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Testimony by

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I am pleased to appear before this subcommittee on behalf of the Federal Reserve Board to discuss the economic implications of the so-called "too-big-to-fail" doctrine and proposed legislation dealing with this issue. The concerns encompassed by the term too-big-to-fail are among the most important reasons why we need to reform not only our deposit insurance system, but also the broader structure of financial institutions and regulation. The Board urges the Congress to view too-big-to-fail as one element of a very complex set of problems that need to be attacked on several fronts.

At the outset, I want to emphasize that the Board appreciates and is sensitive to the equity and efficiency arguments frequently advanced for eliminating too-big-to-fail policies. We are extremely uncomfortable with any regulatory policy that differentiates among banks, or their customers, largely on the basis of that institution's size. Under the too-big-to-fail doctrine, uninsured deposits at large banks typically have been protected in full -- through purchase and assumption resolution methods -- while those at smaller institutions generally face a greater risk of some loss.

Fairness alone would seem to argue that the treatment of depositors at a failed bank be independent of its size. Indeed, on many occasions the Board has indicated its view that the presumption should be that regulatory

policy is equally applicable to banks of all sizes. It is desirable that no bank should assume that its scale insulates it from market or regulatory discipline, nor should the depositors with uninsured balances in a large bank assume that they face no risk of loss should that institution fail. For these reasons, the Board supports those provisions of the Treasury proposal that would enhance the accountability of, and tighten the criteria used by, regulators in resolving failed banks.

However, we believe strongly that it would be imprudent for the Congress to exclude all possibility of invoking too-big-to-fail under any circumstances. One can contemplate situations where uninsured liabilities of failing institutions should be protected, or normal regulatory actions delayed, in the interest of macro economic stability. Such a finding typically would be appropriate only in cases of clear systemic risk involving, for example, potential spillover effects leading to widespread depositor runs, impairment of public confidence in the broader financial system, or serious disruptions in domestic and international payments and settlement systems.

In practice, situations representing true systemic risk are rare. Indeed, one can envision improved circumstances in which even a very large bank could fail and not pose an inordinate risk to the economy. Unfortunately, the specific considerations relevant to such determinations

are not fixed, but will vary over time with, for example, the underlying strength of the financial system and the economy.

In principle, systemic risk also could develop if a number of smaller or regional banks were to fail. Partly because such failures could potentially have severe consequences for a community or region, purchase and assumption resolutions have not only been used with large banks, but often with small institutions as well. Nevertheless, in practice systemic risks are more likely to be associated with failures of large institutions that are major participants in interbank financial markets, and in clearance and settlement systems for securities transactions.

The Board endorses reforms that would foster a stronger and more resilient banking system, one in which bank failures would be less likely and, should even a very large bank fail, the strength of other institutions would be sufficient to limit the potential for systemic risk. Thus, over the years we have been committed to higher capital standards, to the reduction of risk in the payments system, to finality criteria for clearing houses and payment systems, and to improved international cooperation in the areas of payments systems and banking supervision. For the same reason, we also support the Treasury's proposals calling for frequent on-site examinations, prompt corrective

action policies, interstate branching, and a broader range of permissible activities for financial services holding companies with well-capitalized bank subsidiaries. With these changes, we believe that over time the financial system and the economy could better tolerate large bank failures, thereby minimizing the likelihood that regulators would need to invoke too-big-to-fail.

Even in such an environment, however, it would be impossible to confidently assert that a systemic risk situation involving one or more troubled banks would never occur, in large part because of varying macroeconomic and other circumstances. In our view, therefore, it is not only prudent, but essential that policy makers retain the capacity to respond quickly, flexibly, and forcefully in conditions involving extensive risk to the financial system and the economy. I would note that while there surely are elements of unfairness in too-big-to-fail policies, unfairness also would result if regulators were required to ignore systemic risks. Such a mandate could needlessly expose banks and other financial institutions, their customers, and the broader society to severe economic disruptions and hardships that were neither of their own making nor within their control.

Mr. Chairman, the remainder of my remarks today will amplify on the reasons that have led to Board to these views.

Systemic Risk

The fundamental reason why it may sometimes be necessary to protect certain uninsured creditors or delay normal regulatory actions is systemic risk. Systemic risk refers to the possibility that financial difficulties at one bank, or possibly a small number of banks, may spill over to many more banks and perhaps the entire financial system. So long as problems can be isolated at a limited number of banks, but confidence maintained in the broader banking and financial system, there is little or no systemic risk.

