be a case of the devil you know is better than the devil you don't know.

And we are talking about SIFI and these systemically significant institutions, but I had recently, as a freshman—I am a freshman on this committee, so I wasn't here for those debates. I am sorry that my friend from Illinois got duped twice into voting for this. And as he was pointing out in his diatribe—it wasn't a diatribe, close to, almost a question—that, somehow or another, this was driven by people who love big banks and who love Wall Street.

I had a visit up to Wall Street while I was here with a couple of other freshmen. We sat down and had a meeting with a CEO and a CFO from one of those major banks, not one of the nine, but a major bank. And they looked at us, and one of the statements was, "Congressman, if we ever find ourselves in this situation again, you simply are going to have to do the bailout again." At which point, I said, "No disrespect, but I am curious. Where do you live?" The answer was Westchester, of course. I said, "Do you know anybody—have any of your of your friends or neighbors actually lost their job, much less their home, over what happened?" And the CFO kind of paused, and she kind of looked up at the ceiling for a second, and she said, "Well, honestly, no, I can't." I said, "Here is the problem. From Zeeland, Michigan, I can." I know people. My family is involved in construction, all right? It has been a very, very difficult time. And those ripple effects that my friend from Missouri is talking about are huge.

And I am concerned—Moody's made note of this a year ago, that this language was out there. I think part of the problem is, the American people and the marketplace—and I am more concerned about, frankly, the American people than I am the marketplace—don't believe our actions match our words here.

So I am sure my friend from Illinois, who never dreamed he would be coming here to bail out Wall Street but ended up doing it twice, has every good intention. But this institution does not have a good track record, regardless of party label, of making sure that our friends back home in those small community banks and in those credit unions and in those other areas that are trying to provide that credit for those—whether it is rural or suburban or even urban areas, that we don't have a very good track record of following our own words. And it seems to me that is a crucial element here, that we do not have the markets that actually believe what we have been saying that we are doing.

And it seems to me—and, Madam Chairwoman, I appreciate you doing this hearing to underscore that and reiterate that for us.

Thank you.

Chairwoman CAPITO. Thank you.

Mr. Grimm, for 5 minutes.

Mr. GRIMM. Thank you, Madam Chairwoman.

Mr. Krimminger, just to follow up, and expand upon what Mr. Luetkemeyer said, I guess I have a little trouble with the idea of the premise that the FDIC will take a failed institution and they will liquidate that institution. Is that correct?

Mr. KRIMMINGER. That is what we have done, yes.

Mr. GRIMM. And under Dodd-Frank, if we have one of these situations where we have a large institution, we are going to sell it off and we are going to try to get—obviously, if it is functioning, you will get more money. So the sooner we are able do that, the better. Is that correct?

Mr. KRIMMINGER. Absolutely.

Mr. GRIMM. Because there is only a handful of these very, very large institutions, you have to assume that, say, out of the nine, if one were to fall, the other eight are going to pick up a vast majority of that business. Is that a strong possibility?

Mr. KRIMMINGER. There are a couple of options there. That is one possibility. You can break up the institution in the resolution process and sell some of the business lines, which may be valuable to another firm.

Another option would be to put it into a bridge financial institution and essentially recapitalize that bridge so that it could be then offered off to the private market for recapitalization itself. It would be close. All prior shareholders would be zeroed out, so to speak, they would have lost all their money. But it could be recapitalized so that you wouldn't increase concentration.

Mr. GRIMM. Right. That is my concern, is that we have one or two of these large institutions in a situation where they need to be liquidated, the market to absorb them is going to make those other seven, eight major institutions that are going to try to eat them up, probably be in a position to pay the higher price, it is going to make them even more complex and more interconnected, possibly compounding the problem.

Is that a concern? Is that something the FDIC is conscious of, cognizant of, and considering?

Mr. KRIMMINGER. It is a concern today in bank failures. It would be a concern in the future in a resolution under Dodd-Frank, because when one firm buys another firm, it does certainly increase concentration.

Mr. GRIMM. I just want to emphasize also, we have heard the argument made 3 or 4 times today that none of these large institutions want to be considered SIFIs. They are all lobbying not to be and making it very clear that they don't want to be subject to more regulations.

That, in and of itself, doesn't necessarily mean, though, that is not conclusive evidence, that Dodd-Frank is doing what it intended to do. Is that accurate to say, Mr. Krimminger?

Mr. KRIMMINGER. I think that what—I am not going to comment on what it does or does not mean, because it could mean a bunch of different things, I think. But I think it certainly is indicative of the institutions not wanting to have heightened supervision and additional capital and liquidity requirements.

Mr. GRIMM. Have you known of any circumstance ever in the history of banking where an institution wanted higher capital and more regulation?

Mr. KRIMMINGER. I will have to think about that, but I can't recall, off the top of my head.

Mr. GRIMM. It is going to be "no."

Ms. Romero, do you?

Ms. ROMERO. No. It is not surprising that the banks don't want enhanced requirements and enhanced supervision.

Mr. GRIMM. So I would conclude from that, that it is not a reflection on whether Dodd-Frank is good, is bad, is indifferent, or meets its goals. It is just simply, no financial institution is ever going to opt in for higher capital requirements or more regulation. That, to me, just seems like common sense. So I wanted to say that, since that argument was mentioned 3 or 4 times, that certainly is not conclusive as to Dodd-Frank in any way, shape, or form.

Enforcement—I think we can talk about the best rules and regulations ever promulgated in the history of the United States, but they are only as good as the enforcement.

Mr. Krimminger, your FDIC banks now, don't they have some type of leverage ratio requirements?

Mr. KRIMMINGER. Yes. All U.S. banks today have leverage ratio requirements, correct.

Mr. GRIMM. The average approximately 12 to 1, give or take?

Mr. KRIMMINGER. I would have to look at what the average actually is, but that is probably reasonable.

Mr. GRIMM. Probably in that ballpark?

Mr. KRIMMINGER. Minimum.

Mr. GRIMM. Right. Is there anything in Dodd-Frank that sets an explicit ratio so that these financial institutions are not overleveraged?

Mr. KRIMMINGER. I do not believe there is a specific leverage ratio in Dodd-Frank. Certainly, there are heightened capital standards that are, we think, very important in section 171 of Dodd-Frank to set a floor so that you can't go below those capital standards. But I don't believe there is a specific leverage ratio per se in Dodd-Frank. That would be set by regulation.

Mr. GRIMM. Do you think that is something that should be looked at or considered?

Mr. KRIMMINGER. As you know, no doubt, the FDIC has long advocated strict leverage ratio requirements for institutions. Obviously, it would depend on what ratio would be set before I could tell whether it would be something good from our perspective or not.

Mr. GRIMM. Fair enough.

My time has expired. Thank you.

Chairwoman CAPITO. Mr. McHenry, for 5 minutes.

Mr. MCHENRY. Thank you, Madam Chairwoman.

And to the witnesses, I certainly appreciate your testimony, and I thank you for your service to our government.

Ms. Romero, thank you for your hard work taking over as acting head of SIGTARP—as acting SIGTARP, I should say. And in connection with that, your January report, quarterly report, in the context of the Financial Stability Oversight Council, you cite a quote from Secretary Geithner in which he says, "You don't know what is systemic and what is not until you know the nature of the shock."

And when you talk about systemic risk for non-bank financial institutions, do you think the FSOC will be able to determine properly, identify these firms that are systemically important before the fact?

Ms. ROMERO. I think, now, one of the issues that we saw—that interview with Secretary Geithner was in connection with our audit of the bailout of Citigroup—was that the determination that Citigroup was systemically significant was really an ad-hoc decision, and it was really one based on some gut instinct and fear of the unknown.

What they need to do now, what FSOC needs to do now is set up some objective criteria. They have set out general criteria—interconnectedness and size and liquidity. But they do need to set

some objective criteria. We understand that there may be, in some cases, some need for some subjectivity for different industries, for example. But they have to set not only objective criteria but a framework in applying that criteria. Because now, when someone says, "The criteria is size and interconnectedness," no one knows what that means. And that is what FSOC is working toward, and that is what they need do.

Mr. MCHENRY. And that has been in your quarterly recommendations, right?

Ms. ROMERO. It has been part of our audit. It is part of our work on the Council of IGs, CIGFO, that has oversight over FSOC.

Mr. MCHENRY. Okay. And in connection with the Citi report as well, you cite in that report, "After the deal was announced, the impacts on the market's perception of Citi was immediate. Its stock price stabilized"—you mentioned this in your testimony—"Its stock price stabilized, its access to credit improved, and the cost of insuring its debt declined."

So you think that designating firms as "systemically important" will result in similar market perceptions and actions?

Ms. ROMERO. I think that remains to be seen. Right now, no one knows what it means—what is going to happen if there is the designation. And so I think the markets are watching for that. I think, right now, until there are some statements made as to what it means to be systemically significant and the enhanced supervision and if there is simplification that comes from that, the markets are going to watch that.

Until the markets are convinced that what that means doesn't include a future government bailout, all the competitive advantages that normally are associated with "too big to fail" are going to continue to persist and market discipline is going to be reduced.

Mr. MCHENRY. Thank you.

Mr. Krimminger, in terms of the S&P's announcement that they are going to make permanent the prospect of government support in their ratings of these eight largest firms, and they have received basically a ratings uplift with the notion that there would be a Federal backstop to these largest institutions, do you think that is a fair assessment?

Mr. KRIMMINGER. I think that, as I had mentioned earlier in my testimony, the uplift that these firms have gotten has been in existence long before the crisis and long before Dodd-Frank. Actually, just before the crisis, they began to be a little more—the rating agencies, that is—began to be a little more explicit about the basis for the uplift.

My discussions with the rating agencies indicated that the reason for the uplift continuing is that they are looking at the residual effects of the prior assistance that was provided as well as, as they put it, the unpredictability of what a future law could be. They agree with me, however, when I have asked them the question pointedly, that the current law does not allow for the bailouts done in 2008.

And I would just note in closing that Moody's has put these institutions—or put the uplift under review for a downgrade based upon their view that the statute says that there is not going to be a bailout, so they should probably at least reduce it, if not eliminate it.

Mr. MCHENRY. Moody's actually says in their report that it is "unlikely to withdraw all government support from the ratings of these eight banking groups." So they even cite it in their January-of-this-year report.

Ms. Romero, in your testimony, you say, "Cheaper credit is effectively a subsidy, which translates into greater profits, giving the largest financial institutions an unearned advantage over their small competitors."

What are your thoughts on this development?

Ms. ROMERO. I think it still continues to exist. I think the market still perceives these institutions as "too big to fail." They are bigger than they were pre-crisis. There is now concentration in the industry. So that is what has to be reversed that has not been reversed yet.

It is possible that if the regulators take action, that could be reversed. But understand what I am saying. I am talking about dramatic action that takes some significant courage on the part of the regulators to try to protect the greater financial system from one or two or others of these systemically significant institutions from suffering a material distress.

Mr. MCHENRY. Thank you.

Chairwoman CAPITO. Thank you.

Our first panel is concluded and dismissed. I would like to thank both of the witnesses. I think we have had a very good discussion.

At this time, I would like to call up our second panel of witnesses. And I will introduce them individually once they get seated.

I would now like to begin the second panel.

I would like to thank our witnesses for being here today and for your patience with sitting through the first panel. I appreciate that.

I will introduce you first for the purpose of giving a 5-minute opening statement.

First, Mr. Stephen J. Lubben, Daniel J. Moore Professor of Law, Seton Hall University School of Law.

Welcome, Mr. Lubben.

STATEMENT OF STEPHEN J. LUBBEN, DANIEL J. MOORE PROFESSOR OF LAW, SETON HALL UNIVERSITY SCHOOL OF LAW

Mr. LUBBEN. Thank you for having me, Madam Chairwoman.

I thought that, rather than rehashing what I have written in my prepared statement, I might just focus in on three particular issues that I wanted to highlight.

First of all, especially since I am a bankruptcy person, I think there is a tendency to focus on the Orderly Liquidation Authority in isolation. And so, right up front, I want to make the important point that I think there is a strong connection between Title I and Title II of Dodd-Frank and, for that matter, between Title II and all the preexisting regulations, like prompt corrective action, so that, to some degree, what happens with regard to the Orderly Liquidation Authority in Title II is going to be driven by what happens beforehand in Title I and by those regulations, how those regulations are applied—for example, whether there are adequate capital charges put in place for "too-big-to-fail" financial institutions.

The second point I was going to make is just to lay out my cards on the table as to why I don't think a pure bankruptcy system will work, despite some of the comments this morning. And so, in this regard, I may be somewhat on the same page as Professor Barr.

First of all, speed and liquidity. As I say in my written testimony, I think that as fast as cases like Lehman and General Motors went, ideally, it would be even faster. So one good aspect of the Dodd-Frank Orderly Liquidation Authority is that the sale or the transfer can happen on the very first day of the case.

The other one is liquidity. You do not want the financial institution to collapse on the first day. Maybe some people do want it to collapse on the first day, but if you don't want the financial institution to entirely collapse on the first day, then you need some sort of liquidity to back that up. And the unfortunate reality is that probably in any financial crisis, it is going to be the government. So I think, rather than focusing on whether or not that liquidity exists, it is better to focus on how do we either make sure that the industry pays for it or that the government gets paid back when they do have to pay it out.

In connection with this point, I will just say, too, that I think we need to be very careful about drawing lessons from the Lehman Brothers bankruptcy case and what that tells us how about how Chapter 11 works with regard to large financial institutions. The Lehman Brothers bankruptcy case, as the FDIC is fond of noting, had no preplanning whatsoever, but that is not typical for most large Chapter 11 cases. So we have to be careful about that.

So if that is the case, then I get to my third point, and this is where I probably diverge here. One of the problems I see with the Orderly Liquidation Authority, it is the overriding question of, will it work?

And the reasons why I wonder about whether it will work is, first of all, there is uncertainty about when it applies. And this was referred to in some of the earlier questions today. It would have been a lot simpler, if we wanted to go down this road with Orderly Liquidation Authority, to say it applies to a set of financial institutions, period. Instead, we have this odd system where Chapter 11 applies unless the Treasury Secretary decides it doesn't apply, and then Orderly Liquidation Authority applies.

I am not sure that is a very workable thing. There is the scope of the Orderly Liquidation Authority. The analogy is often drawn to what the FDIC has done in the past with regard to bank resolution. The FDIC has full control over the entire bank. The FDIC will not have full control over a financial institution under the Orderly Liquidation Authority because it doesn't apply to the bank part, it doesn't apply to the insurance company part; it only partially applies to the broker dealer part.

And then there is the final question of transparency, which I think gets to a question of legitimacy. Certainly, in the financial community, the people that I have talked to, there is just some real concern about the FDIC's ability to resolve these complicated financial claims in a timely manner, and the way that they are going to do it, since they don't have any obligation to do so publicly.

And when we get to the question of ability, there is also the question of staffing, which I think was alluded to also in the first

panel today. Does the FDIC have the ability to staff the resolution of multiple large financial institutions simultaneously? I think there is some real skepticism on that point.

So, despite what the FDIC has occasionally said about me in the past, I am not a bankruptcy fanatic, but, rather, I think the Orderly Liquidation Authority could be improved from what it is.

[The prepared statement of Mr. Lubben can be found on page 82 of the appendix.]

Chairwoman CAPITO. Thank you.

Our next panelist is the Honorable Michael Barr, professor of law, University of Michigan Law School.

Welcome.

STATEMENT OF THE HONORABLE MICHAEL S. BARR, PROFESSOR OF LAW, UNIVERSITY OF MICHIGAN LAW SCHOOL

Mr. BARR. Thank you, Madam Chairwoman.

