Statement of
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on
Systemically Important Institutions and the Issue of "Too Big to Fail"
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Chairman Angelides, Vice Chairman Thomas, and Commissioners, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) on how systemic risks can be managed and mitigated in the wake of the financial crisis using the new tools provided by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[1]

The market turmoil of late 2008 is now largely behind us, but the consequences for the U.S. financial system and economy continue. The fall of 2008 was marked by unprecedented levels of mortgage defaults, extreme risk aversion in financial markets and, finally, generalized illiquidity in global money markets. This chain of events ultimately led to the problems of a number of large, complex banks, bank holding companies, and non-bank financial companies, some of which were subject to prudential supervision and the FDIC's resolution authority and some that were not. Taken together, these financial disruptions had a rapid and highly adverse effect on real economic activity here and around the world. The events led to unprecedented government intervention to restore order to the financial markets, including the bailouts of a number of large financial institutions both here and abroad.

While the financial system and the U.S. economy are now recovering from the immediate effects of the crisis, it has caused widespread damage to communities across the nation. Millions of families have experienced job loss, home foreclosure, and reduced savings and retirement funds. Businesses—small ones in particular—have suffered from declining consumer demand and tight credit. State and local governments have faced substantial budgetary shortfalls. Hundreds of community banks have failed and many more remain troubled. Clearly, the impact of the financial crisis will be felt for some time to come.

As the recovery slowly moves forward, it is important to apply the lessons learned in the crisis and implement strong, sensible reforms that will prevent a costly recurrence. The facts surrounding the collapse of two large banks—Washington Mutual Bank (WaMu) and Wachovia Bank—illustrate many of the challenges faced by the FDIC in resolving large, complex financial institutions under the rules in place at that time. In addition, because holding companies of large banks and non-bank financial companies were subject to the Bankruptcy Code when they ran into trouble, their failures were much more difficult to resolve without either bailing-out stakeholders or causing systemic risk

to the financial system. Failing non-bank financial companies also could only be resolved under the Bankruptcy Code, further exacerbating the financial crisis.

My remarks today will primarily focus on the provisions to enhance financial company regulation and resolution procedures recently enacted in the Dodd-Frank Act. If properly implemented, these provisions will not only reduce the likelihood of future financial crises but will also provide effective tools to address large financial company failures when they do occur without resorting to taxpayer-supported bailouts or damaging the financial system.

Dilemmas Faced in Resolving Large Bank Failures During the Crisis

In my January 2010 testimony before the FCIC, I discussed a number of interrelated factors that contributed to the buildup of risks in our financial system and led to the crisis. Many of those causal factors stemmed from a set of misaligned incentives among all of the parties to the securitization process—including borrowers, loan originators, credit rating agencies, loan securitizers, and investors. Differences in the regulation of capital, leverage, and consumer protection between institutions in the shadow banking system and the traditional banking sector, and the almost complete lack of regulation of over-the-counter derivatives, allowed regulatory arbitrage to proliferate. Even within the regulatory system, existing authorities were not always used and consumers were not adequately protected. Moreover, the lack of an effective resolution process for large, complex financial institutions limited regulators' ability to manage the crisis as it unfolded.

Liquidity Crisis. Starting in mid 2007, global financial markets began to experience serious liquidity challenges related mainly to rising concerns about U.S. mortgage credit quality. As U.S. home prices fell, recently-originated subprime and non-traditional mortgage loans began to default at record rates. These developments led to growing concerns about the value of financial positions in mortgage-backed securities and related derivative instruments held by major financial institutions in the U.S. and around the world. The difficulty in determining the value of mortgage-related assets and, therefore, the balance-sheet strength of large banks and non-bank financial institutions ultimately led these institutions to become wary of lending to one another, even on a short-term basis.

Disruptions in the interbank lending market and declines in the value of mortgage-related security holdings directly affected the stability of bank funding and the liquidity of bank asset portfolios. During late 2007 and early 2008, the FDIC began to see failures of some smaller depository institutions that occurred not because the institution had become critically undercapitalized, but because of a rapidly deteriorating liquidity position. The FDIC was in several cases forced by events to move more quickly to resolve these institutions than would normally be the case for failures arising from capital deficiency.

In early 2008, the liquidity crisis began to have serious consequences for larger banks, thrifts, and non-bank financial companies with heavy exposures to mortgage-related

assets. Starting with Bear Stearns in March 2008, a succession of large institutions experienced funding crises that led to either their failure, conservatorship, or forced acquisition. But the most severe blow to the financial markets came from the bankruptcy on September 15, 2008 of the $600 billion investment bank Lehman Brothers, which was immediately followed by the collapse and bailout of the $1 trillion insurance corporation American International Group (AIG). The Lehman bankruptcy has been cited as prompting "significant changes in spreads and access to credit" in the interbank market because it was interpreted as "an implicit shock to the market's belief that large banks would not be allowed to fail."[2] Moreover, the well-documented shortcomings of the bankruptcy process as applied to financial companies, in terms of its ability to ensure funding, complete settlements, and promptly restore certainty to financial valuations, likely contributed to the disruptions that resulted from Lehman.[3] As a result, between September 12th and October 10th, the TED spread, a measure of the cost of interbank borrowing relative to Treasury yields, more than tripled from 135 basis points to 464 basis points, with half of that increase occurring by September 24th.[4]

Effect on WaMu and Wachovia. These events were but a prelude to the final week of September 2008, when the FDIC and other regulators were forced to deal with the failure of WaMu ($307 billion in assets) and a funding crisis at Wachovia Bank ($782 billion in assets). These institutions, at that time, were the largest federally insured banking institutions ever to fail or require government assistance.[5] Similar to the previous cases of large mortgage specialists, the serious asset quality problems of these institutions arising from mortgage defaults were ultimately eclipsed by a funding crisis as the markets backed away from further exposure to them. As the two companies' financial condition weakened, unsecured borrowing lines were cut, secured borrowing lines were restricted, and deposits were withdrawn at an accelerating pace. Market pressure and deposit outflows increased rapidly in the wake of the Lehman bankruptcy and the AIG collapse.

