An Update on Ending Too Big to Fail

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Good afternoon. Thank you, Adam, for that kind introduction and for you and your colleagues at the Peterson Institute co-hosting this important event with us. Scholars at the Peterson Institute have been leaders in addressing financial stability and systemic risk issues, and we are pleased to collaborate with you on today's event. Before I begin, I would just like to remind everyone that the views I express today are my own and not necessarily those of the Federal Open Market Committee or the Board of Governors, which sets supervision and regulatory policy for the Federal Reserve System.

I come at the too-big-to-fail (TBTF) problem from the perspective of a policymaker who was on the front line responding to the 2008 financial crisis. Over the past six years, legislators and regulators have worked hard to address TBTF. My colleagues in the Federal Reserve System, working closely with other financial regulators, have implemented important tools and regulations that are making the financial system stronger under the reform framework Congress established.

I agree that many current reform efforts are headed in the right direction, particularly those that make banks[2] stronger with additional capital and deeper liquidity. But I do not think these measures go far enough. As a result, we are working on a plan to end TBTF and are hosting a series of public symposiums, including today's, that bring together some of the foremost experts on financial stability, bank regulation and systemic risk. And we have asked these experts to explore the current and potential alternative regulatory frameworks to address the risks posed by large banks. Today I will update you on that effort.

Specifically, I will cover three main items in our initiative to end TBTF:

- First, information from our May symposium makes me even more committed to recommending transformational solutions to address the systemic risks posed by large banks. What I heard suggests deep and broad agreement that the largest banks in the country are still TBTF and that we need to act now to fix this problem.

[1] I thank Ron Feldman, Danita Ng, Jenni Schoppers, and David Wargin for giving helpful feedback on this speech.
[2] I use "banks" in this talk to include banks, bank holding companies and other nonbank financial institutions.

- Second, I will highlight some of the key take-aways from our first two symposiums that reinforce my concerns about current efforts to address TBTF. I left our May symposium profoundly skeptical that current efforts will ultimately work.

- Third, I will end with important questions that have been raised in our initiative so far that require additional understanding. Then I look forward to having a discussion with Adam, Bertrand and the audience.

Common ground on what needs to occur

I started the ending TBTF initiative knowing that while we would have many supporters across the spectrum, many others might disagree with our effort. And, not surprisingly, we have received significant criticism from big banks and their lobbyists who would like to discredit this important initiative. But one of the main take-aways from our symposiums was the relatively broad agreement on some of the central parts of our effort.

First, we need massive structural changes in the financial system and among large banks. Even those participants in our symposiums who expressed confidence in the current regulatory approach agree that a fundamental restructuring of the banking system is coming. They view such a restructuring as an indicator that the current framework is having the desired effect. Rather than the government deciding how to restructure the banking system, the new regulations will ultimately force large banks to restructure themselves. Indeed, there are examples of large financial institutions beginning to shed assets in response to new regulatory pressures. Give it more time, these experts argue. Almost none of the experts we have consulted with believe the industry can and should stay in its current form. The only disagreement was about the scale and the speed of that restructuring.

Second, large banks currently remain TBTF. While a majority of experts on our bank resolution panel[3] from our symposium in May expressed confidence that the new resolution framework would ultimately be effective for large banks, a majority of them

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[3] Panelists were Ben S. Bernanke, Distinguished Fellow in Residence, Economic Studies, Brookings Institution and former Chairman of the Board of Governors of the Federal Reserve System and the Federal Open Market Committee from February 2006 to January 2014; J. Christopher Flowers, Managing Director and CEO of J.C. Flowers & Co.; Richard J. Herring, Jacob Safra Professor of International Banking and Professor of Finance, Wharton School, University of Pennsylvania; David A. Skeel, S. Samuel Arsht Professor of Corporate Law, University of Pennsylvania Law School.

also argued that if a large bank ran into trouble today, it would still need a taxpayer bailout because the implementation of the new regulations remains incomplete. Consistent with this observation is the recent result of the living will exercise. Of the eight largest U.S. banks, both the FDIC and the Federal Reserve recently deemed the living wills of five of them “not credible.[4]” Two of the eight banks were deemed “not credible” by either the FDIC or the Federal Reserve, but not both. The living will of the one final bank, the best of the group, wasn’t actually rated “credible.” It was just not “not credible.” That doesn’t inspire a lot of confidence.