Over 2½ years ago, the United States and the global economy faced the worst economic crisis since the Great Depression. The crisis was rooted in years of unconstrained excess on Wall Street and prolonged complacency in Washington and in major financial capitals around the world.

One year ago, President Obama signed the Dodd-Frank Act, which tackles the key problems that led to the crisis and will help to end the perception of "too big to fail." The Act provides for supervision of major firms based on what they do rather than their corporate form. Shadow banking is brought into the daylight. The largest firms will be required to build up their capital and liquidity buffers, constrain their relative size, and restrict their riskiest activities.

The Act comprehensively regulates derivatives with new rules for exchange trading, central clearing transparency, and margin. The Act creates a new Consumer Financial Protection Bureau. And the Act creates an essential mechanism for the government to liquidate failing financial firms without putting the taxpayers or the economy at risk.

With respect to resolution, before Dodd-Frank, the government did not have the authority to unwind large financial firms that failed, such as Bear, Lehman, and AIG, without disrupting the broader financial system. When the financial crisis hit, that left the government with the untenable choice between taxpayer-funded bailouts and financial collapse.

Today, major financial firms will be subject to heightened prudential standards, including higher capital and liquidity requirements, stress tests, and living wills. These standards will force firms to internalize the costs that they impose on the system and will give them incentives to reduce their size, complexity, leverage, and interconnections. Should such a firm fail, there will be a bigger capital buffer to absorb losses. These measures will help to reduce the risk that any firm's failure will pose a danger to the stability of the financial system.

But as Lehman's collapse showed quite starkly, there are times when existing tools were simply not adequate to deal with the insolvency of a large financial institution in times of severe stress. That is why the Act permits the FDIC, in limited circumstances,

to resolve the largest financial companies outside of bankruptcy, consistent with the approach long taken for bank failure.

This is the final step, in my view, in addressing the problem of moral hazard, to make sure that we have the capacity to unwind major financial firms in an orderly fashion that limits collateral damage to the system.

Under the Orderly Liquidation Authority, the FDIC is provided with the tools to wind down a major financial firm at the brink of failure. Shareholders and other providers of regulatory capital to the firm will be forced to absorb losses, and culpable management will be terminated. Critical assets and liabilities of the firm can be transferred to a bridge institution, while any remainder is left in the receivership estate. Any required funding for the FDIC to provide liquidity can be obtained through Treasury borrowing that is automatically repaid from the assets of the failed firm or, if necessary, from other ex-post assessments on the largest financial firms. Taxpayers are not on the hook. The resolution authority allows the FDIC to wind down a firm without putting the financial sector and the economy as a whole at risk.

The objectives of resolution differ from those of the Bankruptcy Code. The purpose of the Bankruptcy Code is to reorganize or liquidate a failing firm for the benefit of its creditors. The resolution authority is structured to manage the failure of a financial firm in a manner that protects taxpayers and the broader economy. This purpose is explicitly different from the Bankruptcy Code, and that is why the Act is narrowly tailored to situations in which there are exceptional threats to financial stability.

In the future, major financial institutions would have prepared a living will embodying a liquidation strategy and would have been subject to comprehensive supervision. Such firms would have larger capital buffers and stringent conditions imposed on them.

But we need to have some humility about the future and the ability to predict any financial crisis. In a severe crisis, if one or more financial firms fail and prudential measures are insufficient, a receivership should be available.

This has three key advantages over the past: first, the FDIC could swiftly replace the board and senior management; second, a temporary stay of counterparty termination and netting rights, during which the FDIC could transfer qualified financial contracts to a third party or a bridge institution; and, third, the ability to set up a bridge firm with financing from the FDIC to fund necessary liquidity.

In my view, the Dodd-Frank Act puts in place the key reforms that were necessary to end the perception of "too big to fail" and to establish a firm foundation for financial stability and economic growth in the decades ahead.

Thank you.

[The prepared statement of Mr. Barr can be found on page 54 of the appendix.]

Chairwoman CAPITO. Thank you.

I would like to begin the questioning.

Mr. Barr, in your 5-minute statement there, you made two—and you might have made others that I missed—but you talked about Dodd-Frank being able to constrain—would work to constrain the

relative size of the institutions and that through further Dodd-Frank regulations, there would be incentives to reduce size. We just heard—and I think we know this to be true—that the bigger institutions are actually bigger than they were several years ago.

How is that working? We have had Dodd-Frank for almost a year, and, obviously, neither one of these constraints of relative size or incentive to reduce size—how is that going to change here in the next year or 2 years, in your mind?

Mr. BARR. Madam Chairwoman, the increase in size of these institutions occurred during the financial crisis, prior to the passage of the Dodd-Frank Act. What we have seen since the passage of the Dodd-Frank Act and the implementation of the BASEL III capital rules is that those firms are building bigger capital buffers and, at least in several instances, reducing balance sheets, shedding off riskier sets of activities. And I think we are going to continue to see that—

Chairwoman CAPITO. So, would I take that to mean that that is constraining their size, if they are shedding their balance sheet? Is that the main thing, in your mind?

Mr. BARR. Madam Chairwoman, the phrase that I used in my testimony and that I believe is the case is that the Dodd-Frank Act will constrain their relative size—that is, as a share of the financial sector as a whole. So, in particular, I was referring in my remarks and in my longer testimony to the provision in the Dodd-Frank Act that limits the liabilities of any one large financial firm to no more than 10 percent of the liabilities of the financial system. If they reach that level, then they are constrained in their ability to acquire or merge with other financial firms. They can continue organic growth. That is a relative constraint on relative size.

I also believe that the implementation of the BASEL III capital rules, the Collins amendment, the FDIC's new assessment system, will all have the effect of providing a kind of tax on firms as they continue to grow, particularly on the short-funded liability side of the system. So what you will see over time—and this will take time—is a relative constraint on the growth of any one firm as a share of the overall financial system.

Chairwoman CAPITO. But a relative growth of one firm—and then when you look at the SIFIs in whole, that continues to grow and have a larger share, market share, in the country.

We have heard a lot about regulations for our community banks. The gentleman from Georgia talked about the failures of banks in his home State, and that is a concern. I would like to ask Mr. Lubben if he would like to comment on that point. Because, in my mind, "too big to fail" is a lot of things, but "too big to fail" is getting so big that you can't fail—that you can't be permitted to fail.

Mr. Lubben?

Mr. LUBBEN. It seems to me that Dodd-Frank really has only an indirect effect on this issue. It has an indirect effect in the sense that it—and this is somewhat what Michael was speaking about—that it puts a kind of tax on the bigger financial institutions, so that to the extent that smaller institutions are more nimble and more competitive, they may eventually take market share away from the bigger financial institutions. But that strikes me as a kind of a glacial way of going about solving that problem.

On the other hand, I do have my doubts about whether anybody has the political fortitude to try to tackle the issue of financial institutions being too big head-on.

Chairwoman CAPITO. And the SIGTARP, when she was here at the first panel, she kept going back to that, in terms of a way to assure that the bigness is not part of the problem. She talked about the systemic—did you want to make another comment?

Mr. BARR. Just to that point, if I might. I don't think that it is purely a question of the size of the institution. You also want to know, what is the size of the capital buffer, what are the other protections built into the system?

We have very large institutions in the United States. They are a fraction of the size of our GDP of our economy. They are, in comparison, quite small, say, with respect to U.K. or Swiss firms, which are many multiples of their economy.

I think what we want in our system is exactly what you said, which is a diversity of kinds of financial institutions. We need to have a system that is strongly supportive of community banks and credit unions and thrifts around the country. I think that is one of the great strengths of the American system that we need to preserve and protect.

Chairwoman CAPITO. Mr. Lubben, really quickly, do you think it is plausible under the current law that the government will refrain from bailouts in times of severe financial crisis?

Mr. LUBBEN. It depends. The phrase "bailout" is subject to multiple interpretations, so it depends what precisely you mean by that.

I think the government will refrain from bailing out the failed financial institution itself. What the Orderly Liquidation Authority does allow them to do, though, is bail out the counterparties to that financial institution, so not unlike the treatment that Goldman got with regard to AIG.

And in the sense that the financial institution that fails, I think as was—the point that was made repeatedly this morning was right—that financial institution has to fail and under the law. What the Orderly Liquidation Authority does allow, though, is the funding of the counterparties to that financial institution. So, in some sense, that is a bailout, a bailout of the counterparties of the failed financial institution.

So that is a long way of saying "no."

Chairwoman CAPITO. All right, thank you.

Ms. Maloney for 5 minutes.

Mrs. MALONEY. I want to thank both of the panelists for coming. And thank you, Professor Barr, for coming all the way from the University of Michigan.

A great deal of the debate today on both sides was about the modified bankruptcy versus the Dodd-Frank resolution authority. And I want to point out that during the debate and work on Dodd-Frank, at no time did my colleagues in the Republican Party propose regulatory reforms to prevent a company from endangering the system by becoming "too big to fail."

And, specifically, many people have argued today that the Republicans would say that alternative uses of a variant reorganization bankruptcy would have allowed the company to survive, in-

stead of mandating its liquidation. Could you go into greater detail?

I will note that we had the bankruptcy authority during the crisis. Lehman is still in bankruptcy; it hasn't been resolved. And in the bankruptcy proceeding, there is no provision that you don't use taxpayers' money to help them out.

Could you—you were here during the hearing, and you saw the arguments back and forth. And I wish that you would go forward with why the proposal that is in Dodd-Frank is superior to bankruptcy in terms of the overall economy and safety and soundness and the taxpayer.

Mr. BARR. Thank you, Representative Maloney. I would be happy to start.

There are a number of key changes that are put in place in the Dodd-Frank Act that will make the financial system more resilient in the future: higher capital requirements, particularly for the largest, most complex firms; higher capital requirements at the holding company level—holding companies before were largely ignored and now they are a central feature of higher standards in the system; greater limits on interconnectedness among firms; limits on loans to one borrower; limit on inter-financial-institution credit exposure; limits on the riskiest activities of firms related to proprietary trading and hedge fund investment; limits on the ability of financial institutions to use loopholes in the law to evade regulatory requirements; the moving of a savings-and-loan holding company into the same structure as a bank holding company and their supervision at the holding-company level by the Federal Reserve; increased assessments based on total liability in the system for the largest firms by the FDIC; a much greater move to consolidated, uniform supervision standards; annual and transparent stress tests of all the major institutions so there is a horizontal review of the safety and soundness of those institutions; a requirement of living wills for those institutions that have the ability and the requirement to simplify their organizational structure and better align them. That is all before you get to the question of resolving a firm. Those are all measures designed to make the financial system more resilient.

With respect to resolution, the Dodd-Frank Act made several key changes. It eliminated the ability of the Federal Reserve under 13(3) to provide assistance to an individual failing institution. It removed the prior authority of the FDIC to issue a similar approach in the form of open bank assistance to a failing firm. And it provided the liquidation authority that has been the central topic of discussion today that provides that the firm that is failing will be put out of its misery, or our misery; culpable management will be fired; and shareholders and regulatory capital will be wiped out.

And then there is a provision in there that permits the FDIC to continue the firm in a bridge firm or to sell it using a liquidity provision that I think all four of your speakers this morning believed is an essential element of any system that is designed to preserve financial stability at a time of great economic stress.

Mrs. MALONEY. Could you comment on bankruptcy and the alternative? They keep saying bankruptcy would work. Obviously, it didn't work; we are still mired in Lehman. But could you specifi-

cally address the bankruptcy alternative as not being appropriate going forward?

Mr. BARR. I think that the entire package of reforms that Dodd-Frank put forward are essential for ending the problem of "too big to fail." I don't think that tweaking the bankruptcy system alone would resolve the problem.

If you had decided—if the Congress decided, instead of providing special resolution, to go through the bankruptcy route, I believe that Congress would have found itself recreating the entire regulatory structure and calling it bankruptcy.

I think the essential elements include supervision, capital requirements, the ability to intervene before a firm fails, the ability to have a stay of netting rights under the contract, the ability to fire culpable management, and the ability to fund through liquidity in that crisis period. So that whole package of reforms was essential.

I think the bankruptcy process, unfortunately, has a different set of purposes, and it achieves those purposes, I think, reasonably well. But they are not the same purposes that the Congress is trying to achieve in making the financial system more resilient.

Mrs. MALONEY. Yes, and preventing. Thank you so much.

My time has expired.

Chairwoman CAPITO. Thank you.

Mr. Renacci for 5 minutes.

Mr. RENACCI. Thank you, Madam Chairwoman.

And thank you, gentlemen, for being here.

I think we would agree today that the Orderly Liquidation Authority is better than bankruptcy because bankruptcy doesn't have some of the things that are available to the Orderly Liquidation Authority. So the question would be, if we were able to change the Bankruptcy Code so that some of the attributes of the Orderly Liquidation Authority were there, would it not be better?

Let me tell you why I am saying that. I have actually sat in the chair and had to take seven companies—I was hired—seven companies through the bankruptcy system. So I see it as a good way. It protects creditors, it protects assets. The only difference, from what I see, is that it doesn't have—and, Mr. Lubben, you said this earlier—the ability for speed and liquidity.

So if we were able to change the Bankruptcy Code to ensure speed and offer liquidity, tell me why you don't believe the bankruptcy system would not offer the same opportunities as the Orderly Liquidation Authority. And it would take government out of liquidation and put the courts system into the liquidation process.

Mr. Lubben first, and then Mr. Barr.

Mr. LUBBEN. I do think that if you modified the Bankruptcy Code you could achieve, probably, a better solution than either pure bankruptcy or the Orderly Liquidation Authority. I think, to be clear, it would create a new kind of system that would be neither bankruptcy nor bank resolution; it would be some sort of hybrid of the two. But I think that is doable and, in some ways, might be preferable.

Speed, liquidity—I would add the additional criteria that you would want to have the regulators have the ability to commence a case, not just the company itself. I think, given those conditions

and echoing what was said about the needs to also address the safe harbors—but I know that is not necessarily this committee's jurisdiction—if you can do all those things, then I think you can get to the same place. And I think it would probably be preferable because it would, I think in many respects, be more transparent and more legitimate to a lot of people in the market.

Mr. RENACCI. Mr. Barr?

Mr. BARR. I think that you could make changes to bankruptcy law that would make it more effective than it currently is. I agree with some of the suggestions that Professor Lubben made.

I still think it would be an inferior solution to the one that Congress has already enacted. Because what Congress has enacted is an overarching system of supervision, capital requirements, and resolution authority that work together as a whole to improve the resiliency of the financial system. You have the ability of regulators to intervene, to supervise the institution, to increase capital requirements, to increase liquidity requirements, and to intervene on an early basis if a firm gets into financial trouble, so that the resolution aspect of Dodd-Frank is at the tail end of a supervisory process.

And I would suggest that is the more useful frame to think about resolution in than as a separate matter akin to bankruptcy.

Mr. RENACCI. But, again, you would have government intervention versus court intervention on both sides. And I am trying to keep the government out of this, by the way, as much as possible, although I know we need regulations and we need supervision. And I think if the regulators would have stepped up in 2008, maybe some things would not have occurred.

So the question is, what is better?

Mr. BARR. I would agree with you that the key is having supervisors supervise and regulate and impose capital requirements and be involved. There is no way around that.

I think what we had in the lead-up to the financial crisis in 2008 was a failure of supervision, regulation, and legal structure that was corrected in the Dodd-Frank Act and needs now to be implemented to be effective. And I think that is really where our energies ought to focus in the coming years.