Unable to raise capital to counter the losses and liquidity stress, WaMu was closed on Thursday September 25th. The following day, Wachovia experienced increased liquidity pressure as the market reacted to the company's rapidly deteriorating financial condition. On Friday, September 26th, the market was no longer accepting Wachovia's liabilities as its stock plunged and its credit default swaps rose sharply. Some parties declined to advance the Bank overnight funds and counterparties advised that they would require greater collateralization on any transactions with the Bank.

As liquidity problems were building at Wachovia during the weeks of September 15th and September 22nd, the FDIC maintained frequent contact with the primary federal regulator—the Office of the Comptroller of the Currency (OCC)—and the Federal Reserve Board (FRB) as to the liquidity position of the Bank. On the evening of Thursday, September 25th, two regular counterparties declined to lend to the Bank; however, as the Bank was a net seller of fed funds this signal was not viewed by the OCC as a catastrophic development.[6] As discussed later, the failure of WaMu was announced late in the evening on September 25th. As of the morning of Friday, September 26th, the OCC indicated to the FDIC that the institution's liquidity problems were manageable. By the end of the day on Friday, September 26th, however,

Wachovia management informed bank regulators that market acceptance of Wachovia liabilities was vanishing and that the institution faced a near-term liquidity crisis. Although Wachovia had already started the process of selling itself following the collapse of Lehman, these heightened liquidity challenges set in motion a highly-accelerated effort to find a solution under which it could be resolved while protecting insured depositors and minimizing damage to the wider financial system.[7]

Resolution Outcomes. Despite the similarities between WaMu and Wachovia in terms of their asset quality and liquidity problems, disparities in the timeframe available to respond to each situation and the quality of available information about their structure and counterparty relationships resulted in vastly different resolution decisions and outcomes. In the case of WaMu, the FDIC had time to plan and implement an orderly resolution in advance. WaMu had been marketing itself early in 2008, and a number of institutions had conducted extensive due diligence of the institution. It had also been the subject of intensive FDIC supervisory attention for many months. Although the FDIC had only a short amount of time to market the institution, we were able to solicit bids from a number of potential acquirers because of the information they had already acquired directly from WaMu. When circumstances forced the closure of WaMu late on the evening of September 25th, one day earlier than originally planned, the FDIC was still able to complete the orderly transfer of its more than 2,300 branches to JPMorgan Chase by the next day.

Other factors also aided the FDIC's efforts to resolve WaMu. Even with assets of over $300 billion, WaMu was vastly simpler in its structure compared with other similarly sized depository institutions. Its main institutional focus was on mortgage lending. While WaMu had derivatives contracts, they were used for hedging and not as part of a market-making operation. In addition, WaMu held no foreign deposits and there were no major holding company subsidiaries involved in significant financial services such as a broker dealer that might result in large losses if forced into bankruptcy as a result of the failure of the thrift.

In this particular case, with the benefit of a large cushion of unsecured liabilities exposed to loss in the failure, the Deposit Insurance Fund did not incur any loss due to the failure of WaMu. Instead, unsecured, non-depositor creditors incurred all of the losses, in accordance with the statutorily prescribed priority for the payment of claims. The transaction demonstrated that in the case of an institution with a relatively simple organizational and legal structure, which is not highly connected to counterparties that would expose them to catastrophic loss, the FDIC's receivership authority and operational capacity in place as of 2008 was sufficient to resolve a $300 billion institution with 2,300 branches without resorting to a bailout and without creating further disruption to the financial system.

By contrast, the short timeframe for developing a resolution strategy and soliciting acquirer bids sharply limited the FDIC's options in the case of Wachovia. Given the prevailing market conditions, Wachovia's size, structure, counterparty relationships and activities rendered it very difficult to resolve under the FDIC's statutory least-cost mandate without risking systemic effects. Also, Wachovia's debt provided back-up

liquidity support to many other traded instruments. Based on available information, default on Wachovia's counterparty obligations could have contributed further to overall market instability. Accordingly, Wachovia was found by the FDIC Board, the FRB and the Treasury, under the statutory provisions in place at that time, to pose a systemic risk to the financial system. This finding permitted the FDIC to consider other resolution options that might not be the least costly to the Deposit Insurance Fund and that might result in protection for certain investors and other counterparties in addition to insured depositors.