Third, we must act now to address TBTF. There was also a shared concern that as memories of the crisis fade, the will to complete the implementation of current reforms (let alone introduce new ones) weakens. This outcome leaves the financial system exposed to unacceptable risks if reforms are left incomplete. Indeed, this is part of the motivation for our ending TBTF initiative: to trigger a serious national conversation about the risks posed by large banks while we still remember how painful the crisis was for society.

Fourth, we must stop risk from shifting in response to reforms. Even with a safer banking system in place, I firmly believe we must take action to prevent risk from simply going to another corner of the financial system. Experts at our symposium seemed to agree that some steps must be taken to actually reduce risk and not simply move it around.

The issue of risk-shifting from the commercial banking sector to the shadow banking system is particularly acute in the United States. According to the Financial Stability Board, the United States has the largest shadow banking sector, with $14.2 trillion in 2014, representing more than a third of global shadow banking assets reported by 26 developed and emerging countries across the globe.[5]

But important differences remain on how to end TBTF

There is more agreement than I expected on the key reasons to move forward with our ending TBTF initiative. By contrast, what I heard at our meetings confirms that I may have important differences with some colleagues about how much progress has been

[4] See the April 13, 2016, press release on resolution plans at http://www.federalreserve.gov/newsevents/press/bcreg/20160413a.htm.
[5] See the Financial Stability Board’s Nov. 12, 2015, report at http://www.fsb.org/2015/11/global-shadow-banking-monitoring-report-2015/.

made and the best way to address them. Many of these differences focus on the idea that we will solve TBTF by imposing losses on long-term debt holders of large banks (the so-called total loss-absorbing capacity or TLAC plan) during a stressed economic environment.

In a prior speech,[6] I explained why I do not have confidence that the contingent convertible debt included in the TLAC plan should actually count as capital because I doubt it will actually face losses in a crisis. I explained why I believe it is a mechanism to spread risk rather than contain it.

Why do I think a plan that requires the government to stick losses on long-term debt holders during a crisis will not work?

First, this approach is too complex and has too many moving parts to work when we need it to. Complexity is the enemy of a robust plan. Let me review the crisis response for a point of comparison. Arresting the 2008 crisis required the overwhelming force of the combined powers of the Federal Reserve, Treasury and FDIC all firing in unison. Our solution was fairly simple: put the balance sheet of the federal government behind the private financial system. We did that by providing as much liquidity as possible to as many stressed corners of the market as possible, and by shifting as many potential losses as we could from the private sector to the public sector. It was extremely blunt, but it was ultimately effective.

Do we really believe that in the middle of economic distress when the public is looking for safety that the government will start imposing losses on debt holders, potentially increasing fear and panic among investors? Policymakers didn't do that in 2008. There is no evidence that their response in a future crisis will be any different. When I heard experts describe the TLAC approach during our symposium, it sounded like a plan that requires everything to work out perfectly when we know that in a crisis, that simply does not happen.

A policy analyst recently asked me if we really could resolve a large bank during a crisis. I responded by asking him if he thought we could dismantle an aircraft carrier in the middle of a hurricane. It's not a perfect analogy, but he got my point.

[6] See the April 18, 2016, speech before the Minnesota Chamber of Commerce at https://www.minneapolisfed.org/news-and-events/presidents-speeches/update-on-minneapolis-fed-ending-too-big-to-fail-initiative.