Mr. RENACCI. One other quick question. Living wills, I know we talk about this as an advance opportunity. As a CPA and a business owner, putting living wills out there and having—I am not too sure how long they would last, because a living will could actually have to be updated daily, if not weekly, depending on what the entity was going into.

So we are all running on a premise that the living will could be the answer. But would both of you comment and tell me whether you would agree or disagree that a living will, if not changed on a weekly basis sometimes, would not really be capable of handling the track of which direction these companies have gone.

Mr. BARR. I will start, and then others can join in.

I agree that a living will is not a silver bullet, to mix our metaphors. It is not the sole answer to how the system needs to work in the future. I think it is an additional useful tool in the supervisory process and will facilitate early resolution.

I also agree with you that, to be effective, living wills have to be updated almost on a continuous basis. That is, a living will is a document that helps the firm track its business risk against its legal organizational structure. It is going to need to be updated and should be updated, I think, on a continuous basis.

Mr. LUBBEN. Just to chime in on that, I am deeply skeptical of the living wills. I think they have some potential, but you are right, they have to be updated almost continuously. And I think you also have to expect that both regulators and boards will have much more foresight than they did in the past to be able to see the problems before they develop.

And as somebody who also has experience in the bankruptcy area, I know that boards of distressed companies routinely suffer from what we refer to as "terminal optimism." And, it is hard for me to get to the point where I will trust that that system is going to work as designed. Theoretically, it sounds nice, but I am skeptical.

Mr. RENACCI. Thank you.

Chairwoman CAPITO. Thank you. The gentleman's time has expired.

Mr. Canseco?

Mr. CANSECO. Thank you, Madam Chairwoman.

Let me ask a very brief question with regards to Title II, section 210, sections (a)(9)(D), limitation on judicial review. This provision severely limits creditors' right to appeal any decisions. And I don't want to quote from it because it will take too much of our time.

But doesn't that, in fact, impose an additional burden on our economy, if creditors have no right of appeal from any decisions of—

Mr. BARR. If I might begin with an answer, that provision is the same kind of provision that has long existed in the bank failure law. And it is interpreted by the FDIC and by the courts to permit claimants to bring, not an appeal of an administrative ruling, but an actual de novo case in district court to adjudicate their claims. So they have full right to say that the claim that has been disallowed should, in fact, have been permitted.

Mr. CANSECO. It says in subsection (i), "Any claim or action for payment from, or any action seeking a determination of rights with respect to, the assets of the covered financial company for which the Corporation has been appointed receiver, including any assets which the Corporation may acquire from itself as such receiver."

So it cannot go out there to Federal court and even bring it up de novo, because they will throw subsection (d) in their face.

Mr. BARR. Again, I am happy to discuss this with your staff and counsel for the committee at any time, but that provision has been interpreted by both the FDIC and the courts to permit de novo review of claims. And that would be the same under this procedure. And, in addition, there are other judicial protections, as you know, built into the Act.

Mr. CANSECO. Okay. Thank you.

Recently, economists at the Richmond Federal Reserve published a paper estimating how large the Federal safety net for the financial sector has become. A study earlier this decade shows that, in 2002, approximately 45 percent of liabilities in the financial sector

had some kind of government backing. The recent paper completed by the Fed from Richmond showed that, by the end of 2009, nearly 60 percent of financial sector liabilities had either an explicit or implicit government backing. This includes everything from FDIC-insured deposits to pension guarantees to the debt of Fannie Mae and Freddie Mac.

So we are at a point today where nearly two-thirds of all the liabilities in our financial sector are guaranteed by the government, and most of these liabilities are concentrated in the largest financial institutions.

I would be interested to hear your thoughts on how this contributes to moral hazard, but also how it threatens to perpetuate "too big to fail," given that large institutions are benefitting the most from these guarantees.

Mr. BARR. I would agree with the idea that the government needs to reduce its exposure in the financial sector. I think the Dodd-Frank Act makes it much easier for the government to do that.

The kinds of expansions that occurred during the financial crisis were extraordinary actions that the Congress, the FDIC, the Federal Reserve, and two different Treasury Secretaries felt were essential to preserve financial stability. But they ought to have been on a temporary basis, and they ought now to be wound down.

Mr. CANSECO. Mr. Lubben, do you want to comment?

Mr. LUBBEN. In part, again, this goes back to the question of the size of some of the "too-big-to-fail" institutions and what we want to do and what we have the political will to do, regulatorily speaking, with regard to those institutions. They are what they are, and I think we have to face up to that reality.

Mr. CANSECO. Thank you. My time has expired, and I yield back.

Mrs. MALONEY. May I clarify?

Chairwoman CAPITO. The gentlelady, yes, from New York.

Mrs. MALONEY. I am looking at the Public Law. And the limitation on judicial review, when you read the item, "Any claim or action for payment from, or any action seeking a determination." Before, it said, "except as otherwise provided in the Title," and it clearly provides in the Title "de novo review." And we can get you that paperwork.

Thank you.

Chairwoman CAPITO. Okay. Thank you.

Mr. Luetkemeyer for 5 minutes.

Mr. LUETKEMEYER. Thank you, Madam Chairwoman.

As we look at this Orderly Liquidation Authority, how effective do you think it is going to be, from the standpoint that a bank is a unique institution—it is a unique business entity from the standpoint that much of its business is transacted on the basis of confidence, the belief that if I loan you money, I am going to get it back; or if you invest money with me, you are going to get it back from me. And with the Orderly Liquidation Authority, we are sort of again believing that business is going to kind of go on, everybody is going to be okay.

And, Professor Lubben, you made the statement that the FDIC is even not in full control of the liquidation, because there is going to be a lot of it that is going to be outside their purview.

Would both of you like to comment on how it is going to, in reality, work? Is this really going to be able to be something we can actually do because of the uniqueness of a banking institution?

Mr. LUBBEN. Maybe I can start with that.

I have serious concerns about how an actual orderly liquidation case would go, particularly if you start to think about an institution like Citibank or Citigroup. Part of that will be an Orderly Liquidation Authority; part of it will not. Especially if you imagine, purely hypothetically, a time when they still own an insurance company, it becomes even more complicated.

I think the best I can say about Dodd-Frank in this regard is, we can hope that the Title I provisions prevent us from ever getting to that point in the first place. And so, in that sense, I think that Dodd-Frank does do something good.

But I think there are real concerns about how an Orderly Liquidation Authority case will run, what kind of litigation will spin out of such a case. Because I think, while I agree that there are rights to court review, they are kind of cumbersome and they may not really get us to a place that is really any better than we are with regard to Lehman Brothers today.

And there is this question of, does the FDIC have the staff and the capability to handle multiple resolutions simultaneously? Because, again, I don't think they are going to happen in isolation. I think they are going to come in bunches.

Mr. LUETKEMEYER. This was my concern a while ago, if you listened to my questions, that I think that, as they get bigger and bigger, they are all systemically linked together, therefore if one is in trouble, the whole outfit is in trouble and our whole system is in trouble. And now, while this sounds like a wonderful program to try and get this situation under control, I think that this bill has exacerbated our situation by allowing them to get bigger, and we don't have the kind of controls in place that we need to be able to hold these folks.

Mr. LUBBEN. Again, in part, that will depend on how the Title I provisions are implemented.

Mr. LUETKEMEYER. Right. Okay.

Professor Barr?

Mr. BARR. If I could, I think it is a good idea for all of us to have a great deal of humility about our ability to predict the future. And I think being skeptical about that is a good thing.

I think that the Act takes that as the right approach, in the sense that the Act, the Dodd-Frank Act, attempts to build in bigger buffers into the system, more resiliency into the system, higher levels of capital, greater liquidity requirements—

Mr. LUETKEMEYER. If I can interrupt just a second?

Mr. BARR. Yes, please.

Mr. LUETKEMEYER. My time is running out here.

And you made the comment a while ago, to follow up on your point right there with regards to the type of investment, the type of risk that you are taking on, you made the comment a while ago with regards to derivatives. It is a huge problem for a lot of these bigger institutions. A couple of them don't have a lot of involvement in it, but many of them do.

And the derivatives market—I was listening to somebody the other day, and they were telling me that the derivatives market now is 10 times the GDP of the world. That scares the heck out of me. It just boggles my mind. It scares me to death, because we have these institutions involved in this, and we have them all linked together, and here we go.

So where are we with Dodd-Frank with regards to sort of divesting ourselves or minimizing our risk along that line?

Mr. BARR. The Dodd-Frank Act, I think, fundamentally changes the basic system of oversight and regulation in the derivatives market. I think it is one of the essential reforms that the Dodd-Frank Act put in place.

Mr. LUETKEMEYER. We are not there yet, are we?

Mr. BARR. No. With respect to all the provisions of the Dodd-Frank Act, as is typical under any law, you need to implement it through rules. And the rule-writing is proceeding quickly, but it is not done.

Mr. LUETKEMEYER. Right. Okay.

One more quick question here is—I guess my concern is that, again, we go back to the foundation of where we are at with this, with the bigger guys getting more risky. Are you comfortable with this bill having solved the problem? Or do you think it is going to exacerbate it? Or do you think we are headed down the road with—or, should we do more, I guess is my question.

Mr. BARR. I think the bill and the changes that are being made to capital requirements are the right framework to proceed on. I think when those are fully done, when those are fully implemented, we will have a much more safe, resilient financial system in the future. Is it going to prevent every financial crisis in the future? No way.

Mr. LUETKEMEYER. Dr. Lubben, really quickly?

Mr. LUBBEN. I would agree with what was just said, but I would note that the focus is all on before-the-hand regulation. And you really do need to think about the what-if scenario of resolution, also, ahead of time. And I think that is the big unfinished aspect of Dodd-Frank. It strikes me that Orderly Liquidation Authority is kind of a job half-done. And I would hope it would be improved, but we will see.

Mr. LUETKEMEYER. Thank you very much.

Thank you, Madam Chairwoman.

Chairwoman CAPITO. Thank you.

Mr. Canseco, did you want to make a clarification?

Mr. CANSECO. Madam Chairwoman, if I may just ask a follow-up question.

Gentlemen, both of you seem to be law professors and very much knowledgeable of the Dodd-Frank Act. Where in the Act does this de novo review for creditors—where is it specified?

Mr. BARR. I apologize; I don't have my Act or section in front of me. Perhaps Professor Lubben can.

But I can assure you that the Act and the way that the provision that you read has been interpreted in the past by both the FDIC and the courts permits parties to proceed for their claims, for de novo review of their claims.

And as I indicated before, I would be happy to follow up with your staff and committee staff with the particular specifications.

Mr. CANSECO. But, Professor, this law isn't even a year old. And where has a court ruled on Dodd-Frank and on the issue of creditors?

Mr. BARR. I apologize. The provision I am talking about is the provision that is equivalent to the provision that has been interpreted by the courts and the FDIC in the past consistent with what I just said.

Mr. CANSECO. Thank you.

Mr. BARR. And I would be happy to follow up with you after.

Mrs. MALONEY. If the gentleman would yield, we have the exact section of the law right here. We can—

Mr. CANSECO. Would you cite it to me, please?

Mrs. MALONEY. Okay. It is on page 1466, Public Law 11203. And it is section 4, under (d).

Chairwoman CAPITO. I think we can take this discussion maybe—

Mr. CANSECO. All right.

Chairwoman CAPITO. —behind and let our witnesses go.

I would like to express my gratitude for your patience and for your intellect and for your ability to really answer some very in-depth questions. So I appreciate that.

The Chair notes that some members may have additional questions for this panel which they wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

At this point, I will close the hearing.

I would like to say just one final comment for myself. I think my big takeaway here: Best-laid plans, all good intentions to try to figure out how to avoid what happened. We are really not going to know unless we have to use this mechanism again. Let's hope we don't have to use this mechanism. I think that would be the best takeaway we could have today.

Thank you very much.

[Whereupon, at 12:50 p.m., the hearing was adjourned.]

A P P E N D I X

June 14, 2011

Ending Too Big to Fail
Testimony of Michael S. Barr
Professor of Law
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Brookings Institution & Center for American Progress[1]
before the
Subcommittee on Financial Institutions and Consumer Credit
Committee on Financial Services
United States House of Representatives
June 14, 2011

I. Introduction

Over two years ago, the United States and the global economy faced the worst economic crisis since the Great Depression. The crisis was rooted in years of unconstrained excess on Wall Street, and prolonged complacency in Washington and in major financial capitals around the world. The crisis made painfully clear what we should have always known--that finance cannot be left to regulate itself; that consumer markets permitted to profit on the basis of tricks and traps rather than to compete on the basis of price and quality will, ultimately, put us all at risk; that financial markets function best where there are clear rules, transparency and accountability; and that markets break down, sometimes catastrophically, where there are not.

For many years, a core strength of the U.S. financial system had been a regulatory structure that sought a careful balance between incentives for innovation and competition, on the one hand, and protections from abuse and excessive risk-taking, on the other. When that balance was properly struck, the U.S. financial system worked at its best. The American financial system often surpassed other major developed economies in innovation and productivity growth. It was generally good at directing investment towards the companies and industries where the returns would be the highest. Its regulatory checks and balances helped create a remarkably long period of relative economic stability which, in turn, gave rise to extraordinary national wealth. And it did so while providing investors and consumers with strong protections. It endured crises and recessions, including the costly bank and thrift failures of the late 1980s and early 1990s; these, however, did not threaten the foundations of the financial system.

Over time those great strengths were undermined. The careful mix of protections we created eventually eroded with the development of new products and markets for which those protections had not been designed. And our regulatory system found itself outgrown and outmaneuvered by the institutions and markets it was responsible for regulating and constraining.

In particular, the growth of the "shadow banking" system permitted financial institutions to engage in maturity transformation with too little transparency, capital, or oversight. The years leading up to the recent crisis saw the significant growth of large, short-funded, and substantially interconnected financial firms. Huge amounts of risk moved outside the more regulated parts of the banking system to where it was easier to increase leverage. Legal loopholes and regulatory gaps allowed large parts of the financial industry to operate without oversight, transparency, or

[1] Organizations provided for affiliation purposes only. Testimony is solely on my behalf.

restraint. Entities performing the same market functions as banks escaped meaningful regulation on the basis of their corporate form, and banks could move activities off balance sheet and outside the reach of more stringent regulation. Derivatives were traded in the shadows with insufficient capital to back the trades. "Repo" markets became riskier as collateral shifted from Treasuries to poorer quality asset-backed securities. The lack of transparency in securitization hid the growing wedge in incentives facing different players in the system and failed to require sufficient responsibility or risk retention from those who made loans, or packaged them into complex instruments to be sold to investors. Synthetic products multiplied risks in the securitization system. The financial sector, under the guise of innovation, piled ill-considered risk upon risk.

As the shadow banking system grew, our system failed to require real transparency, sufficient capital or meaningful oversight. Rapid growth in key markets hid misaligned incentives and underlying risk. Financial innovation often outpaced the capacity of managers, regulators and markets to understand new risks and adjust. Throughout our system we had increasingly inadequate capital buffers – as both market participants and regulators failed to account for new risks appropriately. Short-term rewards in new financial products and rapidly growing markets overwhelmed or blinded private sector gatekeepers, and swamped those parts of the system that were supposed to mitigate risk. Consumer and investor protections were weakened and households took on risks that they often did not fully understand and could ill-afford.