On the morning of Monday September 29th, before U.S. financial markets opened for the day, the FDIC Board and the FRB voted to recommend a systemic risk determination to the Treasury Secretary, who (in consultation with the President) made the final determination authorizing the FDIC to provide assistance to Citigroup for its acquisition of Wachovia. Proposed government assistance would have come in the form of an asset guaranty on a portion of Wachovia's assets in exchange for $12 billion in Citigroup preferred stock and warrants. The terms of the asset guaranty called for Citigroup to absorb the first $42 billion in losses on a $312 billion segment of Wachovia's assets, with the FDIC covering losses above that amount. While aggregate losses on these assets were projected by FDIC staff to range between $35 billion to $52 billion, losses in that range would not have exceeded the first loss position and compensation for the guaranty and, therefore, no loss to the Deposit Insurance Fund was projected. Under the terms of the proposed transaction, losses were to be absorbed entirely by equity holders, who stood to receive only about one dollar per share in the transaction. Debt holders, uninsured depositors, and other counterparties were to be protected from loss in the interest of mitigating adverse systemic effects on financial markets and other financial institutions. However, these loss projections were subject to some uncertainty due to the compressed time frames for the performance of this analysis.

In the end, the Citigroup transaction was superceded by an unassisted bid by Wells Fargo to acquire Wachovia that was announced on Friday, October 3rd. The deal provided Wachovia shareholders with some $15.1 billion in Wells Fargo stock (about seven dollars a share when announced), thereby improving their outcome compared to the terms of the deal with Citigroup.

The contrast between WaMu and Wachovia illustrates how the complexities of resolving large financial institutions could, under the rules in place in 2008, result in disparate treatment for investors and counterparties in different institutions. The next section provides more background on the complexities associated with resolving large financial institutions and the critical shortcomings of the commercial bankruptcy process as a resolution method in crisis situations. These considerations will lead in the following section to a discussion of how the new resolution tools provided under the Dodd-Frank Act can make this process more efficient and more equitable if properly implemented.

Resolving Large, Complex Institutions. Large financial institutions pose a variety of special challenges when they fail because of their size, structure, counterparty relationships and activities. Perhaps most notably, large financial services organizations that are dominant players in certain specialized markets for financial assets can create

a *systemic risk* simply by virtue of their extensive counterparty exposures. These exposures, and even linkages between business lines within a given organization, may not be readily apparent prior to failure. Without the necessary tools in place to understand and mitigate these exposures, the failure of such an institution could impose losses or liquidity stresses on counterparties that are so large and widespread that they would lead to still more failures and/or the disruption of the interbank lending market, thereby destabilizing the entire financial system. Large, complex institutions are also difficult to resolve because they have fewer potential acquirers (who themselves may be negatively impacted by the failure of the target institution), and may have franchises (such as broker dealer operations) whose value dissipates quickly following failure.

Another crucial barrier to accomplishing an orderly resolution of a failed financial institution involves the complexity of its structure. Large bank holding companies or other nonbank financial institutions frequently have many different business lines, any one of which may extend across different subsidiaries, other legal entities, or international jurisdictions. Under the resolution authority available in 2008, even if the FDIC were to be appointed receiver for an insured depository institution subsidiary of a bank holding company, many of the operations of that bank might lie wholly or partially outside of the insured institution and be subject to the Bankruptcy Code or the laws of a foreign country. Prompt and efficient resolution of a failed institution, which is essential to preserving financial market stability in a crisis, is very difficult to achieve under tight timeframes in the face of such complexities.

Limitations of Bankruptcy. The U.S. bankruptcy process is highly effective in reorganizing or liquidating the operations of nonfinancial companies. However, as the FDIC has pointed out in previous testimony, it has some critical shortcomings when it is applied to large financial institutions. A bankruptcy court does not regularly resolve financial firms. Nor does it have the capacity to work with financial regulators to prepare in advance for such a firm's failure, as the FDIC does routinely. The standard bankruptcy process of debtor in possession and the appointment of new trustees or a creditors committee makes it impossible to undertake the type of extensive pre-planning that is essential to the FDIC's ability to provide continuity for critical operations, ensure a prompt acquisition of the failed institution and minimize economic disruption.

When large financial companies enter bankruptcy, they may be unable to complete settlements and access sources of liquidity. For example, about 100 hedge funds used Lehman as their prime broker and relied heavily on the firm for financing. As administrators took charge of the London business and the U.S. holding company filed for bankruptcy, positions held by those hedge funds at Lehman were frozen. Large financial firms are particularly dependent on short-term, market-based funding and their assets are highly vulnerable to a loss of market confidence. Like banks, financial firms (holding companies and their affiliates) can experience "runs" if their short-term liabilities come due and cannot be rolled over. The liquid assets of a large financial firm can dissipate quickly, and a protracted litigation process may seriously impair franchise value, increasing resolution costs and potentially destabilizing the financial system.

In contrast to the overnight resolution of WaMu and transfer of its assets and liabilities to JPMorgan Chase, Lehman has offered only a "blueprint" for its reorganization some 18 months after its Chapter 11 filing. The extensive delays and cumbersome process in bankruptcy also make the process very costly in the case of large financial firms. As of July 2010, fees and expenses incurred in the administration of the Lehman bankruptcy had already amounted to approximately $918 million.[8] Moreover, experts have estimated that some $75 billion in value to investors has been destroyed by the form of the Lehman bankruptcy.[9] In contrast to the high cost and long timeframe of the bankruptcy process, the relative speed and predictability of the receivership process provides a measure of certainty to financial markets, which can be essential in mitigating the effects of a market shock.