One of the most serious and immediate potential effects of the failure of a very large bank is an impairment of the payments system that is so widespread as to disrupt the economic activity of the nation. In modern economies, the ability of individuals and firms to make and receive payment for goods and services is usually taken for granted. But, clearly, trade and commerce would be curtailed if this ability were substantially impaired for a major portion of the economy. One aspect of the potential problem is clear: When a bank fails, the ability of its depositors to make payments from their accounts would be severely limited were it not for government intervention designed to maintain the liquidity of insured, and sometimes uninsured, balances. Recent examples of the potential hardship such disruptions could place on exposed depositors can be seen in the failures of the Ohio, Maryland, and Rhode Island deposit

insurance systems. Clearly the problems could be greater in the case of the failure of a large bank, or a contagion of failures at many banks.

There is another aspect of systemic risk that is generally not as well understood. Large banks are major providers of payments and other "correspondent" banking services for smaller banks, as well as other financial institutions. Often these interbank relationships involve holdings of relatively sizable compensating or clearing balances at correspondent banks. Such interbank relationships are a key mechanism by which problems at a large correspondent bank can be transmitted to other financial institutions. There are two ways this can occur. First, the loss of access to their balances at the correspondent could cause other financial institutions to experience liquidity and solvency problems of their own. Second, the failure of a major correspondent bank could cause clearing and settlement problems for the customers of other banks and financial institutions that, ultimately, depend on the correspondent for payments services. Both of these possibilities were concerns, for example, in the 1984 failure of Continental Illinois National Bank, which was an especially important participant in interbank markets.

Some of the clearest examples of payments system-related systemic risk are associated with foreign exchange markets, which involve the largest banks from all the major

industrial countries, and are closely linked to and integrated with domestic money and capital markets. On any given day, a major bank will have entered into foreign exchange contracts to be settled on a future day, typically two days hence in the case of "spot market" contracts. If for any reason exchange rates were to move in the interim, a bank failure during this period could subject its counterparties, both banks and nonbanks, to unexpected capital losses.

Usually of greater immediate concern is the settlement risk arising from the traditional practice of paying out foreign currencies in settlement of foreign exchange contracts before counter-payments in U.S. dollars are fully completed. This practice arose because European banking markets operate in time zones at least 5 or 6 hours earlier than U.S. markets, while far eastern markets operate in time zones 13 or 14 hours earlier. The result is that both U.S. and foreign banks are typically exposed to the risk of losing the full amount of foreign currency paid out while they are awaiting dollar payments. This settlement risk, although managed by banks through various techniques, may amount to substantial temporary exposures lasting for a few hours during the day. Failure to complete these transactions in a timely manner would not only subject the counterparties to risk of loss, but could undermine confidence in domestic and international payments systems,

whose smooth functioning is essential to flows of goods and financial capital around the world.

To reduce systemic risks in the payments system, in recent years the Federal Reserve has worked with private payment and clearing systems to develop policies and procedures to reduce payments system risk. We believe that these initiatives have lowered the potential disruption to counterparties on large dollar networks. Still, it is the case that general instability in the banking system, such as would occur in a true systemic risk situation, could lead to multiple clearing and settlement failures. The Board believes that it is in the public interest for policy makers to have the tools and flexibility to prevent such an event.

Another serious aspect of systemic risk is the possibility of widespread depositor runs on both healthy and unhealthy banks. Such runs could be engendered by the failure of a major bank, for example, if such a failure generated significant uncertainty regarding the health of other banks. In days past, the primary concern was that depositors would run to currency, thereby causing a rapid and precipitous decline in the money supply and in the ability of banks to maintain old and make new loans. Today, while a flight to currency is not a realistic concern, in large part because of the success of the safety net, rapid and expanding runs from domestic bank deposits to government securities, other money market instruments, and foreign bank

deposits could still seriously disrupt the process of intermediation on which many borrowers depend.

The process by which savings are turned into loans and other forms of financial investment is crucial to the creation of real capital in our economy, and therefore central to the means by which increased productivity and higher living standards are achieved. Banks are obviously major contributors to this process. Indeed, the primary value added of banks is their ability to attract and pool depositors' funds by issuing liquid liabilities, and then provide financing to individuals and firms for productive purposes by creating relatively illiquid loans.

A credit relationship between a borrower and a particular bank is not necessarily easily transferred to another financial institution. The unique information collected by individual banks about their customers is often expensive to acquire, and may be the result of years of close interaction. True, securitization and technological change are making it increasingly possible for many bank customers to access credit markets directly, and the resultant decline in the value of the bank franchise is one of the key issues that needs to be addressed in banking reform. But for now -- and for the foreseeable future -- there will exist a core of business and other borrowers for whom banks serve as a primary source of funds. For example, data from our 1988 National Survey of Small Business

Finances indicate that of those small businesses having a loan or lease with a financial institution, more than half obtained such financing exclusively from one depository institution; and more than 80 percent had a loan or lease with a commercial bank. Moreover, it should be recognized that many securities are backed by bank credit guarantees or liquidity facilities.