Rising home and other asset prices had helped to feed the financial system's rapid growth, and to hide declining underwriting standards and other underlying problems in the origination and securitization of mortgage loans. When home prices began to flatten, and then to decline, fault lines were revealed. The asset implosion in housing led to cascades throughout the financial system, and then to contagion from weaker firms to stronger ones. Failures in the shadow banking system fed failures in the more regulated parts of the banking system. And then, in the fall of 2008, credit markets froze. The over-reliance on short-term financing, opaque markets and excessive-risk taking that had been the source of significant profit on Wall Street and in financial capitals globally, fanned a panic that nearly collapsed the global financial system.

The major U.S. investment banks merged, failed, or sought a life-line from the Federal Reserve as newly converted bank holding companies. The federal government injected capital into major commercial banks shaken in the aftermath of the collapse of Lehman Brothers. The FDIC put in place guarantees across the entire banking system. The Federal Reserve pumped liquidity into the financial system to halt further economic collapse. A dangerous run on money market mutual funds was halted by guarantee and liquidity programs set up by Treasury and the Federal Reserve. Congress enacted a major stimulus plan to keep the economy from cratering.

Yet stabilizing the financial sector did not address the failures that led to the crisis. Further action was necessary to restore discipline to our financial markets, adequate protections to consumers and investors, and the market's long-term ability to generate economic growth for future generations of Americans. The test of whether a financial system works is whether it does a reasonable job of channeling savings to finance future innovation and growth. The test is whether it protects consumers and investors. And the test is also whether it can do so while supporting, not harming, the economy. In the lead up to 2008, our system failed that test.

II. Ending Too Big to Fail Through Enhanced Supervision, Higher Capital Levels, and Market Reforms

That is why comprehensive reform was essential. One year ago, President Obama signed into law the Dodd-Frank Act—the most sweeping reform of financial regulation since the New Deal. The Act provides for supervision of major firms based on what they do, rather than their corporate form. Shadow banking—through large, interconnected financial firms, OTC derivatives, "repo" funding markets, hedge funds, and securitization—is brought into the regulatory daylight. The largest financial firms will be required to build up their capital and liquidity buffers, constrain their relative size, and place restrictions on the riskiest financial activities. The Act comprehensively regulates derivatives markets with new rules for exchange trading, central clearing, transparency, anti-abuse provisions, and capital and margin requirements. The Act provides for data collection and transparency so that in no corner of the financial markets can risk build unnoticed. The Act creates an essential mechanism for the government to orderly liquidate failing financial firms without putting taxpayers at risk. The Act creates a new Consumer Financial Protection Bureau and provides for consumer and investor protections. In sum, the Act provides a strong foundation on which the U.S. must now carefully build a more stable and balanced regulatory system--a system that protects consumers and investors, that rewards innovation and that is able to adapt and evolve with changes in financial markets.

Before Dodd-Frank, if an entity were a bank, then it had tougher regulation, more stringent capital requirements, and more robust supervision. But if an entity were an investment bank engaged in the same activities, then it was able to abide by different rules. For example, when U.S. investment banks needed to find a "consolidated holding company regulator" in order to meet European Union standards for doing business in Europe, the Securities and Exchange Commission set up a "voluntary" Consolidated Supervised Entity program with little oversight. The SEC was not established as a prudential regulator, did not have clear regulatory oversight for investment bank holding companies, and had little experience and few trained examiners. Moreover, the leverage requirement that served as a backstop for capital requirements on banks was not applied to these investment banks. In effect, the system allowed large financial institutions to choose the regulator that would offer the least restrictive supervision.

The Federal Reserve did not have any authority to set and enforce capital requirements on the major institutions that operated businesses outside of bank holding companies. That meant it had no supervision over investment banks, diversified financial institutions like AIG or the nonbank financial companies competing with banks in the mortgage, consumer credit and business lending markets. The Office of Thrift Supervision viewed its role as supervising thrifts, not their holding companies (such as AIG). And regulators permitted banks and thrifts themselves to engage in risky mortgage lending, stepping in with guidance only when it was too late.

Today, Dodd-Frank has provided authority for clear, strong and consolidated supervision and regulation by the Federal Reserve of any financial firm--regardless of legal form--whose failure could pose a threat to financial stability. We will have a single point of accountability for tougher and more consistent supervision of the largest and most interconnected financial firms.

All bank holding companies will be supervised by the Fed, and the largest ones will be subject to heightened standards. The Office of Thrift Supervision has been abolished, and all Savings & Loan Holding Companies will be supervised by the Fed. Non-bank financial institutions designated by the Financial Stability Oversight Council will also be Fed-supervised. The voluntary investment bank holding company regime has ended.

Dodd-Frank provides for more stringent prudential standards for these major bank and nonbank firms. The Fed is charged with putting in place stronger requirements for capital and liquidity. Annual stress tests will be conducted on these firms. There are enhanced rules on affiliate transactions, lending limits, and counterparty credit exposures. The Fed is required to use macro-prudential supervision, which takes into account not only the risks within the institution, but the risks that the institution poses to the financial system as a whole. Major firms will be subject to a concentration limit that generally prohibits a financial company from engaging in mergers or acquisitions that would result in the firm's liabilities—including wholesale funding and off-balance sheet exposures—exceeding 10 percent of the liabilities of financial companies as a whole. These enhanced prudential measures for major financial firms are likely to reduce risk in the financial system and reduce any "too big to fail" distortions.

Before Dodd-Frank, no regulator or supervisor had the legal authority or responsibility to look across the full sweep of the financial system and take action when there was a threat. Our financial markets have suffered for the lack of an effective system for monitoring and responding to systemic risks or threats to financial stability as they arise. Today the Financial Stability Oversight Council (FSOC) is accountable to identify threats to financial stability and to address them. The FSOC will have access to information across the financial services marketplace. A new Office of Financial Research is empowered to collect data from any financial firm, and to develop and enforce standardization for data collection.

Before Dodd-Frank, the OTC derivatives market--with a notional amount of $700 trillion at its peak--grew up in the shadows, with little oversight. Enormous risks built up in these markets – without effective constraints or any robust monitoring by regulators. Credit derivatives, which were supposed to diffuse risk, instead concentrated it. Synthetic securitization with embedded derivatives magnified failures in the real securitization market. Major financial firms used derivatives to increase their credit exposure to each other, rather than decrease it. We should never again face a situation – such as AIG's $2 trillion derivatives portfolio – where the potential failure of a virtually unregulated, capital deficient major player in the derivatives market can impose devastating risks on the entire system. The opacity of this market meant that the government and market participants did not have enough information about the location of risk exposures in the system or the extent of the mutual interconnections among large firms. So, when the crisis began, regulators, financial firms, and investors had an insufficient understanding of the degree to which trouble at one firm spelled trouble for another. This lack of information magnified contagion as the crisis intensified, causing a damaging wave of margin increases, deleveraging, and credit market breakdowns. Lack of transparency, insufficient supervision, and inadequate capital left our financial system vulnerable to concentrations of risk, and to abuse.

Today, regulators are putting in place the tools to comprehensively regulate the OTC derivatives market for the first time. The Act provides for regulation and transparency for transactions in

this market. It provides for strong prudential, capital, and business conduct regulation of all dealers and other major participants in the derivatives markets. And it provides for regulatory and enforcement tools to go after manipulation, fraud, and other abuses in these markets.

The Act requires all standardized derivatives to be centrally cleared, which will substantially reduce the build-up of bilateral counterparty credit risk between major financial firms. Central clearing parties would be subject to strong prudential supervision. Such derivatives would be traded on exchanges or alternative swap execution facilities, which would improve pre- and post-trade price transparency. Exchange trading will help to improve price competition as well as to improve safety and soundness in the derivatives system, as market participants and regulators will have full access to current prices in the event of system disruptions. Even non-centrally cleared OTC derivatives would be reported to a trade repository, making the market far more transparent. The Act provides for prudential regulation of all OTC dealers and all other major players in the OTC markets, so that adequate capital, business conduct rules, and prudential supervision will apply to all market participants. The Act provides for robust capital and initial margin requirements for derivative transactions that are not centrally cleared, providing a strong incentive to use central clearing and a bigger buffer should problems arise in the OTC markets.

At the same time as the Act reforms derivatives markets, it provides a new framework for regulation of financial market utilities and critical payment, clearing, and settlement activities, including not only those in the derivatives markets but also the wholesale funding "repo" markets that are critical to the shadow banking system. In the lead up to the financial crisis, major financial firms became increasingly funded not by traditional bank deposits, or even longer-term funding in the commercial markets, but rather by overnight funding in the repo markets. And these markets became increasingly concentrated in only two major clearing banks. As the market became more concentrated, it also became riskier because counterparties came to accept not only Treasury securities as collateral, but also highly rated asset-backed securities. And these securities, in turn, became riskier, as credit rating agencies became increasingly willing to label as safe assets that were lower quality—including pools of securities backed only by poorly underwritten subprime and Alt-A mortgages. When the financial crisis hit, the repo markets froze, causing a massive contraction in available credit.

The Dodd-Frank Act fundamentally reforms the wholesale funding markets by providing strong authority for the Federal Reserve to regulate financial market utilities and critical payment, clearing, and settlement activities; to set new rules for capital, collateral and margin requirements; and to establish uniform prudential standards across the market. These reforms are coupled with basic changes to liquidity requirements for major financial firms under the Basel III rules, liquidity concentration limits under the Act, and reforms to the deposit insurance system that will encompass all depository liabilities. These reforms will have the effect of taxing short-term liabilities and forcing firms to internalize more of the costs of this funding system. At the same time, SEC changes to regulations of money market mutual funds under Rule 2a-7 will mean that such funds have stronger liquidity positions.

The Act also fundamentally transforms regulation of the last major element of the shadow banking system—securitization. The Act requires deep transparency into the structure of securitizations, including information about the assets and originators. Securitization sponsors

must generally retain risk in the securitizations they sponsor, so that incentives are better aligned among participants in the system. Capital rules will better account for actual risk. Parallel changes in accounting rules will now bring the most common forms of securitizations onto the balance sheet. Credit rating agencies will be subject to comprehensive oversight by the SEC, including policing of ratings shopping and conflicts of interest; ratings themselves will be more transparent—including key information on rating methodology, compliance with methodology, underlying qualitative and quantitative data, due diligence, and other protections.

Before Dodd-Frank, consumer protection regulation was fragmented over seven federal regulators, most of which chose to focus their energies in areas other than protecting consumers. Regulators lacked mission focus, market-wide coverage, and consolidated authority. Nonbanks could avoid federal supervision. Banks could choose the least restrictive consumer approach among several different banking agencies. Federal regulators preempted state consumer protections laws without adequately replacing these important safeguards. Fragmentation of rule writing, supervision and enforcement led to finger-pointing in place of effective action.

Today, the Consumer Financial Protection Bureau has market-wide coverage. The Bureau will focus on more effective regulation and supervision. The CFPB will set high and uniform standards across the market. It will focus on improving financial literacy for all Americans. And it will help to end profits based on misleading sales pitches and hidden traps; rather, banks and nonbanks can compete vigorously for consumers on the basis of price and quality.

III. Ending Too Big to Fail Through the Orderly Liquidation Authority

Before Dodd-Frank, the government did not have the authority to unwind large, highly leveraged, and substantially interconnected financial firms that failed – such as Bear Stearns, Lehman Brothers, and AIG – without disrupting the broader financial system. Firms benefited from the perception that they were "too-big-to-fail"-- a presumption that they would receive government assistance in the event of failure. Such a presumption reduced market discipline and encouraged excessive risk-taking by firms. It provided an artificial incentive for large firms to grow even larger. It created an unlevel playing field with smaller firms. And when the financial crisis hit, it left the government with the untenable choice between taxpayer-funded bailouts and financial collapse.

Today, major financial firms will now be subject to heightened prudential standards, including higher capital and liquidity requirements, stress tests, and "living wills." Major financial firms will be required by these standards to internalize the costs that they impose on the system, which will give them incentives to shrink and reduce their complexity, leverage, and interconnections. And should such a firm fail, there will be a bigger capital buffer to absorb losses.

These measures will help to reduce risks in and among the largest financial institutions. In the event that such an institution fails, these actions will minimize the risk that any individual firm's failure will pose a danger to the stability of the financial system. Thus, bankruptcy proceedings will remain the dominant option for handling the failure of a non-bank financial institution.

The crisis, however, showed that the U.S. government simply did not have the tools to respond effectively when the failure of one or more major financial institution threatened financial stability. As Lehman's collapse showed quite starkly, there are times when the existing options under the Bankruptcy Code are simply not adequate to deal with the insolvency of large, complex and interconnected financial institutions in times of severe crisis.

That is why the Dodd-Frank Act permits the government, in limited circumstances, to resolve the largest and most interconnected financial companies outside of the traditional bankruptcy regime and consistent with the approach long taken for bank failures. This is the final step in addressing the problem of moral hazard. To make sure that we have the capacity – as we do now for banks and thrifts – to break apart or unwind major non-bank financial firms in an orderly fashion that limits collateral damage to the system. Under the orderly liquidation authority, the FDIC is provided with the tools to wind down a major financial firm on the brink of failure. Shareholders and other providers of regulatory capital to the firm will be forced to absorb any losses. Management of the firm culpable for its losses will be terminated. Critical assets and liabilities of the firm can be transferred to a bridge institution, while any remainder is left in the receivership estate. Any required funding for liquidity can be obtained through Treasury borrowing that is automatically repaid from the assets of the failed firm, or, if necessary, from an ex post assessment on the largest financial firms. In that manner, the resolution authority allows the government to impose losses on shareholders and creditors without exposing the system to a sudden, disorderly failure that puts the financial sector as a whole at risk.

The objectives of the resolution regime differ from those of the Bankruptcy Code. The purpose of the Bankruptcy Code is to reorganize or liquidate a failing firm "for the benefit of its creditors". The resolution authority is structured to manage the failure of a financial firm in a manner that protects taxpayers and the broader economy and promotes stability in the financial system. This purpose is explicitly different than the purposes of the Bankruptcy Code, but that is why the Act is narrowly tailored to situations in which there are exceptional threats to financial stability.

The Dodd-Frank approach is modeled on the long standing regime for bank failure. There are significant and tested safeguards in the Act modeled on the bank failure law to protect creditor rights. In addition, creditors in the resolution process are protected by the same system of judicial review that has existed for the FDIC (and its predecessors) for its receivership and conservatorship authorities for more than 75 years. The Act seeks to respect the Bankruptcy Code's fundamental principles of fairness and equity among similarly situated stakeholders. As is the case under the Bankruptcy Code's best-interests test and under the model in place for bank resolution, in the limited circumstances where the Act permits deviation from those principles, the Act expressly guarantees that stakeholders will be made no worse off by a regulator's use of resolution authority than would be the case in a liquidation under Chapter 7 of the Bankruptcy Code. The Act also maintains the right of an affected company to seek judicial review following the appointment of a receiver or conservator and a claimant's right to challenge a regulator's disallowance of its claim.

As with any new authority, the first and most central questions are: how would this work? How would it be different than what is possible today? What would happen if the U.S. government were once again faced with situations like those of September 2008?

Major financial institutions would have prepared a "living will" embodying a liquidation strategy and, in most cases, a supervisory recovery plan to map out contingencies for how the firm would respond to avoid failure during a period of severe financial distress or instability. Such firms would have larger capital buffers in the event of economic stress, and stringent conditions imposed on the use of "hot" money funding, including liquidity requirements over one month and one year time frames. Regulators would have the authority to supervise the firm for system-wide risks and to impose tough prudential measures. As a firm faced capital or liquidity problems, regulators would order early remediation. But we need to have some humility about the future and our ability to predict and prevent every systemic failure of a major financial firm.