Former Rules Led to Systemic Risk. Large, complex banking institutions inevitably are part of complex holding company structures that include both banks and non-banks. While the Federal Deposit Insurance Act (FDI Act) provides a sound framework to resolve banks, the events of 2008 demonstrated that U.S. law did not provide a similar framework for the liquidation of a holding company or its non-bank subsidiaries. In addition, many complex activities were conducted through off-balance sheet vehicles and transactions that masked the extent of the exposures and their potential impact on other market participants. In a case where the failure of a bank could create systemic risks, the FDIC had adequate legal authorities in place in 2008 to address those risks under the FDI Act. Where the risks could be created by the failure of the broader holding company or non-bank subsidiaries, there was simply no alternative to the use of the Bankruptcy Code with the potential difficulties illustrated by the bankruptcy proceedings involving Lehman Brothers.

While I have described how these factors influenced the resolution strategy in the case of Wachovia, I would add that complex organizational structures and extensive counterparty exposures were an even larger problem when the FDIC was providing or considering open-bank financial assistance to Citibank and Bank of America in late 2008 and early 2009. While the injection of preferred equity into a number of large financial institutions under the Troubled Asset Relief Program was authorized by statute rather than through an administrative finding of systemic risk, the underlying premise of the program was that the failure of these institutions posed a systemic risk that must be avoided, even at the cost of a bailout.

How New Resolution Tools Will Help Prevent Financial Crises and Bailouts

In my testimony before this Committee in January 2010, I outlined what I saw as the three pillars of financial reform needed in the wake of the crisis: resolution authority, systemic oversight, and consumer protection. I am pleased that Congress has passed an historic package of reforms that address each of these areas. On resolution authority, the new law gives the FDIC broad authority to use receivership powers, similar to those used for insured banks, to close and liquidate systemic financial firms in an orderly manner. On systemic oversight, it creates the Financial Stability Oversight Council (FSOC) to provide a macro view to identify and address emerging systemic risks and close the gaps in our financial supervisory system. Regulators also are

empowered to provide much-needed oversight to derivatives markets. On consumer protection, the unregulated shadow financial sector is finally being placed under the oversight of a Consumer Financial Protection Bureau (CFPB) that will set and maintain strong, uniform consumer protection rules for both banks and non-bank financial firms.

The new regulatory tools made available by the Dodd-Frank Act provide a roadmap for maintaining financial stability in the face of potential systemic risks posed by large, complex, interconnected financial institutions and financial activities. They force large, complex financial firms to take primary responsibility for managing the risks that they pose to the financial system. They also provide regulators with the authority to verify the effectiveness of these risk management plans. In the less likely event of a future financial crisis, these tools provide an orderly and transparent means for winding down systemically important financial companies. Having a detailed plan in place to deal with systemically risky financial companies creates a measure of certainty for financial market participants, and, therefore, enhances the stability of the financial system.

Resolution Plans. Detailed plans for rapid and orderly resolution in the event of financial distress or failure—often referred to as "Living Wills—are now required of all non-bank financial companies designated by the Council for supervision by the FRB and all bank holding companies (BHC) with at least $50 billion in assets.

The FDIC and FRB are now developing the required implementing regulations, which must be completed within 18 months of enactment. The FDIC strongly believes that it is essential that these regulations be in place as soon as feasible to enhance preparedness for any future crisis. These resolution plans will help to ensure that systemically risky companies take responsibility for reassessing the complexity of their operations and the risks it creates for the firm and the financial system. Requiring these companies to submit resolution plans also imposes the responsibility of assessing the effectiveness of risk management plans on the companies themselves, as they will have to explain their plans in detail to the FDIC, the FRB, and their primary regulators. For example, the Dodd-Frank Act requires that each plan must describe fully the ownership, structure, assets, liabilities, and contractual obligations of the company and identify cross-guarantees tied to different securities, major counterparties, and a process for determining to whom the collateral of the company is pledged. In addition to these statutory requirements for resolution plans, the FRB and the FDIC may jointly require by rule or order other information that may be useful in the orderly resolution of a company.

As discussed in greater detail below, the company's failure to do so may result in the imposition of more stringent capital, leverage, or liquidity requirements, or restrictions on the growth, activities, or operations of the company, or any subsidiary thereof, until the company resubmits a plan that remedies the deficiencies. If, after two years and more stringent requirements or restrictions, the company has failed to resubmit an acceptable plan, the FRB and the FDIC, in consultation with the Council, may jointly require divestiture of certain assets or operations to facilitate an orderly resolution under the Bankruptcy Code. In other words, the government would be authorized to break up the institution so that it no longer creates undue risk to the financial system.

Backup Examination and Enforcement Authority. The Dodd-Frank Act also authorizes the FDIC to examine a non-bank financial company supervised by the FRB or a BHC with at least $50 billion in assets, in certain circumstances, if the FDIC Board determines such an examination is necessary to determine the condition of the company for purposes of implementing the FDIC's orderly liquidation authority. Before conducting a backup examination, the FDIC will review any available and acceptable resolution plans submitted by the company, as well as available reports of examination, and coordinate to the maximum extent practicable with the FRB to minimize duplicative or conflicting examinations. However, just as in the bank context, backup examination authority likely would play a key role in the planning for any potential orderly liquidation of a systemically important financial company under Title II of the Dodd-Frank Act.

Similarly, the Dodd-Frank Act gives the FDIC backup enforcement authority over a depository institution holding company if the conduct or threatened conduct of the depository institution holding company poses a risk to the Deposit Insurance Fund. The conduct of the depository institution holding company also may form the basis for a backup enforcement action with respect to an insured depository institution subsidiary. This new authority recognizes that the activities and practices of the holding company may affect the safety and soundness of the insured depository institution.