We need only look to the economic and other costs imposed by the so-called "credit crunch" to get a sense of the critical importance of credit creation by banks to the stability and growth of our economy. In addition, research on the Great Depression points to the destruction of this function, caused by widespread bank failures, as a major contributor to the severity and length of the Depression. These arguments suggest that a rapid shift of deposits from one major portion of the banking industry to another -- say from banks considered weak to those considered strong -- would seriously disrupt credit creation. Such a disruption could easily feed into the real economy.

The implications of widespread difficulties in the banking sector -- including perhaps major disruption of the payments system and extensive depositor runs on healthy banks -- are not likely to be confined to banks. In large part this is due to the interconnections that I have already described between banks, other financial and commercial firms, and households. But there are other reasons why a

loss of confidence at banks could spread. For example, all types of financial institutions depend on the maintenance of public confidence in the broad financial system for the successful conduct of their business. Problems in banking could reduce confidence in this broader system.

In addition, other financial intermediaries, for example investment banks, depend on commercial banks for substantial amounts of short-term credit. A significant reduction in the supply of bank credit would reduce the ability of these institutions to provide underwriting services and liquidity support to a wide variety of securities markets, including those for stocks, bonds, and commercial paper. The resultant contraction in the availability and liquidity of such investment vehicles would tend to exacerbate the effects of a reduction of loans at banks. Indeed, the continued provision of credit to other financial intermediaries was one of the Board's primary concerns in our efforts to minimize the adverse effects of the October 1987 stock market break.

Large commercial banks are also major and direct participants in a variety of key financial markets. Examples include the markets for government securities, mortgage-backed securities, and foreign exchange. In their role as major participants and market-makers, large banks are a primary source of liquidity for these markets. For this reason alone, the collapse of a major bank's

participation could, for a time, significantly impair the functioning of these markets. In short, a variety of strong arguments can be made for the need to manage carefully the withdrawal of a major bank from financial markets.

The Congress and the banking regulators should take pride in the fact that systemic risk seems today to be a somewhat remote problem. One of the fundamental purposes of our banking safety net is to prevent systemic risk from becoming an observable reality. I think there can be no doubt that over the last half century we have been extremely successful in achieving this goal. Indeed, stability in the banking system has undoubtedly contributed to the much milder contractions in the economy that we have experienced since World War II relative to earlier times. The problem is that we have also paid a price for our success. An excessive degree of moral hazard has been allowed to develop within the system. This has been manifested in various ways, including low bank capital ratios, high asset risk at many banks, reduced market discipline by depositors, and ultimately large losses by the deposit insurance funds. But reform should not deny or eliminate the benefits of our success; rather, it should attempt to maintain the benefits while minimizing their costs.

Further Actions Needed to Reduce Systemic Risk

As I noted earlier, the Board urges the Congress to view too-big-to-fail as one element in a complex set of problems that should be attacked simultaneously. In this regard, Chairman Greenspan and other Board members have argued repeatedly in favor of fundamental reform of our system of banking and financial regulation. Most recently, Chairman Greenspan testified last week before the Financial Institutions Subcommittee of the House Banking Committee on the Board's views on these issues. I shall not repeat his remarks here today except to reiterate my earlier observation that a vital component of the ultimate solution to too-big-to-fail is a stronger banking system. We should promptly adopt reforms that will achieve this goal, including greater emphasis on capital adequacy, prompt corrective action to deal with financially distressed depositories, timely on-site examinations, full interstate branching, and a broader range of permissible activities for financial services holding companies with well-capitalized banking subsidiaries. As I noted earlier, by increasing the safety and soundness of our banking system, these reforms would lessen the likelihood of a major systemic threat and a need to invoke too-big-to-fail.

A way to equalize the benefits of too-big-to-fail policies across depository institutions is to eliminate the deposit insurance limit, implying explicit 100 percent

insurance for all deposits, including those in excess of $100,000. I would note that such a change in policy would further increase the degree of moral hazard in the banking system, virtually eliminate depositor discipline, and increase potential taxpayer liability. To offset these effects, much higher capital ratios and unacceptably intrusive regulation might be required.

It is important to understand that, even in a circumstance where too-big-too-fail is invoked, the stockholders, bondholders, and senior managers of the insolvent bank lose. This occurs even when all depositors are made whole and the bank continues in operation. Thus, from the point of view of the owners, bondholders, and senior managers, the application of too-big-to-fail policies still would imply de facto failure of the bank, since their financial interest in the bank would be extinguished. In this sense, too-big-to-fail implies no inequity of treatment across banks. Moreover, in the Board's view it is these very agents -- stockholders, bondholders, and senior managers -- who are in the best position to exert market discipline on the bank so as to limit the risk that the bank will ever become financially impaired.