In a severe crisis, if one or more major financial firms fail, and prudential measures, remedial action, and capital buffers prove inadequate, special resolution should be available. The Dodd-Frank Act builds in important safeguards for the use of such authority, including by requiring concurrence of the Treasury Secretary, two-thirds of the Board of the Federal Reserve, and two-thirds of the Board of the FDIC (or the Securities and Exchange Commission in the case of a broker-dealer). If the financial firm's board does not consent, prompt judicial review is required.

A receivership under this authority would have three essential elements that would improve execution and outcomes relative to the tools that were available in the fall of 2008: First, the FDIC could swiftly replace the board and senior management with new managers. Second, a temporary stay of counterparty termination and netting rights, during which the FDIC could transfer qualified financial contracts to a third party or bridge institution without counterparty consent or court approval. Third, the ability to set up a bridge bank with secured financing from the FDIC to fund liquidity and capital needs, in order to mitigate the "knock on" effects of any firm's failure; to fund its operations, pending its sale or winding down; and to preserve the business franchise, and protect viable assets of stronger subsidiaries pending their sale. This would have the potential to end the firm – wind it down – without contributing to system-wide failure.

In sum, the nation would no longer have to make the untenable choice between taxpayer bailouts and market chaos. Instead, the Dodd-Frank reforms provide the FDIC with the authority to wind down any firm whose failure would pose substantial risks to our financial system, in a way that will protect the economy while ensuring that the failed firm, and if necessary other large financial firms – not taxpayers – bear any costs.

To be sure, the creation of a domestic resolution authority is not enough. Large financial institutions operate globally. Resolution of a major firm will require international cooperation among regulators participating in existing supervisory colleges which monitor the largest financial firms.. That is why it is so critical that other nations develop and implement special resolution regimes with similar tools and authorities, which is the essential first step to being able to resolve such global firms.

IV. Ending Too Big to Fail through International Reforms

While the United States is implementing the Dodd-Frank Act, it is critical that global reforms proceed as well. In particular, the United States should continue to press for progress on raising the quality and quantity of capital; reducing the moral hazard of systemically important financial institutions; and imposing new rules for capital, margin, exchange trading, central clearing, transparency and oversight of the OTC derivatives market.

Much progress has been made through the Basel Committee on Banking Supervision to raise global capital standards. In Basel III, minimum capital ratios are set at a level that will represent a significant increase in firms' requirements. These new requirements include the creation of a capital conservation buffer above the minimums, which if breached will restrict firms' ability to pay dividends or buy back stock. Such restrictions will help shore up a firm's capital base before it reaches a point of no return. Basel is now at work on how to implement a capital surcharge for the largest, most interconnected financial firms. The Basel Committee is also examining how to use new contingent capital instruments—in which debt transforms into equity under specified circumstances—to force firms to internalize the costs of their own failure.

Not only is Basel raising the ratios, but just as importantly, it is also raising the quality of capital that underlie them. The new capital requirements will focus on common equity, excluding other liabilities that did not act as a buffer to absorb losses in the crisis. There will be strict limits in the capital calculation on counting minority interests, as well as on the aggregate contribution of investments in other financial institutions, mortgage servicing rights and deferred tax assets.

Moreover, Basel is increasing the capital required for banks' riskiest activities, such as trading positions and counterparty credit exposures. Capital calculations for trading exposures will be based on stressed market conditions, and the charges for securitization exposures will be increased substantially. In both derivatives and secured lending transactions, firms will be subject to a capital charge for deterioration in the credit worthiness of counterparties. For the first time, Basel III will also be introducing a new, internationally applied, leverage ratio requirement that includes firms' off balance sheet commitments and exposures.

Furthermore, Basel III will be instituting explicit quantitative liquidity requirements for the first time, to ensure that financial firms are better prepared for liquidity strains. Under the new rules, firms will have to hold enough highly liquid assets to meet potential net cash outflows over a 30 day stress scenario. Basel will also require a minimum amount of stable funding over a one year time period, relative to a firm's assets, commitments and obligations. These liquidity requirements will be crucial in helping to mitigate severe strains like those that we saw on the financial sector at the time of the collapse of Bear Stearns and Lehman Brothers during 2008.

In addition, countries must implement the resolution recommendations agreed by G-20 Leaders, which are a necessary prerequisite for effective cross-border resolution of systemically important financial institutions. While many in Europe are focused on using contingent capital as a means to improve resolution, these efforts are not enough. Contingent capital will not be sufficient on

its own to permit the resolution of a major financial firm without wide-scale harm to the markets, and must not be used as an excuse to avoid legislating strong resolution regimes internationally.

Both our financial system and this crisis have been global in scope. So solutions have been and must continue to be global. The U.S. has not waited for the international community to act before building a new foundation in the Dodd-Frank Act, and there must not be an international race to the bottom on regulatory standards.

V. Conclusion

The United States had an urgent obligation to fix the failures that threatened our financial system and helped trigger the worst global economic crisis since the Great Depression, and a recession that has cost American families and American businesses so dearly. The Dodd-Frank Act puts in place the key reforms that were necessary to end the perception of "too big to fail," and to establish a firm foundation for financial stability and economic growth in the decades ahead.

STATEMENT OF

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on

"DOES THE DODD-FRANK ACT END TOO BIG TO FAIL?"

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
FINANCIAL SERVICES COMMITTEE
U.S. HOUSE OF REPRESENTATIVES
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Chairman Capito, Ranking Member Maloney, and members of the Subcommittee, thank you for the opportunity to testify today on behalf of the Federal Deposit Insurance Corporation (FDIC) on the question of whether the Dodd-Frank Wall Street Reform and Consumer Protection Act ends "Too Big to Fail."

Prior to the enactment of the Dodd-Frank Act, the market operated in the belief that the largest financial institutions were "Too Big to Fail." This resulted in ineffective market discipline and insufficient consideration of moral hazard by management and investors. The financial crisis of 2008 centered on those institutions that constituted the so-called shadow banking system—a network of large-bank affiliates, special-purpose vehicles, and nonbank financial companies that existed not only largely outside of the prudential supervision and capital requirements that apply to federally insured depository institutions in the U.S., but also outside of the FDIC's process for resolving failed insured financial institutions through receivership.

Further, several of the large, complex U.S. financial companies at the crux of the 2008 crisis could not be wound down in an orderly manner. This required policymakers to take steps that were unpalatable. Bank holding companies, other large financial companies, and major components of their operations were subject to the Bankruptcy Code, as opposed to bank receivership laws. Many of those firms also had major operations outside the U.S., which inevitably would be resolved separately in bankruptcy proceedings, as occurred in the Lehman Brothers, Inc. bankruptcy proceedings. Given the options of a bankruptcy proceeding in the middle of the 2008 financial turmoil or

providing financial assistance to avoid potential insolvencies, policymakers in several instances chose to provide financial assistance. Given the absence of a non-bankruptcy option to prevent a disruptive collapse, government assistance was necessary to prevent the effects of these failures from cascading through the financial system, freezing financial markets and stopping the economy in its tracks.

As it happened, these fears were realized when Lehman Brothers, Inc. — a large, complex, nonbank financial company — filed for bankruptcy on September 15, 2008. Anticipating the complications of a long, costly bankruptcy process, counterparties across the financial system reacted to the Lehman Brothers failure by seeking the safety of cash and other government obligations. Subsequent days and weeks saw the collapse of interbank lending and commercial paper issuance, and a near complete disintermediation of the financial system. The only remedy was massive intervention on the part of governments around the world, which pumped equity capital into banks and other financial companies, guaranteed certain non-deposit liabilities, and extended credit backed by a wide range of illiquid assets to banks and nonbank firms alike. Even with these emergency measures, the economic consequences of the crisis have been enormous.

If certain key elements of the Dodd-Frank Act, such as the orderly liquidation authority, had not been adopted, the pre-crisis expectation of government support for the larger financial companies, and the demonstrated reality of the support during the crisis, would have institutionalized a level of moral hazard that would lay the foundation for a future crisis. With the pre-existing expectation of a government backstop, the largest

financial companies are insulated from the normal discipline of the marketplace that applies to smaller banks and practically every other private company. Unless reversed, the result is likely to be more concentration and complexity in the financial system, more risk-taking at the expense of the public, and, in due time, another financial crisis. However, the Dodd-Frank Act introduces several measures in Title I and Title II that, together, provide the basis for a new supervisory and resolution framework designed to render any financial institution "resolvable," in a manner that mitigates systemic risk to the financial stability of the U.S. while minimizing moral hazard. This orderly liquidation authority effectively eliminates the implicit safety net of Too Big to Fail that has insulated these institutions from the normal discipline of the marketplace.

The new framework for resolving companies designated as Systemically Important Financial Institutions - or SIFIs – under the Dodd-Frank Act effectively ends Too Big to Fail. Certain tools granted by the Act are critical to imposing the market discipline that previously was lacking in these institutions. The three basic elements of the Dodd-Frank Act that together help end Too Big to Fail are: the power to designate and subject SIFIs to heightened prudential supervision by the Federal Reserve Board ("FRB"); the power to collect the information necessary to plan and prepare for or to avoid the necessity of the resolution of a SIFI, including the requirement for SIFI's to prepare detailed resolution plans; and the orderly resolution authority to ensure that, if necessary, a SIFI can be resolved without recourse to a bailout.

In my testimony I would like to clarify some misconceptions about these authorities and highlight some priorities the FDIC sees for their effective implementation.

SIFI Designation. The new Financial Stability Oversight Council (FSOC), chaired by the Treasury Secretary and made up of the other financial regulatory agencies, is responsible for designating SIFIs, based on criteria that are now being established. The Dodd-Frank Act specifies a number of factors to be considered when designating a nonbank financial company as a SIFI for supervision by the FRB, including: leverage, off-balance-sheet exposures, and the nature, scope, size, scale, concentration, interconnectedness and mix of activities of the SIFI enterprise. We believe that the ability of an institution to be resolved in a bankruptcy process without systemic impact should be a key consideration in deciding whether to designate a firm as a SIFI. This consideration is consistent with, and implicit in, the analysis of the other factors described above. The FSOC is in the process of developing a combination of qualitative and quantitative measures of potential risks to the U.S. financial stability that may be posed by individual nonbank institutions.

It is important to clarify that being designated as a SIFI will in no way confer a competitive advantage by anointing an institution as Too Big to Fail. The reality is that SIFIs will be subject to heightened supervision and higher capital requirements. They also will be required to develop and maintain detailed, analytical resolution plans showing how they can be resolved under the Bankruptcy Code. The preparation of these plans will require these companies to consider how their businesses can best be structured

and operated in a way to maximize shareholder value and achieve a workable set of resolution options. In short, this process should improve efficiency.

Ultimately, a SIFI could be required to restructure its operations if it cannot demonstrate that it is resolvable in an orderly manner under the Bankruptcy Code. However, we fully anticipate that SIFIs will pursue the resolution planning process in a way to meet the statutory requirements. In light of these significant regulatory requirements, the FDIC has detected absolutely no interest on the part of any financial institution in being named a SIFI. Indeed, many institutions are vigorously lobbying against such a designation.

It is essential, however, that the FSOC act expeditiously to gather information and designate the appropriate SIFIs. Otherwise, we face the specter of a "deathbed designation" of a SIFI, whereby the FDIC would be required to resolve the firm under a Title II resolution without the benefit of a resolution plan or the ability to conduct advance planning, both of which are so critical to an orderly liquidation. This situation, which would force the FDIC to exercise its authority as receiver at a severe and possibly crippling disadvantage, must be avoided at all costs. Thus, we need to be able to collect detailed information on a limited number of potential SIFIs as part of the designation process. We should provide the industry with some clarity about which firms will be expected to provide the FSOC with this additional information, using simple and transparent metrics, such as firm size, similar to the approach used for bank holding companies under the Dodd-Frank Act. This should reduce some of the mystery

surrounding the process and should eliminate any market concern about which firms the FSOC has under its review. By collecting information in advance of designation, the FSOC can be much more judicious in determining which firms it designates as SIFIs. This will minimize both the threat of an unexpected systemic failure and the number of firms that will be subject to additional regulatory requirements under Title I of the Dodd-Frank Act.

The FSOC issued an Advanced Notice of Proposed Rulemaking ("ANPR") last October and a Notice of Proposed Rulemaking ("NPR") on January 26, 2011, describing the processes and procedures that will inform the FSOC's designation of nonbank financial companies under the Dodd-Frank Act. We recognize the concerns raised by several commenters to the FSOC's ANPR and NPR about the lack of detail and clarity surrounding the designation process. This lack of specificity and certainty in the designation process is itself a burden on the industry and an impediment to prompt and effective implementation of the designation process. That is why it is important that the FSOC move forward and develop some hard metrics to guide the SIFI designation process. The sooner we develop and publish these metrics, the sooner this understandable uncertainty can be resolved. The FSOC is in the process of developing for comment further clarification of the metrics that will provide more specificity as to the measures and approaches we are considering using for designating non-bank firms as SIFIs.

SIFI Resolution Plans. Once designated, the SIFIs will be subject to heightened prudential supervision by the FRB and required to maintain detailed, *credible* resolution plans that demonstrate that they are resolvable under the Bankruptcy Code if they should run into severe financial distress. As noted in Chairman Bair's February 2011 testimony before the Senate Banking Committee, the court-appointed trustee overseeing the liquidation of Lehman Brothers found that the lack of a disaster plan "contributed to the chaos" of the Lehman Brothers bankruptcy 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, analytical resolution plans in advance, and authorizing an on-site FDIC team to conduct pre-resolution planning, the Dodd-Frank Act gives the FDIC, the FRB and the FSOC information from the largest potentially systemic financial companies that will allow for extensive advance planning both by regulators and by the companies themselves. The SIFI resolution plan framework under the Dodd-Frank Act provides the informational advantage that was lacking in the crisis of 2008.

The FDIC recently released a paper detailing how the filing of resolution plans, the ability to conduct advance planning, and other elements of the framework could have dramatically changed the outcome if they had been available in the case of Lehman.[1] Under the new SIFI resolution framework, the FDIC should have a presence at all

[1] "The Orderly Liquidation of Lehman Brothers Holdings under the Dodd-Frank Act," *FDIC Quarterly*, Vol. 5, No. 2, 2011. http://www.fdic.gov/regulations/reform/lehman.html

designated SIFIs, working with the firms and reviewing their resolution plans as part of their normal course of business. If this is the case, the onsite presence of the FDIC would not be seen as a signal of distress, but rather as a positive sign that management is routinely being encouraged to consider fully any downside consequences of its actions, to the benefit of the institution and the stability of the system as a whole.

The law also authorizes the FDIC and the FRB to require, if necessary, changes in the structure or activities of these financial institutions to ensure that they meet the standard of being resolvable through bankruptcy in a crisis. The FDIC hopes that the SIFIs themselves will take action to meet the statutory requirements because it will improve efficiencies and make our system more resilient. Certainly, the FDIC and the FRB must be willing to use their authority actively to require organizational changes that promote the ability to resolve SIFIs, if a resolution plan is not credible.

As currently structured, many large banks and nonbank SIFIs maintain hundreds - even thousands - of subsidiaries and manage their activities within business lines that cross many different organizational structures and regulatory jurisdictions. This can make it very difficult to implement an orderly liquidation of one part of the company without triggering a costly collapse of the entire company. To solve this problem, the FDIC and the FRB must be willing to insist on organizational changes that better align business lines and legal entities well before a crisis occurs. Unless these structures are rationalized and simplified in advance, there is a real danger that their complexity could make a SIFI resolution far more costly and more difficult than it needs to be.