Resolution Authority. Title II of the Dodd-Frank Act establishes the authority for resolving failed systemically important non-bank financial companies in a manner substantially similar to the FDIC's resolution process for depository institutions. If these tools had been in place before the recent financial crisis, the FDIC could have avoided the dilemmas it faced in resolving large bank failures in late 2008 specifically because it would also have had the authority to resolve their holding companies. Most importantly, had a clear path for the orderly resolution of systemically important financial companies been in place prior to the Bank of America takeover of Merrill Lynch and the almost concurrent bankruptcy of Lehman Brothers, investors would have had much more certainty as to how regulators would deal with the failure of large banks and nonbank institutions. Thus, much of the chaos that ensued in September 2008 could have been avoided. Indeed, as noted in FDIC's earlier testimony, the rapidly deteriorating financial condition of both WaMu and Wachovia was in large part triggered by other high-profile failures, most notably the bankruptcy of Lehman Brothers.

Before taking action under the orderly liquidation authority, the Dodd-Frank Act requires the FDIC to determine that such action is necessary for purposes of financial stability and not for the purpose of preserving the covered financial company. The FDIC must also ensure that the shareholders do not receive payment until all other claims are satisfied and the Orderly Liquidation Fund is repaid. Unsecured creditors must bear losses in accordance with the priority of claims provisions. Management and directors responsible for the failure must be removed. Finally, the FDIC is prohibited from taking an equity interest or becoming a shareholder in any covered financial company or covered subsidiary.

Had the backup examination authority and authority to require resolution plans been in effect in 2008, the FDIC would have had earlier direct access to the institution's

deteriorating condition and a detailed resolution plan provided by Wachovia Corporation in hand to help in planning for a response to its impending failure. This would have facilitated much better planning for the resolution of the bank and for the resolution of the holding company and the non-bank affiliates of Wachovia under either the Bankruptcy Code or the Dodd-Frank Act. Losses would have appropriately fallen on shareholders and unsecured debt holders. Distortions and delays in the resolution process—created by the need to separate certain assets and liabilities of insured depository institutions from those of the parent company and affiliates—could have been avoided. Moreover, resolution plans would have provided the FDIC with a roadmap for winding down any and all systemically important financial companies—FDIC-insured and otherwise—without resorting to taxpayer bailouts.

Also, had the current law been in place in 2008, market expectations would have been different. The Dodd-Frank Act makes clear that its purposes include ending "Too Big to Fail" and minimizing moral hazard, as well as mitigating systemic risk. For example, the Title II orderly liquidation authority for non-bank financial companies is to be exercised in the manner that best fulfills those purposes such that creditors and shareholders will bear the losses.[10] In addition, market concerns about a meltdown of the financial sector should be diminished because, under the Dodd-Frank Act, the FDIC should have advance access to the information necessary to have a plan in place to resolve large, complex financial companies in an orderly fashion.[11]

Action the FDIC Has Already Taken

Even as Congress was finalizing the details of the Dodd-Frank legislation, the FDIC was already moving on a number of fronts to better implement existing authorities to manage risks and to consider how best to exercise new authorities under the provisions of the legislation. During the past two months, the FDIC has moved in a number of areas to better exercise existing regulatory authorities and expedite implementation of powers newly authorized under the Dodd-Frank Act.

Back-Up Exam and Enforcement Memorandum. On July 12th, the FDIC Board voted to revise its Memorandum of Understanding (MOU) with the other primary federal banking regulators to enhance the FDIC's existing backup authorities over insured depository institutions that the FDIC does not directly supervise. The revised agreement will improve the FDIC's ability to access information necessary to understand, evaluate, and mitigate its exposure to insured depository institutions, especially the largest and most complex firms.

As previously discussed, the events of September 2008 illustrate how the complexity and opaqueness of large, complex depository institutions require the FDIC to have a more active on-site presence and greater direct access to information and bank personnel in order to fully evaluate the risks to the Deposit Insurance Fund. The need to revise the existing MOU was previously identified by the Inspectors General of the FDIC and the Treasury Department in their *Evaluation of Federal Regulatory Oversight of Washington Mutual Bank* in April 2010. The Report criticized the existing MOU because it limited the FDIC's ability to make its own independent assessment of risk to the

Deposit Insurance Fund and required the FDIC to place unreasonable reliance on the work of the primary federal regulator. I believe our new agreement satisfies the recommendations of this report and the commitment for action I made personally in response to it.

Further, I believe that the new agreement strikes that reasonable balance between preserving the role of the primary federal regulator and providing the FDIC with the information that is critical to meeting our statutory responsibilities. Much work lies ahead in implementing the terms of the new MOU. While the FDIC will benefit from a stronger and more robust agreement, our ultimate success will depend heavily upon our ability to work together collectively as regulators and to respect the roles and responsibilities that we have each been given to protect the financial system.