Federal Reserve Role in Identifying Systemic Risk

The Board believes that it should have a role in determining when systemic risk exists. As the nation's

central bank, the Federal Reserve has responsibilities for the health of the domestic and international payments and financial systems. Thus, the Federal Reserve has both the perspective and the expertise that are useful for evaluating the systemic risk implications of a given crisis or imminent bank failure. Our responsibilities in this regard are carried out in part through administration of the discount window, which would likely be involved in any attempt to manage the demise of a major bank in an orderly way. To carry out our responsibilities for assessing systemic risk and administering the discount window it is particularly important that we have the thorough understanding of banks and the payments system operations that we obtain through close and frequent contact with large banking organizations.

With the increasing globalization of banking, the world's central banks will need more than ever to coordinate responses to developments that may originate anywhere and may impact domestic and international payments systems and financial markets. Thus, the Board believes that it is essential that the Federal Reserve -- in order to conduct its stabilization policies, including protecting against systemic risk -- have intimate familiarity with all banking organizations having a substantial international presence.

Inevitably, a determination of whether systemic risk is a substantial concern must be made on a case-by-case basis. Furthermore, the Board understands that it may be

all too tempting for regulators to declare that systemic risk requires deviation from normal regulatory procedures. For these reasons the Board supports the Treasury's proposal that both the Board and the Secretary of the Treasury, who also has major responsibilities for ensuring financial stability, as well as protecting taxpayers' funds, should jointly determine when systemic risk justifies such a deviation. Such a requirement would help to ensure that a systemic risk exemption is not abused without rendering the decisionmaking excessively cumbersome and time consuming.

Other Issues

Mr. Chairman, in your letter of invitation you inquired as to how a policy of too-big-to-fail, by which I understand you to mean a policy of protecting against systemic risk, should be funded. This is a difficult issue. On the one hand, banks, and particularly the largest banks, are clear beneficiaries of a policy that greatly reduces the likelihood of depositor runs on healthy banks. Thus, a case can be made for funding such a policy through deposit insurance premiums. On the other hand, the general public surely benefits from too-big-to-fail policy, and thus taxpayer funding may be justifiable. Moreover, the Board is concerned about the adverse impact of continued high -- let alone rising -- deposit insurance premiums on the competitiveness, size, and viability of our banking system.

Rather than focus on the relatively narrow issue of funding systemic risk, the Board would prefer to concentrate on the more general need to recapitalize the bank insurance fund. The Board believes that any plan to recapitalize BIF must provide sufficient resources without imposing excessive burdens on the banking industry in the near term. The Board also believes that loans to BIF that would be repaid with future premium revenues are the best means of striking this difficult balance. But I would stress that BIF recapitalization should be considered within the context of the broader set of reforms I described earlier. If such reforms are enacted, the Board fully expects that the probability of facing a failure with systemic implications will decline over time. Thus, in the long run, the issue may become moot.

The final aspect of a policy of ensuring against systemic risk that I would note is that it is very rare to observe large bank failures in other industrialized nations. Two important reasons for this experience include the operation of financial safety nets abroad, and the structure of foreign banking and financial markets. Indeed, many observers argue that an implicit policy of too-big-to-fail is followed in these nations.

Virtually all of the industrial countries have deposit insurance systems. Often, however, these systems do not provide the same explicit protection for depositors as

the FDIC. Support for the largest banks appears most likely to be channeled through countries' tax systems. In a few nations, the direct government ownership of some banks can also be regarded as part of the banking safety net. In addition, the possibility of direct government intervention to deal with severe problems at key financial institutions is not ruled out in most countries, although such intervention has been highly unusual. The fact is that regardless of institutional structure, observers conclude that explicitly or implicitly the norm in other industrial nations is that the largest banks will not be allowed to collapse. Thus the United States is far from being alone in having policies in place to deal with systemic risk. The Board believes that the widespread adoption of such policies abroad bears witness to the possible systemic cost of the uncontrolled collapse of a major bank.

Conclusion

In closing, I would reiterate the Board's strong support for the principle that the presumption of policy should be that regulatory actions apply equally to banks of all sizes. However, one of the primary reasons why there is a safety net for depository institutions is that failure of these firms can produce systemic risks, and unchecked systemic risk can impose major costs on the entire economy. Over the last half century a fundamental, and successfully

achieved, goal of policy has been to avoid systemic problems in the banking sector. In addition, the broad set of financial reforms proposed by the Treasury and supported by the Board would, in the Board's view, help further to reduce the chance that we would find ourselves in a situation of serious systemic risk. But we should not fool ourselves into believing that we can guarantee that an impending bank failure will not be a threat to the stability of our economy. Real life is never so neat and tidy, the structure of the economy is not so fixed, and our ability to understand fast-breaking developments is not so perfect that we could ever ensure that. Therefore the Board strongly urges Congress to continue to allow policy makers the flexibility to interrupt our normal regulatory and failure resolution procedures for the purpose of protecting against systemic destabilization.

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