Second, this approach leans too heavily on supervisory wisdom. One question asked about TLAC at our meetings was, why not simply have banks' capital be entirely equity instead of both convertible debt and equity? An answer I heard from some regulators is that having a smaller equity cushion will prompt supervisors to act more quickly as the equity is erased by losses. At that point, the supervisors can move the firm into resolution where the debt converts and becomes the equity of the recapitalized new firm, thus avoiding taxpayer bailouts. If supervisors waited longer to act under this approach, the losses of the bank might consume the long-term debt as well, leaving nothing for the recapitalization.

I object to this approach for two reasons. First, it immediately reinforces my concern about complexity. Second, this approach assumes that all-knowing, well-intentioned regulators, seizing a bank earlier, will somehow reduce the total losses the bank ultimately faces. I vividly remember the collapse of Bear Stearns in March 2008. In a couple of weeks, Bear Stearns went from normal operations to insolvency.
Once creditors seriously doubted the viability of Bear, the outcome was largely sealed. Closing Bear a week earlier would not have reduced the large losses Bear had due to its bad investments, which were made long before the stress became apparent to management or bank supervisors.

We have very talented professionals in the Federal Reserve System and in other financial agencies. But we must be humble. We would not have had a financial crisis in the first place if government officials were wiser than everyone else. I've mentioned this before, but when I first went to Treasury in 2006, Treasury Secretary Henry Paulson directed his staff (including me) to work with financial regulators to look for what might trigger the next crisis. We looked at a number of scenarios, including an individual large bank running into trouble or a hedge fund suffering large losses, among others. We didn't consider a nationwide housing downturn. It seems so obvious now, but we didn't see it, and we were looking. We should design our regulatory framework to assume that, as in 2008, regulators won't have better insights than market participants. We must assume they won't see a future crisis coming until it is too late.

Finally, this approach defies market logic. Part of the rationale for using convertible debt in the new regulatory framework is that it is supposed to be significantly cheaper than equity; hence, borrowing costs for Main Street should be lower. But is this really true?

On one hand, regulators are saying believe us, contingent debt is as good as common equity in its power to absorb losses if a bank runs into trouble. We will really force bondholders to take losses.

On the other hand, the same regulators are saying investors will price these securities closer to debt than equity. But if these securities truly do face equity-like downside risk, (by the way, without the upside of equity), why would investors price them more like debt?

I see three possible explanations: (1) The securities *aren't* really going to face losses, so they aren't really capital. They will be cheaper than equity because they are really debt, which means they won't provide much financial stability benefit. (2) The securities really *are* going to face losses, and investors will then price them more like equity, so there is little benefit for their added complexity, compared with banks just issuing more common stock. Or (3) investors will misunderstand the risk and underprice these convertible securities similarly to debt, while regulators will really make them face losses like equity.

It strikes me that a regulatory framework that relies on investors' mispricing risk may work for a time but isn't likely to work over the long term.

Questions going forward

Today's symposium is important because we are exploring, in greater depth, the trade-offs associated with higher capital standards. Increased capital, in the form of common equity, solves many problems. It is the simplest and arguably the most powerful tool to make banks stronger. It can reduce, rather than increase, complexity. Its simplicity means that it also has the best chance of working over decades as the financial system evolves and new financial instruments are introduced. Higher capital may also reduce pressure on supervisors.

More capital has downsides that need further exploration. In particular, higher capital could raise the cost of lending and potentially reduce economic activity. But to what extent? How should we measure such costs?

Increased capital standards for large banks have the potential to push risk to non-banks, such as hedge funds and insurance companies. Experts appropriately ask, if we substantially increase (and simplify) capital standards for banks and that drives risky activities elsewhere, has financial stability really improved? This is an important question.

We touched on this in our May symposium, where experts discussed whether a tax on financial firm debt could be a means to level the playing field so that risk isn't pushed to nonbanks. But this introduces many additional questions: How should regulators size such a tax? To whom should it apply: all financial institutions or just nonbank financial institutions? Would there be unintended consequences of such a tax?

These are some of the questions we are going to continue to try to answer as our ending TBTF initiative proceeds. All of this work will culminate in our recommended plan to end TBTF, which we are committed to releasing to the public by the end of the year.

Thank you.