Creation of the Office of Complex Financial Institutions. The new authorities provided under Dodd-Frank, and the importance of dedicating more resources to monitoring risks among the largest and most complex financial institutions and planning for the contingency that one or more of them might fail, led the FDIC Board in August to approve the creation of a new Office of Complex Financial Institutions, or CFI. The CFI will perform continuous review and oversight of bank holding companies with more than $100 billion in assets, as well as non-bank financial companies designated as systemically important by the new Financial Stability Oversight Council. The CFI will also be responsible for carrying out the FDIC's new authority under the Dodd-Frank Act to implement orderly liquidations of systemically important bank holding companies and non-bank financial companies that fail. Just as important, this Office will be responsible for working closely with our colleagues at the Department of Treasury, the FRB and the other banking agencies to ensure that all of the provisions of the Dodd-Frank Act are implemented in a way that makes prudential supervision and resolution of complex institutions as effective as possible.

Roundtables on Financial Reform. Just this week, the FDIC held the first in a series of Roundtables with external parties on the implementation of the Dodd-Frank Act, part of our overall effort to bring transparency into the rulemaking process. This first discussion centered on the new resolution authority provided for under the Act, and included government officials, industry executives, academics, and investors. We are also seeking input by encouraging the public to submit views via e-mail on how the FDIC should implement aspects of the new law for which the FDIC has responsibility. These comments will become part of the record and will be posted on the FDIC website.

Our efforts to bring transparency into the rulemaking process will include public disclosure of meetings between senior FDIC officials and private sector individuals so as to enhance the openness and accountability of our process. This voluntary public disclosure policy will apply to all meetings that include a discussion on how the FDIC should interpret or implement provisions of the Dodd-Frank Act that are subject to independent or joint rulemaking by the FDIC.

Proper Implementation Is Essential to the Effectiveness of New Regulatory Tools

By their nature, the powers and authorities created by the legislation will require a great deal of care and effort for proper implementation. If implementation is not properly carried out, the reforms could be ineffective in preventing future crises or containing financial market disruptions should they occur. I would like to highlight for the Commission what I see as the three main areas of priority for implementation under the new law.

New Orderly Liquidation Authority. The new liquidation authority in the Dodd-Frank Act is a fundamental part of why the new law provides the U.S. with the tools to end "Too Big to Fail." The reason is simple. It provides a framework for a liquidation process for the largest, non-bank financial firms that can prevent a disorderly collapse, while protecting taxpayers from any future bailouts. This framework consists of two vital components that must be mutually supporting. First, the Dodd-Frank Act includes supervisory and regulatory powers designed to give the FDIC, and other regulators, the information and cooperation from the largest financial firms that is necessary for more effective oversight and – most essential for any future liquidation – for effective advance planning for an orderly dissolution of the firm. Second, Title II incorporates the critical legal powers for an effective liquidation process – modeled on those used by the FDIC to resolve thousands of failing banks. These two components must be mutually supporting because an orderly liquidation is impossible without both. Even if the FDIC were given the legal powers of the Dodd-Frank Act, it cannot implement an effective liquidation process without access to information, cooperation from the largest financial firms and other regulators, and the opportunity to conduct extensive advance planning. In fact, without advance planning, the FDIC could not have effectively resolved the many insured banks that have failed during the current financial crisis.

Effective planning requires access to information through regulatory cooperation and through the back-up examination authority and resolution plans ("Living Wills") regulatory authority provided by the Dodd-Frank Act. Using this framework, it is essential that the FDIC, other federal regulatory agencies, and the largest financial firms work closely together to ensure effective planning for any future crisis. Such planning will ensure a credible resolution process to end "Too Big to Fail" and make sure that all market participants can operate with greater certainty. This will enhance market discipline and, through that discipline, promote a more resilient, efficient financial marketplace in the future.

The value of access to information through cooperation and back-up examinations is self-evident. The importance of the new resolution plan authority is even more essential for the orderly liquidation of large, complex financial conglomerates. A few examples will illustrate the point. First, large and complex financial firms are highly interconnected and operate through financial commitments and operational dependencies both within the conglomerate structure and through connections with other firms. Second, these firms operate through a web of trading, credit, and liquidity relationships in exchanges, clearing houses, custodians, lines of credit, securities settlement structures, and other market infrastructure elements that cannot be addressed for the first time upon insolvency. Third, large financial firms operate across national borders and conduct business around the clock. This creates a set of complex legal and operational

challenges during normal business times that will become infinitely more complex during any insolvency.

The importance of requiring large financial firms to prepare complete resolution plans was recently underscored by the Trustee charged with liquidating Lehman Brothers, Inc., in his investigative report prepared under the Securities Investor Protection Act. The Trustee concluded, in part, that a critical improvement for any insolvency proceeding would be a regulatory requirement to prepare a "living will" that details all of the firm's operations, interconnections, dependencies, and vulnerabilities so that crisis responses could be better planned in the future.[12] The new authority provided by the Dodd-Frank Act incorporates and expands upon these conclusions by requiring the detailed involvement of the firm in future resolution plans and regulatory approval.

The provisions for resolution plans incorporated into Title I of the Dodd-Frank Act provide the necessary framework. The statutory provisions require the FDIC and the FRB to jointly issue regulations within 18 months to implement the resolution planning and reporting requirements. Importantly, the statute requires both periodic reporting of detailed information by the largest financial firms and development and submission of a plan "for rapid and orderly resolution in the event of material financial distress or failure."