Such changes are also likely to have collateral benefits for the firm's management in the short run. A rationalized organizational structure will put management in a better position to understand and monitor risks and inter-relationships among business lines, addressing what many see as a major factor that contributed to the crisis. That is why—well before the test of another major crisis—we must put in place high informational standards for resolution plans and be willing to insist on organizational changes *where necessary* in order to ensure that SIFIs meet the standard of resolvability.

The Dodd-Frank Act requires the FDIC and the FRB jointly to issue final regulations within 18 months of enactment to implement new resolution planning and reporting requirements. These rules will apply to bank holding companies with total assets of $50 billion or more and nonbank financial companies designated by the FSOC as SIFIs. A Notice of Proposed Rulemaking for such a joint rule on *Resolution Plans and Credit Exposure Reports* was published in April, and the comment period closed last week. Under the NPR, covered companies would be required to submit a credit exposures report on a quarterly basis to outline the nature and extent of their exposures. Additionally, covered companies would be required to submit a resolution plan within 180 days of the final regulation. The NPR indicates that resolution plans should identify and map covered companies' business lines to legal entities and provide integrated analyses of their corporate structure; credit and other exposures; funding, capital, and cash flows; domestic and foreign jurisdictions in which they operate; their supporting information systems and other essential services; and other key components of their

business operations. As part of that rulemaking, the agencies are working diligently to develop a thoughtful and substantive process for reviewing resolution plans to determine whether a plan is both credible and would facilitate an orderly resolution of the company under the Bankruptcy Code. If after two years, and the imposition of more stringent standards, the resolution plan still does not meet the statutory standards, the FDIC and the FRB may, in consultation with the FSOC, direct a company to divest certain assets or operations. The resolution plan requirement in the Dodd-Frank Act appropriately places the responsibility on financial companies to develop their own plans "for rapid and orderly resolution in the event of material financial distress or failure" with review by the FDIC and the FRB.

Orderly Liquidation Authority (OLA) Finally, the law provides for an alternative to bankruptcy — an orderly liquidation authority (OLA) that gives the FDIC many of the same receivership powers over SIFIs that we have long used to manage failed-bank receiverships. Bailouts are not permitted.

There appear to be a number of misconceptions as to the nature of the OLA. Some have called it a bailout mechanism, while others see it as a fire sale that will destroy the value of receivership assets. Neither has any basis in reality under the Dodd-Frank Act. The Dodd-Frank Act expressly bars any bailout and prohibits taxpayers from bearing any losses in a resolution. While it is positioned as an alternative resolution mechanism in cases where proceeding through bankruptcy would result in wider financial disorder, the OLA is actually a better-suited framework for resolving claims against

failed financial institutions. It is a transparent process that operates under fixed rules that bar *unequivocally* any bailout of shareholders and creditors, which can be a concern in the case of an ad-hoc emergency rescue program. Not only would the OLA work faster and preserve value better than bankruptcy, but the regulatory authorities who will administer the OLA are in a far better position to coordinate with foreign regulators in the failure of an institution with significant international operations. Further, under the OLA, we can minimize systemic risk and preserve franchise value by running the institution as a bridge financial company, and eventually selling it in parts or as a whole. It is a powerful tool that greatly enhances our ability to provide continuity and minimize losses in SIFI failures.

While Title I of the Dodd-Frank Act significantly enhances the regulators' ability to conduct advance resolution planning for SIFIs and large bank holding companies, Title II vests the FDIC with legal resolution authorities similar to those that it already has with respect to insured depository institutions. If the FDIC is appointed as receiver for a covered financial company, it is required to carry out an orderly liquidation of the company in a manner than ensures that creditors and shareholders appropriately bear the losses of the financial company while maximizing the value of the company's assets, minimizing losses, mitigating risk, and minimizing moral hazard. Under this authority, common and preferred stockholders, debt holders and other unsecured creditors will know that they will bear the losses of any institution placed into receivership, and management will know that it could be replaced. These new requirements will ensure that taxpayers will bear no losses.

The history of the recent crisis is replete with examples of missed opportunities to sell or recapitalize troubled institutions before they failed. But with bailout now off the table by legislative direction, management will have a greater incentive to bring in an acquirer or new investors before failure, and shareholders and creditors will have more incentive to go along with such a plan in order to salvage the value of their claims. In addition, if the institution should ultimately fail, management that is substantially responsible for the failure will be subject to the claw-back of compensation earned during the two previous years. These new incentives to be more proactive in dealing with problem SIFIs should reduce the incidence of outright failure and also lessen the risk of systemic effects arising from such failures.

In implementing the Act's requirements, our explicit goal is that all market players should understand that bailouts are no longer an option. We anticipate that financial institution credit ratings should, over time, fully reflect this fact. Indeed, early this month Moody's placed under review for potential downgrade the "uplift" based on systemic support assumptions that it had previously provided to the deposit, senior debt, and senior subordinated debt ratings of certain large financial companies. Moody's announcement stated that, "The U.S. government's intent under Dodd-Frank is very clear. Going forward it does not want to bail out even large, systemically important banking groups."

The FDIC has issued an Interim Final Rule (IFR) and an NPR to implement certain provisions of Title II, providing clarity and certainty with respect to how key components of the OLA will be implemented. Among other things, this NPR addresses the power to recoup compensation from senior executives and directors when they are materially responsible for the failure of a SIFI; the priorities of expenses and unsecured claims; the claims process; and the treatment of secured claims. These rules provide a roadmap for creditors to better understand their substantive and procedural rights under Title II and thus allows for increased certainty in the planning of transactions and the conduct of business under this new regime. The comments received to the IFR and the NPR are being reviewed, with the expectation of a Final Rulemaking being issued in the coming month.

International Coordination. One of the key lessons of the recent financial crisis is that we must always be prepared to resolve large, globally active, interconnected financial companies. The structures of these companies are highly complex, and the issues associated with their resolutions can be challenging. However, with planning and cross-border coordination, disruptions to global financial markets can be minimized.

First, there is a need for an effective resolution process in every jurisdiction. We also believe that a greater convergence of resolution regimes across countries would be beneficial in dealing with crisis situations.

Second, there must be sufficient supervisory and resolution resources within each country to deal with the scale of a firm's operations within that country. If these resources do not exist, resolution strategies will not be credible and the problem of Too Big to Fail will remain in those jurisdictions.

Third, supervisors need to understand, well in advance, the sometimes complex group structure of a conglomerate. These structures, designed to maximize economic return and minimize taxes, tend to result in economic transactions that extend across legal entities and national borders, making it difficult for one national authority to settle claims and complete transactions in a resolution.

Finally, and related to the prior point, there is a need for close cooperation and dialogue between national authorities both before and during a crisis. In such situations, the ability to share supervisory information and even liquidity resources is key to the ability to resolve the institution without creating wider systemic effects.

There is currently no international insolvency framework to govern how cross-border financial institutions will be resolved. It does not appear that creating such a framework is a realistic near-term goal because a binding, comprehensive international insolvency framework would require countries to resolve difficult questions about who will pay for the resolution. The direct connection between the resolution of financial institutions and who bears the financial burden for losses means that each national authority will tend to protect its domestic creditors and its financial resources. As a

result, most countries have 'ring-fenced' or acted to separately resolve financial firms within their borders with limited regard for the resolution of related companies located outside its borders. However, when national authorities fail to cooperate in resolving a cross-border crisis this can create adverse consequences both for other countries and potentially even for the country that ring fences by reducing the recoverable value of the financial company and creating disruptions for the financial system that rebound to that country's detriment.

There are efforts underway to better deal with these challenges by coordinating resolution processes across national jurisdictions. The FDIC and other U.S. regulatory authorities have been leaders internationally, both in promoting best practices and in promoting convergence of practices. I co-chair the Cross-Border Resolutions Group (CBRG) of the Basel Committee, which released a report last year outlining several important goals for enhancing the cross-border resolutions process. This report outlined specific recommendations for improvements in national laws to achieve a more effective resolution of financial institutions and prevent the past resort to bailouts. The recommended reforms incorporate the powers the FDIC has long had to resolve failing banks. Those powers are now incorporated into Title II of the Dodd-Frank Act.

In view of many countries' unhappy experience with legal frameworks that were not up to the task in 2007 and 2008, many countries have concluded that significant reforms are necessary. The Financial Stability Forum (FSB) and the G-20 leaders have

endorsed these recommended reforms and the CBRG is now assessing the progress in implementing them. While progress has been made, much more remains to be done.

While it would be helpful to negotiate broad agreements in advance that would coordinate resolutions activities and share financial burden, there are inevitable limitations to any approach that subordinates sovereign interests to international authorities. Instead, much progress is being made on these issues through bilateral discussions, which appear to be the best way forward in creating a more predictable cross-border resolutions process. The FSB is coordinating work underway in many countries to develop effective recovery and resolution plans for internationally active financial institutions. In the U.S., the federal banking regulators along with the Securities and Exchange Commission are pursuing this work as well. These efforts are already providing important insights into how the resolvability of SIFIs can be improved. Obviously, in the U.S., these efforts will assist the FDIC and the FRB in our joint work on final rules to govern resolution plans under the Dodd-Frank Act and in the review of the resulting plans.

It is worth noting that no other advanced country plans to rely on bankruptcy to resolve large, international financial companies. The resolution framework and the statutory powers included in Title II of the Dodd-Frank Act have, in fact, become the international standard.

Conclusion

In summary, the measures authorized under the Dodd-Frank Act to create a new, more effective SIFI resolution authority will go far toward reducing risk-taking in our financial system by subjecting every financial institution, no matter its size or degree of interconnectedness, to the discipline of the marketplace. Prompt and effective implementation of these measures will be essential to constraining the tendency toward excess leverage in our financial system and our economy, and in creating incentives for safe and sound practices that will promote financial stability in the future.

In light of the ongoing concern about the burden arising from regulatory reform, we think it is worth mentioning that none of these measures to promote the resolvability of SIFIs will have any impact at all on small and midsized financial institutions except to reduce the competitive disadvantage they have long encountered with regard to large, complex institutions. There are clear limits to what can be accomplished by prescriptive regulation. That is why promoting the ability of market forces to constrain risk taking will be essential if we are to achieve a more stable financial system in the years ahead.

Stephen J. Lubben
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Testimony of Professor Lubben before U.S. House Financial Services Subcommittee on Financial Institutions and Consumer Credit regarding Orderly Liquidation Authority and Too Big to Fail

Washington, D.C. -- June 14, 2011

Chair Capito and Distinguished Members of this Subcommittee:

I am the Daniel J. Moore Professor of Law at Seton Hall University School of Law in Newark, N.J. I have been at Seton Hall since entering academia in 2002, and I teach Bankruptcy, Business Associations, Corporate Finance, and Financial Institutions at the Law School. I also comment on debt and financial distress for the New York Times' *Dealbook* blog, and write about corporate bankruptcy for *Credit Slips*.

Before entering academia, I was an associate for several years with the law firm of Skadden, Arps, Slate, Meagher & Flom in New York and Los Angeles, where I specialized in corporate reorganization.

I was asked by Committee staff to address the broad topic of the Dodd-Frank Act's Orderly Liquidation Authority (OLA) and the specific issue of whether Dodd-Frank had ended "too big to fail."

Taking the last issue first, the notion of ending too big to fail is subject to many definitions. If we mean that we could now liquidate, in a chapter 7-bankruptcy sense, a large financial institution without severe disruption to the financial markets, then Dodd-Frank clearly fails the test

While Dodd-Frank OLA provides for the ultimate liquidation of a financial institution, it does so in a fashion that is closer to a liquidation under chapter 11 of the Bankruptcy Code. Moreover, the orderly liquidation of financial institutions under OLA is primarily achieved by virtue of the FDIC's ability to provide ongoing

liquidity to the financial institution, which many would consider a form of bailout of the financial institution's counterparties.

In short, Dodd-Frank does not end too big to fail if by that term we mean it is possible for a large financial institution to fail without government assistance and not thereby dislocate the financial markets. On the other hand, one might question whether such a goal is politically feasible or realistic, given the significant changes it would require to our financial system as it currently exists.

Turning to the broader issue of Dodd-Frank's Orderly Liquidation Authority, while I think that OLA improves in some respects on chapter 11, OLA created unneeded uncertainty with regard to the resolution of financial institutions and missed the opportunity to integrate the OLA process into the broader structure of insolvency law.

Before beginning this discussion, I should note that much of the functioning of OLA depends on regulators' actions before the onset of financial distress. For example, enforcement of the "living wills" provisions of Dodd-Frank in a way that produces realistic, and up-to-date plans for resolution of the financial institution will make all the difference when it comes time to actually use OLA.

Likewise, it will be vital that regulators use their power to demand rationalization of corporate structures if OLA is going to have any chance of success. Robust capital and collateral requirements, with minimal loopholes, obviously help avoid the need for OLA and the effects of financial distress when it does occur.

With regard to the things Dodd-Frank OLA gets right, I think they can be summarized in two words: speed and financing. OLA speeds up the already quick chapter 11 timeline – seen in cases like Lehman, GM, and Chrysler – to allow the sale of the financial institution on the very first day of the case. Quick formulation and implementation of resolution plans is key if financial distress is to be contained.

Similarly, because financial institutions depend on each other to a degree that Ford does not depend on Chrysler, it is extremely important that a distressed financial institution publicly demonstrate its ability to perform on its obligations on day one of any insolvency proceeding. Moreover, liquidity buys the financial institution time, which it needs for its asset values to stabilize.

This vital liquidity might be provided by private DIP lenders, but at the very least one would want to have a government "backstop" in cases where the lending market entirely shuts down – such as occurred immediately after the Lehman collapse.

Moreover, private DIP financing for a financial institution of any significant size would likely be beyond the market's ability to provide, even in good times. And it is unlikely that many financial intuitions will fail in good times.

Thus, I think it is very commendable that Dodd-Frank OLA provides for FDIC financing of the financial institution pending resolution. This provision will ensure that the financial institution's distress does not spread to its counterparties.

On the other hand, the failure to specify when OLA will apply has created unnecessary confusion. Instead of replacing chapter 11, OLA simply supplants chapter 11 when regulators decide it should. Thus, most financial holding companies remain subject to chapter 11, except for when they are subject to OLA.

The confusion in this regard has been exacerbated by the FDIC's recent decision to denigrate chapter 11 while promoting its hypothetical resolution of Lehman under OLA. This suggests that FDIC does not see chapter 11 as a workable solution for financial institutions, while chapter 11 nonetheless remains the default options for such institutions.

It would have been preferable to apply OLA to a set of financial institutions in all situations, removing the need to guess what a particular Treasury Secretary might do with regard to any particular institution.

Similarly, OLA would better function if it applied to the whole of the financial institution. As it stands now, broker-dealers are partially within OLA and partially within their normal SIPA resolution procedures, while banks and insurance companies are entirely outside of OLA. The only piece of the enterprise that is entirely within OLA is the holding company and its unregulated subsidiaries, but even then they are subject to the previously mentioned confusion about when OLA applies.

The enactment of Dodd-Frank provided an opportunity to create a single forum for resolution of distressed financial intuitions, and it is unfortunate that this opportunity was not realized.

I think there is also real concern about the FDIC's ability to adequately staff the resolution proceedings if several financial institutions encounter distress in quick succession. For example, if OLA had been in effect in the past crisis, FDIC would have had to address Wachovia, Merrill, Lehman, AIG, Citibank, Washington Mutual, and perhaps others almost simultaneously.

It might have been better to adopt something like the chapter 11 model, which relies on private professionals to handle the bulk of the work. Moreover, such an approach ensures that the cost of resolution is internal to the financial institution and thus incurred by its shareholders and junior creditors.