While the statutory information requirements are detailed, the statute appropriately gives the FDIC and the FRB discretion to require more as needed to achieve effective planning. Among the essential information requirements needed to develop effective resolution planning are: identification of the key business lines and legal entities; infrastructural elements that support the businesses, such as information technology, services, risk management, and liquidity; the key legal, funding, and operational interconnections within and outside the group; identification of potentially systemic operations and interconnections; identification and assessment of participation and roles in exchanges, clearing houses, and other financial market infrastructure elements; cross-border operations, assets, liabilities, and dependencies; and key staff and information resources. While this is not an exhaustive list, it illustrates both the foundation information needed and why, fundamentally, participation by the financial firm in the planning process is essential. In short, no outsider can understand the operations of a complex business like an insider.

As a result, the Dodd-Frank Act wisely requires the financial firms to submit a resolution plan to the FDIC and the FRB that is credible to facilitate an orderly resolution of the company. If the plan is not credible to the FDIC or the FRB, then the firm must resubmit the resolution plan to address the identified deficiencies and suggest any needed changes to the firm's business operations and corporate structure that will facilitate implementation of the plan. The FDIC and the FRB can jointly impose more stringent capital, leverage or liquidity requirements on the company or its affiliates if the firm fails to resubmit a credible plan. Finally, if the firm still does not submit a credible plan within two years, the FDIC and the FRB, in consultation with the Council, may require divestiture of certain assets or operations identified by the regulators. While, to some, this may seem like strong authority, it simply reflects the critical importance of full and serious engagement by the financial firms in the resolution planning process if the dire

risks of a disorderly collapse with systemic implications are to be avoided. Having lived through the crisis of 2008, there can be little question about the need both for effective resolution powers and planning.

The process places the burden appropriately on the financial firms to develop their own resolution plans, in consultation with the FDIC and the FRB, which if necessary will assist in an orderly liquidation. Equally key to this process is that it will require a great deal of information and analytical cooperation by the financial firms so that the regulators can make informed judgments about the proposed plan. This process will require financial firms to look critically at the often highly complex and interconnected structures that have developed. If a resolution plan is to be credible, it almost inevitably will require clarity around such corporate structures and business operations. This process ultimately will inure to the financial benefit of investors, financial firms, and certainly the public by cutting costs, improving resiliency, and reducing systemic risk.

Taken together, the new resolution powers, the enhanced regulatory and supervisory cooperation mandated in the law, and the resolution planning authority provide an infrastructure to end "Too Big to Fail." This means that the critical path of implementation applying high standards for transparency and simplification of overly complex financial firms must be pursued aggressively to make this a reality.

Financial Stability Oversight Council. The Dodd-Frank Act established a new Financial Stability Oversight Council and vested it with important responsibilities for identifying financial firms and practices that could create systemic risk in the future and taking action to mitigate those risks. The Council consists of 10 voting members including the FDIC and other key financial regulatory agencies, as well as five non-voting members.

Carrying out the Council's responsibilities is one of the most important tasks that we regulators face in implementing the Dodd-Frank Act. If the Council is to be successful, its members must work together closely and expeditiously to implement the Council's duties.

The Council needs to move quickly to set priorities and start the substantive implementation of the Dodd-Frank Act. One of the highest priorities is identifying the universe of non-bank financial companies that—because of their leverage; off-balance sheet exposures; nature, scope, size, scale, concentration, interconnectedness, and mix of activities; or other factors identified in the Dodd-Frank Act—should be subject to enhanced prudential supervision by the FRB. Among other things, these determinations are critical to ending the regulatory arbitrage that played such an important role in the crisis. Identifying these companies is so critical since this determination triggers the requirement for the nonbank financial company to file an orderly resolution plan with the FRB and the FDIC.

Another key priority for the Council is to identify potentially systemic activities and practices. The Council needs to have a forward looking focus to identify emerging risks and recommend that the primary regulators take quick action to mitigate those risks.

The Council was not established to solve the last crisis, but to work to prevent the next one.

At the same time, the Council members must work together to develop the most effective recommendations for enhanced prudential standards for the range of potentially systemic financial companies and activities. In order to accomplish these challenging tasks, I believe that the Council will need experienced and capable staff from each of the member agencies to work as a team in implementing the Council's responsibilities. Interagency working groups should be established to take full advantage of the knowledge and unique perspective of each of the member agencies.

Bank Capital. One of the most fundamental lessons of the financial crisis is that excessive leverage was a pervasive problem across the global financial system that had disastrous consequences for our economy. I am very pleased that the regulatory reform legislation contained measures not only to improve the quality of capital and make requirements more uniform across the various parts of the banking organization, but also to improve transparency in derivatives markets and move risky trading activities – which tend to amplify effective leverage – out of insured institutions.

As important as these measures are, we have learned that unless regulation is pursued in a coordinated and consistent fashion across the financial system, regulatory arbitrage tends to move the riskiest activities to the parts of the financial system that are regulated the least. That is why the set of reforms under consideration by the Basel Committee on Bank Supervision are so important to implement without delay. These reforms will serve to weed out hybrid instruments that weaken the capital structure, add new capital buffers so deleveraging need not crush lending in a crisis, and place higher capital charges on riskier derivatives and trading activities.

Industry-sponsored studies warn of dire consequences if these needed reforms are implemented. But academic and regulatory experts have shown that the marginal substitution of equity for debt need not be prohibitively expensive for banks, and that long-run economic growth and stability depend crucially on having capital cushions high enough to prevent the wasteful socialization of banking risk.

There is no question that the economic recovery is proceeding more slowly than anyone would like as the asset price and balance sheet excesses of the last boom are being unwound. Cleaning up bank balance sheets and strengthening the quality and quantity of capital is not painless. But these considerations offer no excuse for repeating the mistakes of the past when it comes to responsible capital requirements. I urge a prompt finalization and implementation of new uniform global capital standards so that regulatory uncertainty can be reduced and investors can regain confidence in the long-term efficiency and stability of our financial system.

Consumer Financial Protection Bureau. As reforms are implemented to contain systemic risk and restore stability to our financial industry, we should not forget that the origins of the crisis lay in high-risk mortgage lending practices. As I described in my January testimony, the riskiest subprime and nontraditional mortgage products,

frequently containing interest rate resets and prepayment penalties and all too often made with little or no documentation of income, were frequently originated by mortgage brokers and overwhelmingly funded by private issuers of asset-backed securities. In hindsight, it is clear that stronger lending practices and consumer protections were needed to prevent the proliferation of these risky loans. That is why the FDIC has consistently supported the establishment of a strong consumer protection regulator to protect consumers from potentially harmful financial products and introduce a meaningful examination and enforcement presence in the non-bank financial consumer sector. We look forward to working closely with the CFPB towards achieving these worthy goals.

Conclusion: Actions Taken Now Will Shape the Future of Finance

After several months of spirited debate, Congress has passed an historic package of financial reforms that will shape the financial industry for decades to come. Not only were these reforms needed to address the problems and abuses that led to the crisis, but they offer the opportunity to create a financial system that is once again geared to supporting the American economy, and not the other way around. A stable, profitable and internationally competitive U.S. financial services industry is in everyone's interest. But it is equally important that this earnings capacity be based on the value of the industry's underlying contribution to the economic life of our nation, and not on the ability to exploit a flawed regulatory framework.

If financial reform is about anything, it is about better aligning incentives and internalizing the costs of leverage and risk taking so that financial institutions can safely and efficiently channel capital to its highest and best use in our economy. During the run-up to the crisis, far too much money was directed toward booming, oversupplied real estate markets. The bust that followed is clear evidence that capital had been badly misallocated and could have put to far more productive use in areas such as energy, infrastructure or the industrial base. If our economy is to prosper, and if our nation is to meet the economic challenges looming ahead, our financial sector simply must do its job better.

As we meet today, the law has been written, but much still remains to be determined about the future of American finance. That is why I have emphasized to you the critical importance of our present efforts to promptly and effectively implement the provisions of the Dodd-Frank Act. We are working with our regulatory counterparts to quickly and carefully implement regulations in the areas of liquidation authority and the Financial Stability Oversight Council, and are working with our counterparts on the Basel Committee with regard to international capital standards. These are complex tasks. We are approaching them with both a sense of urgency and a considered view toward their long-run efficacy. And the stakes are high. If we fail to create effective frameworks now for exercising our authorities under the Dodd-Frank Act, we will have forfeited this historic chance to put our financial system on a sounder and safer path in the future.

[1] Pub. L. Nov. 111-203.

[2] Gara Afonso, Anna Kovner and Antoinette Schoar, "Stressed, Not Frozen: The Federal Funds Market in the Financial Crisis," Staff Report No. 437, Federal Reserve Bank of New York, March 2010.

[3] Statement of Michael Krimminger, Special Advisor for Policy, Federal Deposit Insurance Corporation on Too Big to Fail: The Role of Bankruptcy and Antitrust Law in Financial Regulation Reform before the Committee on the Judiciary; Subcommittee on Commercial and Administrative Law; U.S. House of Representatives; 2141 Rayburn House Office Building

October 22, 2009, http://www.fdic.gov/news/news/speeches/archives/2009/spoct2209.html

[4] The TED spread is a barometer of risk aversion in the interbank lending market measured as the gap between the three-month Eurodollar LIBOR rate and the yield on three-month Treasury securities.

[5] In point of fact, Wachovia Bank did not actually fail. However, as a result of the systemic risk determination, government assistance in the form of an asset guaranty program was offered in association with the initial Citigroup acquisition effort. The subsequent purchase of Wachovia by Wells Fargo Corporation was completed without any direct government assistance. We also note that the FDIC Board approved open assistance for Citibank NA on November 23, 2008 under the systemic risk exception to the FDIC's statutory least-cost requirement. With assets of $1.2 trillion, this is now the largest institution ever to receive financial assistance from the FDIC.

[6] Although Wachovia was a net seller of funds, the institution was prudently testing its overnight borrowing capacity with counterparties on a regular basis. While most counterparties they contacted on the 25th did in fact advance overnight unsecured funds, two parties declined.

[7] Total FDIC-insured deposits at Wachovia as of June 30, 2008 were just under $265 billion.

[8] http://www.faqs.org/sec-filings/100813/LEHMAN BROTHERS HOLDINGS INC_8-K/a10-15773_1ex99d1.htm.

[9] Examiner's Report, pg. 725, http://lehmanreport.jenner.com/VOLUME 2.pdf.

[10] Section 204(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

[11] Just this week, the **American Banker** reported that James Giddens—the court-appointed trustee overseeing the liquidation of Lehman Brothers—has stated that

Lehman Brothers' lack of a disaster plan "contributed to the chaos" of its bankruptcy and the liquidation of its brokerage.

[12] Trustee's Preliminary Investigation Report and Recommendations, In re: Lehman Brothers, Inc., Case No. 08-01420 (JMP) SIPA, U.S. Bankruptcy Court, Southern District of New York, filed August 25, 2010.

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