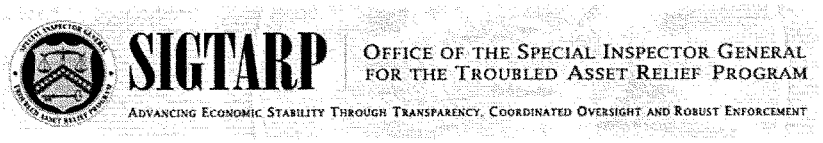
While FDIC asserts that this will be so under OLA, it is not clear that administration of OLA proceedings will not be at least partially subsidized (for example, does FDIC intend to charge overhead to the financial intuitions it resolves?). And in any event, there remains the larger question of FDIC's ability to staff multiple simultaneous resolutions, especially if such resolutions occur during a broader banking crisis that would implicate FDIC's other responsibilities.

Finally, OLA might be better off if it did not rely so much on the bank receiver model, with all the opacity that such a system entails. Without a doubt resolution necessitates pre-planning that happens outside the public eye – but that happens in chapter 11 and SIPA proceedings too.

The decision to put initial review of the case in a secret proceeding in front of the D.C. District Court, a court not particularly known for its insolvency expertise, and place FDIC in charge of all aspects of the resolution process thereafter strikes me as misguided. Transparency and speed are not necessarily incompatible – the sale hearing in Lehman proves that. And transparency is exactly what was lacking in the resolutions of Bear Sterns, AIG, and the apparent resolution of Citibank. OLA will find much greater public acceptance if it is recast with some public window into the proceedings.

More broadly, our financial markets would be well served if OLA were re-formed in a way that increased the transparency and certainty of the process. One key step in achieving this goal will be to better examine how the OLA fits with the existing insolvency systems, such as chapter 11, FDIA, SIPA, and the state insurance receivership statutes.

I appreciate the opportunity to appear before the Committee today to share my views and look forward to any questions.



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HOUSE COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON FINANCIAL INSITUTIONS
AND CONSUMER CREDIT

STATEMENT OF CHRISTY ROMERO

ACTING SPECIAL INSPECTOR GENERAL
TROUBLED ASSET RELIEF PROGRAM

BEFORE THE
HOUSE COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON FINANCIAL INSITUTIONS
AND CONSUMER CREDIT

JUNE 14, 2011

Chairman Capito, Ranking Member Maloney, and Members of the Committee, I am honored to appear before you today to discuss the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or "Act") and whether it ended the concept of "Too Big To Fail."

The Office of the Special Inspector General for the Troubled Asset Relief Program ("SIGTARP") is charged with conducting, supervising and coordinating audits and investigations of the purchase, management, and sale of assets under the Troubled Asset Relief Program ("TARP"). SIGTARP's mission is to promote economic stability through transparency, robust enforcement, and coordinated oversight. In fulfilling its mission, SIGTARP protects the interests of those who funded TARP programs—the American taxpayers.

This Committee is committed to examining whether the moral hazards created by Government interventions in the market in 2008 (which includes TARP) have been resolved. As part of its mission of transparency, SIGTARP has examined the Government's response to the financial crisis through TARP and the increased moral hazard that was an inevitable byproduct of TARP. In order to determine whether this increased moral hazard has been resolved, it is necessary to examine past actions by market participants that made them "too big to fail" and the Government's decisions to stand behind these companies. These decisions made in the wake of the financial crisis have implications for the future. Only by examining the past can we take advantage of lessons learned to better protect taxpayers in the future.

Treasury and Federal banking regulators made decisions related to TARP in order to bolster investor and consumer confidence in the nation's financial system. SIGTARP has shed light on the details of critical decision-making in this area. For example, we released an audit report detailing the decision by the Government to step in and provide an unprecedented bailout

to banks under TARP's Capital Purchase Program ("CPP") in October 2008. At that point in time, a number of events including the failure of Lehman Brothers, Inc., the extension of an $85 billion line of credit from the Federal Reserve Bank of New York to American International Group, and the failure of Washington Mutual, Inc. (the largest depository institution failure) devastated investor confidence in the nation's financial system and set the stage for the unprecedented $700 billion TARP. In October 2008, then-Treasury Secretary Henry Paulson announced the creation of CPP and its intent to increase confidence in the banks and increase the bank's confidence so that they would deploy, rather than horde capital, which in turn was supposed to lead to increased lending. Treasury immediately pledged $125 billion in TARP funds to nine large financial institutions. According to Treasury, these first nine institutions were chosen for their perceived importance to the greater financial system. In a matter of weeks, two of the original nine institutions (Bank of America Corp. and Citigroup, Inc.) needed additional support.

In January 2011, SIGTARP released an audit report entitled "Extraordinary Financial Assistance Provided to Citigroup, Inc." The audit examined the basis for the Government's decision to deem Citigroup to be too systemically significant to be allowed to fail and to provide it with not just $25 billion through CPP, but also with additional Government assistance in the amount of a $20 billion capital injection through the Targeted Investment Program ("TIP") and Government guarantees against losses on certain assets under the Asset Guarantee Program ("AGP"). As detailed in the report, after a frantic weekend dubbed "Citi Weekend," the consensus of Government parties held that it was necessary to save Citigroup at all costs in order to stabilize the nation's financial system. The report describes discussions on November 20, 2008, among the Federal banking regulators and Treasury. Federal Reserve Chairman Ben

Bernanke characterized one call as a discussion of Citigroup's condition and the "too big to fail" issue. During the call, then-Federal Reserve Bank of New York President Timothy Geithner told the other principals, "We've told the world we're not going to let any of our major institutions fail. We are going to have to make it really clear we're standing behind Citigroup."

Although the concept of "too big to fail" existed prior to TARP, public statements and the actions taken by Government officials during late 2008 and early 2009 made it explicit that the Government would stand behind the major financial institutions and not let any of them fail. The Government was focused on sending a message to skittish markets during the height of the financial crisis. After the additional bailout of Citigroup was announced, the impact was immediate and Citigroup stabilized. There are several lessons to be learned from the Citigroup bailout for the future, particularly in light of the enactment of the Dodd-Frank Act. As Federal Deposit Insurance Corporation ("FDIC") Chairman Sheila Bair stated before this very committee on May 26, 2011, "the outcome of the next financial crisis is already being determined by decisions regulators are making today in the Dodd-Frank implementation process."

SIGTARP's Findings and Conclusions in the Citigroup Audit

In November 2008, worried that Citigroup would fail absent a strong statement of support from the U.S. Government, and that such failure could cause catastrophic damage to the economy, then-Treasury Secretary Henry Paulson and then- FRBNY President Timothy Geithner held a series of discussions with FRB Chairman Ben Bernanke, FDIC Chairman Sheila Bair, and then-Comptroller of the Currency John Dugan to discuss bailing out Citigroup. The underlying premise of these discussions was that Citigroup was too systemically significant to be permitted to collapse. According to Chairman Bernanke, it was "not even a close call to assist them."

By late on November 23, 2008, Citigroup had agreed to a Government proposal that would provide Citigroup a package that included asset guarantees and a $20 billion capital infusion in exchange for preferred shares of Citigroup stock. The essential purpose of the deal, as Secretary Paulson and FRBNY President Geithner later confirmed to SIGTARP, was to assure the world that the Government would not let Citigroup fail. After the deal was announced, the impact on the market's perception of Citigroup was immediate: its stock price stabilized, its access to credit improved, and the cost of insuring its debt declined. Citigroup had been saved, at least for the time being.[1]

SIGTARP found that the Government constructed a plan that not only achieved the primary goal of restoring market confidence in Citigroup, but also carefully controlled the overall risk of Government loss on the asset guarantee. As one FRBNY official explained to SIGTARP, the deal was structured to "convinc[e] the skittish market that the Federal Government was taking the risk, even though the risk really remained with Citigroup," because the Citigroup loss position ultimately exceeded anticipated losses. The Government also insisted on a $20 billion capital injection in return for preferred stock, even though Citigroup did not request such an injection. Here, too, the focus was on sending a message to reassure the markets – the Government would not let Citigroup fail.

From the perspective of minimizing taxpayer risk on the asset guarantee transaction itself, the deal with Citigroup looks even better with hindsight. Citigroup did not fail, and the global economy avoided the catastrophic financial collapse that many feared would flow from a Citigroup failure. And while the transactions hardly solved all of Citigroup's problems, the

[1] Just over a year later, Citigroup terminated the guarantee program and repaid the $20 billion of Government-supplied capital.

Government incurred no losses, and even profited on its overall investment in Citigroup by more than $12 billion. Nevertheless, two aspects of the Citigroup rescue bear noting.

First, the conclusion of the various Government actors that Citigroup had to be saved was strikingly ad hoc. While there was consensus that Citigroup was too systemically significant to be allowed to fail, that consensus appeared to be based as much on gut instinct and fear of the unknown as on objective criteria. As Secretary Paulson stated on one of the Citi Weekend conference calls, "If Citi isn't systemic, I don't know what is." FDIC Chairman Bair told SIGTARP that "we were told by the New York Fed that problems would occur in the global markets if Citi were to fail. We didn't have our own information to verify this statement, so I didn't want to dispute that with them." Another FDIC official told SIGTARP that in terms of Citigroup's systemic significance, FDIC directors and other Government entities "made a judgment call." Citigroup CEO Vikram Pandit summed up the feeling at the time when he told SIGTARP that no one knew what the systemic effects of a Citigroup failure would be, and that no one wanted to find out.

Given the urgent nature of the crisis surrounding Citigroup, the ad hoc character of the systemic risk determination is not surprising, and SIGTARP found no evidence that the determination was incorrect. Nevertheless, the absence of objective criteria for reaching such a conclusion raised concerns. Then-Director of the Office of Thrift Supervision John Reich, at FDIC's Board meeting on November 23, 2008, in which FDIC made its determination to proceed with the Citigroup transactions, observed that there had been "some selective creativity exercised in the determination of what is systemic and what's not," and that there "has been a high degree of pressure exerted in certain situations, and not in others, and I'm concerned about parity."

Concerns about "selective creativity" and "parity" could be addressed at least in part by the development, in advance of the next crisis, of clear, objective criteria and a detailed road map as to how those criteria should be applied. Secretary Geithner told SIGTARP that he believed creating effective, purely objective criteria for evaluating systemic risk is not possible: "What size and mix of business do you classify as systemic?...It depends too much on the state of the world at the time. You won't be able to make a judgment about what's systemic and what's not until you know the nature of the shock" the economy is undergoing. Secretary Geithner also suggested that whatever objective criteria were developed in advance, markets and institutions would adjust and "migrate around them." If the Secretary is correct, then systemic risk judgments in future crises will again be subject to concerns about consistency and fairness, not to mention accuracy. The Dodd-Frank Act created the Financial Stability Oversight Council ("FSOC") and charged it with responsibility for developing the specific criteria and analytical framework for assessing systemic significance. That process is under way, with FSOC having invited public comment on those issues. SIGTARP remains convinced that even if some aspects of systemic significance are necessarily subjective and dependent on the nature of the crisis at the time, an emphasis on the development of clear, objective criteria in advance of the next crisis would significantly aid decision makers likely to be burdened by enormous responsibility, extreme time pressure, and uncertain information. Moreover, FSOC must be transparent about how it will apply both objective and subjective criteria to a failing institution, and must seek to gauge the market and adjust the criteria in the event that firms do indeed seek to "migrate around them." Without minimizing the legitimate concerns raised by Secretary Geithner, it is imperative that FSOC not simply accept the adaptability of Wall Street firms to work around regulation, but instead maintain the flexibility to respond in kind.

Second, the Government's actions with respect to Citigroup undoubtedly contributed to the increased moral hazard that has been a direct byproduct of TARP. While the year-plus of Government dependence left Citigroup a stronger institution than it had been, it remained, and arguably still remains, an institution that is too big, too interconnected, and too essential to the global financial system to be allowed to fail. Indeed, a senior FRBNY official told SIGTARP in January 2010 (before the passage of the Dodd-Frank Act), that Citigroup was then still "too big to fail," and that if history repeated itself there is "no question we would do it again...[with] a similar or different program." Citigroup's creditors and counterparties were left largely unscathed by its need for repeated assistance from taxpayers, and the concern voiced by Chairman Bair on February 22, 2009, for the need for management changes "at the top of the house" at Citigroup arguably was not fully addressed. While there have been notable changes at the board level and some changes in management, some of those in Citigroup's senior management who came to the Government seeking assistance in 2008 remain in place.

When the Government assured the world in 2008 that it would use TARP to prevent the failure of any major financial institution, and then demonstrated its resolve by standing behind Citigroup, it did more than reassure troubled markets – it encouraged high-risk behavior by insulating the risk takers from the consequences of failure. Unless and until institutions like Citigroup are either broken up so that they are no longer a threat to the financial system, or a structure is put in place to assure that they will be left to suffer the full consequences of their own folly, the prospect of more bailouts will potentially fuel more bad behavior with potentially disastrous results.

Notwithstanding the passage of the Dodd-Frank Act, which does give FDIC new resolution authority for financial companies deemed systemically significant, the market still

gives the largest financial institutions an advantage over their smaller counterparts. They are able to raise funds more cheaply, and enjoy enhanced credit ratings based on the assumption that the Government remains as a backstop. Specifically, creditors who believe that the Government will not allow such institutions to fail may under price their extensions of credit, giving those institutions access to capital at a price that does not fully account for the risk created by their behavior.

Cheaper credit is effectively a subsidy, which translates into greater profits, giving the largest financial institutions an unearned advantage over their smaller competitors. And because of the prospect of another Government bailout, executives at such institutions might be motivated to take greater risks than they otherwise would, shooting for a big payoff but with reason to hope that if things went wrong they might still be able to keep their jobs.

The moral hazard effects of TARP in general and the bailouts of Citigroup in particular may eventually be ameliorated by full implementation of the provisions of the Dodd-Frank Act, which was intended in part to address the problem of institutions that are "too big to fail." Whether it will do so successfully remains to be seen, with important work by FDIC, FSOC, and a host of other regulators far from complete. Even after those bodies develop and implement new rules and regulations authorized by the Dodd-Frank Act, which would prohibit some of the benefits received by Citigroup under TARP, taxpayers likely won't know about the extent of their continuing exposure until the next crisis. As Secretary Geithner told SIGTARP in December 2010, with the Dodd-Frank Act, the "probability of failure is reduced because the banks hold more capital. The size of the shock that hit our financial system was larger than what caused the Great Depression. In the future we may have to do exceptional things again if we face a shock that large. You just don't know what's systemic and what's not until you know the

nature of the shock. It depends on the state of the world – how deep the recession is. We have better tools now, thanks to Dodd-Frank. But you have to know the nature of the shock."

Secretary Geithner's candor about the difficulty of determining "what's systemic and what's not until you know the nature of the shock," and the prospect of having to "do exceptional things again" in such an unknowable future crisis is commendable. At the same time, it underscores a TARP legacy, the moral hazard associated with the continued existence of institutions that remain "too big to fail." It also serves as a reminder that the ultimate cost of bailing out Citigroup and the other "too big to fail" institutions will remain unknown until the next financial crisis occurs.

The Process for Designating Systemically Significant Financial Institutions

As Chairman Bernanke has stated, "A clear lesson of the past few years is that the government must not be forced between bailing out a systemically important firm and having it fail in a disorderly and disruptive manner." The Dodd-Frank Act charged FSOC with identifying and designating certain non-bank financial companies as systemically important financial institutions ("SIFI") for heightened prudential supervision by the FRB. In addition, FSOC may make recommendations to the FRB regarding the establishment and refinement of heightened prudential standards for nonbank financial companies designated as SIFIs and certain large, interconnected bank holding companies. The Dodd-Frank Act grants FDIC new resolution authority designed to assist in the orderly liquidation of financial companies deemed systemically significant. The Dodd-Frank Act also requires that these institutions prepare resolution plans (sometimes referred to as "living wills") for a rapid and orderly resolution in the event of material financial distress or failure, and allows for the FDIC and FRB to shape these living wills. The Dodd-Frank Act also grants regulatory authority to set more stringent capital,

liquidity and leverage requirements and to limit certain activities that might increase systemic risk.

FSOC's notice of proposed rulemaking for designating nonbank financial companies as SIFIs sets forth a framework of criteria that would be rooted in 11 statutory considerations set forth in the Dodd-Frank Act for such designations, and would generally fall into two categories. The criteria in the first group (size, lack of substitutes, and interconnectedness) address the spillover effect from the firm's distress on the broader financial system. The criteria in the second group (leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny) address a company's vulnerability. If designated as a SIFI under the proposed rule, the largest, most interconnected and highly-leveraged companies would face stricter prudential regulation, including higher capital requirements and more robust consolidated supervision. Public comments reveal two common concerns: (1) the proposed rule is insufficient to provide any guidance as to what the criteria will be for determining which entities are SIFIs and (2) the framework presented, although helpful, needs to be clarified and included in the rule.

Effect of Systemically Significant Designation and the Existence of Too Big To Fail

Whether or not the systemically significant designation will provide a competitive advantage for those institutions ultimately may be dependent on the market's perception of whether the Government will step in again to tell the markets that they stand behind these companies. As Chairman Bernanke stated in a speech to community bankers in March 2010, "if a firm is publicly perceived as too big, or too interconnected, or systemically critical for the authorities to permit its failure, its creditors and counterparties have less incentive to evaluate the quality of the firm's business model, its management, and its risk-taking behavior."

The mere enactment of the Dodd-Frank Act did not end the concept of "too big to fail" in the market's eyes. In January, after the Dodd-Frank Act's enactment, Standard & Poor's ("S&P") and Moody's Investor Service ("Moody's"), announced its intention to make permanent the prospect of Government support as a factor in determining a bank's credit rating. According to S&P, "We believe that banking crises will happen again. We expect this pattern of banking sector boom and bust and government support to repeat itself in some fashion, regardless of governments' recent and emerging policy response." In its ratings, Moody's has assumed Government support for the eight largest banking organizations. As long as the financial institutions, counterparties, and ratings agencies believe there will be future bailouts, competitive advantages associated with "too big to fail" designated institutions will almost certainly persist. As long as the market perceives future bailouts, market discipline will be reduced as creditors, investors and counterparties have less incentive to monitor those institutions they believe the Government will save in the future. Restoring market discipline may be necessarily tied to ending "too big to fail."

It is too early to tell whether Dodd-Frank will ultimately be successful in ending "too big to fail," and that success will be dependent on the market's perception of the effectiveness of the actions taken by regulators and Treasury. As we observed with Citigroup stabilizing after the announcement of additional Government assistance, the market will react to the words and actions taken by regulators. In order to end "too big to fail", the regulators must take effective action now using the tools given to them under Dodd Frank for the markets to be convinced that the Government will not intervene again.

Regulators have a benefit that was missing during the financial crisis—the benefit of time. It is vital that regulators use the time when the nation is not in a financial crisis to

promulgate rules to make effective use of the authorities granted to them under Dodd-Frank. To be effective, regulators should develop objective criteria and a solid framework for applying those criteria, so that should the nation face another potential financial crisis, the roadmap is in place along with all of the needed signposts.

Rules, however, are only as effective as their application. In order to convince markets, promises of the regulators to end "too big to fail" must be matched with actions that signal with certainty that the Government will not make future bailouts. The markets will watch to see the level and type of enhanced prudential supervision that comes from a SIFI designation. The markets will watch to see whether institutions designated as SIFI are restructured and simplified. Regulators have authority to shape the living wills of systemically significant institutions, and to compel substantial changes to the structure and activities of these companies. These actions rely on the courage of the regulators to protect our nation's broader financial system against any institution whose demise could potentially trigger another financial crisis.

Chairman Capito, Ranking Member Maloney, and Members of the Committee, thank you again for this opportunity to appear before you, and I would be pleased to respond to any questions that you may have.

If you are aware of fraud, waste, abuse, mismanagement or misrepresentations affiliated with the troubled asset relief program, please contact the SIGTARP Hotline.

Via Online: WWW.SIGTARP.GOV
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MOODY'S
INVESTORS SERVICE

Announcement: Moody's reviews BofA, Citi, Wells Fargo supported ratings for downgrade

Global Credit Research - 02 Jun 2011

New York, June 02, 2011 -- Moody's Investors Service has placed the deposit, senior debt, and senior subordinated debt ratings of Bank of America Corporation (A2 senior), Citigroup Inc. (A3 senior), Wells Fargo & Company (A1 senior), and their subsidiaries on review for possible downgrade. Each of these ratings currently incorporates an unusual amount of "uplift" from Moody's systemic support assumptions that were increased during the financial crisis. The review will focus on whether these ratings should be adjusted to remove this unusual uplift and include only pre-crisis levels of government support. At the same time, Moody's said that it will assess improvements in Bank of America's and Citigroup's standalone financial strength, and that this may temper the extent of any ratings downgrades that could result from its review of these firms' unusual level of systemic support.

Moody's also placed the Prime-1 ratings of Bank of America's and Citigroup's holding companies on review for possible downgrade. The Prime-1 rating of Wells Fargo's holding company, Wells Fargo & Company, was affirmed. Moody's also affirmed the Prime-1 ratings of all three companies' banking operations, including the Prime-1 ratings of Bank of America, N.A., Citibank, N.A., and Wells Fargo Bank N.A.

These actions had no impact on the FDIC-guaranteed debt issued by these firms, which remain at Aaa with a stable outlook.

MOODY'S CONTINUES TO ASSESS THE IMPACT OF THE DODD-FRANK ACT

Regulatory authorities continue to make progress in rulemaking, however, the final shape of the landscape remains uncertain. Today's rating actions reflect Moody's view that, in light of developments on the Dodd-Frank Act that have occurred to date, the unusual levels of uplift incorporated into the ratings of Bank of America, Citigroup, Wells Fargo may no longer be appropriate.

"The US government's intent under Dodd-Frank is very clear," says Senior Vice President Sean Jones. "Going forward, it does not want to bail out even large, systemically important banking groups." Mr. Jones notes however that Moody's continues to believe that such a group could not be resolved without risking a disorderly disruption of the marketplace and the broader economy. "Even so, the support assumptions built into these three banks' ratings are unusually high, which may no longer be appropriate in the evolving post-crisis environment," added Jones.

Moody's also continues to evaluate whether it should reduce to below even pre-crisis levels its support assumptions for the eight US banks that currently benefit from ratings uplift. In this context, the rating outlook on the deposit, senior debt, and senior subordinated debt ratings of Bank of New York Mellon has been changed to negative from stable. This brings its outlook into line with that of the other US banking groups whose debt and deposit ratings benefit from government support assumptions: JPMorgan Chase & Co, The Goldman Sachs Group, Inc., Morgan Stanley, and State Street Corporation.

Unlike the three institutions placed on review today, the support assumptions incorporated into these five groups' ratings are not unusual -- they remain similar to, not higher than, what they were before the crisis. Although Moody's considers it unlikely that it will withdraw all government support from the ratings of these eight banking groups, the agency will continue to evaluate the amount of uplift derived from support assumptions as regulators write and promulgate rules and regulations that could increase their ability to resolve

these institutions without triggering contagion and broader systemic risk. Given these potential developments, over time this could lead to Moody's reducing its support assumptions for these eight firms to below even pre-crisis levels.

SUPPORT FOR BOFA, CITI, AND WELLS FARGO EXCEEDS PRE-CRISIS LEVELS

Moody's government support assumptions for Bank of America, Citigroup, and Wells Fargo are higher than what similarly rated institutions would have received prior to the crisis. For example, Bank of America N.A.'s and Citibank N.A.'s C- (C minus) unsupported BFSRs translate to a Baa2 rating on Moody's long-term debt scale; prior to the crisis a similarly rated, systemically important bank would typically have benefited from no more than three notches of uplift, meaning its ratings would be no higher than A2. Currently, Bank of America receives five and Citibank four notches of uplift from government support assumptions, bringing their senior ratings to Aa3 and A1, respectively. Wells Fargo's unsupported BFSR of C+ (C plus) translates to an A2 rating on Moody's long-term debt scale; prior to the crisis a similarly rated, systemically important bank would typically have received no more than two notches of uplift, to Aa3. Currently, Wells Fargo's Aa2 senior rating benefits from three notches of uplift.

CONSIDERATION OF IMPROVEMENTS IN STANDALONE FINANCIAL STRENGTH OF BANK OF AMERICA AND CITIGROUP LEAD TO HYBRID RATING REVIEW AND COULD TEMPER DEBT AND DEPOSIT RATINGS DOWNGRADES.

Moody's has affirmed the C- (C minus) standalone bank financial strength rating (BFSR) of each of Bank of America and Citigroup, and affirmed the C+ (C plus) BFSR of Wells Fargo. However, Moody's will consider whether there has been sufficient improvement in Bank of America's and Citigroup's financial strengths to warrant increasing their Baa2 Baseline Credit Assessments (BCAs) to Baa1. Consequently, certain of their hybrid securities were placed under review for possible upgrade. These ratings do not incorporate any systemic support uplift, so the review of their ratings will be focused on the assessment of these firms' standalone financial strength. In addition, to the extent that the BCAs are increased, this would temper the size of the potential downgrades to Bank of America's and Citigroup's debt and deposit ratings.

During its assessment of Bank of America's and Citigroup's BCAs, Moody's will evaluate each bank's progress in improving its risk profile. Each of these banks have increased their equity through internal capital generation, and most of their asset quality indicators have improved. In addition, the costs related to repurchasing mortgages sold to third parties due to breaches in representations and warranties have stabilized at relatively modest levels for Citigroup, though Bank of America continues to experience a high level of repurchase costs, but has entered into settlements with the GSEs and Assured Guaranty that reduce its potential exposure to higher losses under a stress scenario.

Despite this progress, these banks still have sizable residential mortgage exposures; their credit costs could therefore spike if the US economy were to contract again. Further, they continue to face litigation costs related to faulty foreclosure practices.

"Other considerations will include the potential effectiveness of changes in risk management at Bank of America and Citigroup, given their poor performance during the credit crisis and their still sizable capital market activities, which we view as both opaque and volatile," Jones says, "while ongoing capital plans will also be important in our assessment."

The principal methodologies used in rating these issuers were "Bank Financial Strength Ratings: Global Methodology" published in February 2007, "Incorporation of Joint-Default Analysis into Moody's Bank Ratings: A Refined Methodology" published in March 2007, and "Moody's Guidelines for Rating Bank Hybrid Securities and Subordinated Debt published in November 2009, which can be found at www. moodys.com in the Rating Methodologies sub-directory under the Research & Ratings tab. Other methodologies and factors

that may have been considered in the process of rating these issuers can also be found in the Rating Methodologies sub-directory on Moody's website.

Please see ratings tab on the issuer/entity page on Moodys.com for the last rating action and the rating history.

A detailed list of the affected ratings is available on Moody's website, which may be accessed by clicking here http://www.moodys.com/viewresearchdoc.aspx?docid=PBS_SF248072

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Moody's Reviews Banks' Ratings

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Moody's Investors Service said Thursday that it was reviewing the ratings of the Bank of America Corporation, Citigroup and Wells Fargo & Company for possible downgrades.

The banks' current ratings are already in the middle of the investment-grade corporate credit ratings, and that is with a boost from Moody's assumption that the federal government would prevent them from failing in a crisis. Moody's said Thursday that this "too big to fail" assumption might no longer be true.

In a statement, a Moody's senior vice president, Sean Jones, said the Dodd-Frank Act made clear that the government "does not want to bail out even large, systemically important banking groups." One aim of the act, signed into law last July, was to make it easier to break up large financial institutions.

Moody's currently rates Bank of America's senior debt A2, Citigroup's A3 and Wells Fargo's A1. But the implied government backing pushes those ratings up.

The banks may not lose all of that ratings cushion. Moody's said improving financial strength at Citigroup and Bank of America might temper any ratings cuts.

A downgrade would very likely raise the banks' borrowing costs.

In total, eight banks have assumptions of government backing that give them higher ratings. The others are the Bank of New York Mellon Corporation, JPMorgan Chase & Company, the Goldman Sachs Group, Morgan Stanley and the State Street Corporation. Moody's said it continued to evaluate its assumption of federal backing for all of them.

THE WALL STREET JOURNAL.

Moody's, Citing End of U.S. Aid, Warns Bofa, Citi and Wells

By MATT PHILLIPS And DAVID BENOIT
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Moody's Investors Service said it may downgrade credit ratings of some of the biggest U.S. banks, as it reconsiders the likelihood that they will be supported by the government in times of trouble.

Moody's, a unit of Moody's Corp., on Thursday said it is reviewing the ratings of financial giants such as Bank of America Corp., Citigroup Inc. and Wells Fargo & Co. Bank ratings historically have included the assumption that the government would step in to support them during a crisis.

Moody's analysts are reviewing whether the government is less likely to support banks once the new Dodd-Frank financial overhaul rules are put into place. That lack of support could cost the banks one ratings notch or more. On the other hand, Moody's said some improvement in the bank's operations could temper some of those cuts.

"Certainly the intent of the U.S. regulator is pretty clear in that they don't want to support banks going forward," Bob Young, managing director of Moody's banking team, said in an interview. "There's no single thing that we can hang this on; rather it's an evolving post-crisis environment."

The issue of whether any bank should be considered too big to fail has become a lightning rod in Washington and the financial markets. The Dodd-Frank rules include a "systemically important" designation, a category devised for firms considered big enough to threaten the entire financial system if they fail.

Some believe that means the government will step in, as it did during the last financial crisis.

Systemically important "tends to imply that the biggest banks are still too big to fail," said Mike Mayo, a banking analyst with Crédit Agricole Securities. "I see limited evidence that there's a lessening of systemic support."

Credit-rating downgrades would still have important implications for banks. They would likely increase the cost of borrowing for banks as investors demand more compensation for the higher risk.

Moody's rates Bank of America A2, Citigroup A3 and Wells Fargo A1.

Moody's said Bank of America, Citi and Wells Fargo have unusually high support ratings even compared to other giant banks, whose support ratings now are similar to those from before the financial crisis.

Moody's said it is unlikely it would withdraw the assumption of government backing from all ratings, but noted it might reduce assumptions on other banks as well.

Other banks with some government support built into their ratings, Moody's said, include Goldman Sachs Group Inc., J.P. Morgan Chase & Co. and Morgan Stanley, Bank of New York Mellon Corp. and State Street Corp.

Moody's said that it will take into account improvements in asset quality and capital at Bank of America and Citigroup, noting that "this may temper the extent of any ratings downgrades that could result from its review of these firms' unusual level of systemic support."

A Bank of America spokesman said the bank believes its stand-alone rating should be higher because it was last adjusted in November 2009, before initiatives it took to "strengthen our balance sheet, improve capital and liquidity, and reduce our risk profile."

"We welcome the reassessment of our standalone financial strength by Moody's," said John Gerspach, Citigroup's chief financial officer, in a statement.

A Wells Fargo spokeswoman noted the company's ratings "remain among the strongest in the industry."

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