

U.S. DEPARTMENT OF THE TREASURY

Press Center



Assistant Secretary Michael S. Barr Written Testimony House Judiciary Committee Subcommittee on Commercial and Administrative Law

10/22/2009

TG-327

Thank you Chairman Conyers, Chairman Cohen, Ranking Member Smith, and Ranking Member Franks. I appreciate the opportunity to testify today.

The topic before the committee today is central to the task of reform. Just over a year ago, the collapses of Washington Mutual, Wachovia, and Lehman Brothers, and the extraordinary interventions in AIG, severely tested our collective ability to respond to the financial crisis. In the panic that followed, our financial system nearly ground to a halt.

A swift response prevented a truly catastrophic collapse. But last September's events revealed deep weaknesses in our financial system.

It did not take long for the financial contagion to infect the real economy. When President Obama took office, America's growth rate had hit negative 6.3 percent, and monthly job losses had reached 741,000 - the worst in decades.

There are indications that we have moved back from the financial brink and are headed toward economic recovery. Important parts of the financial system are back to functioning on their own. Some of the damage to people's savings has been repaired. We have taken the first steps towards both reducing the government's direct involvement in the financial system and reducing the risks that taxpayers are bearing.

But we cannot ignore the urgent need for action: our regulatory system is outdated and ineffective, and the weaknesses that contributed to the financial crisis persist. Our citizens are paying the price everyday for the failures in our financial system. The progress of recovery *must not distract us* from the project of reform.

The Administration has put forward comprehensive reforms and we are working closely with Congress to enact legislation by the end of this year.

Our goals are simple: to give responsible consumers and investors the basic protections they deserve; to lay the foundation for a safer, more stable financial system, less prone to panic and crisis; and to safeguard American taxpayers from bearing risks that ought to be borne by shareholders and creditors.

I want to begin today by briefly outlining the Obama Administration's approach to financial regulatory reform, and in particular to explain the way that our plan addresses the challenge of those firms whose failure could threaten the stability of the financial system. Then I will address some of the key questions that have been raised about the relationship between the Administration's proposal for resolution authority and bankruptcy, and about the models used as a basis for this resolution authority.

In recent decades, we've seen the significant growth of large, highly leveraged, and substantially interconnected financial firms. These firms benefited from the perception that the government could not afford to let them fail. This perception was an advantage in the market place. Creditors and investors believed that large firms could grow larger, take on more leverage, engage in riskier activity – and avoid paying the consequences should those risks turn bad. It is a classic moral hazard problem.

Of course, during the financial crisis, the federal government did stand behind almost all of these firms. That action was necessary, but there is no question that, *unless we enact meaningful reforms*, the fact that the federal government intervened this past year will have made the problem worse. We take this moral hazard challenge very seriously. Our proposals for reform address it head on. We must end the perception that any firm is too big to fail.

First, the biggest, most interconnected financial firms must be subject to serious, accountable, comprehensive oversight and supervision. The idea that investment banks like Bear or Lehman or other large firms like AIG could escape meaningful consolidated federal supervision should be considered unthinkable from now on.

For the largest, most interconnected financial firms – for any firm whose failure might threaten the stability of the financial system – there must be clear, inescapable, single-point regulatory accountability. The scope of that accountability must include both the parent company and all subsidiaries.

In our view, the Federal Reserve is the agency best equipped for the task of supervising the largest, most complex firms. The Fed already supervises all major U.S. commercial banking organizations on a firm-wide basis. After the changes in corporate structure over the past year, the Fed now supervises all major investment banks as well. It is the only agency with broad and deep knowledge of financial institutions and the capital markets necessary to do the job effectively.

So the first part of our approach to the moral hazard problem is clear, accountable, comprehensive oversight and supervision.

The second part is tougher standards.

The days when being large and substantially interconnected could be cost-free – let alone carry implicit subsidies – should be over. The largest, most interconnected firms should face significantly higher capital and liquidity requirements.

Those prudential requirements should be set with a view to offsetting any perception that size alone carries implicit benefits or subsidies. And they should be set at levels that compel firms to internalize the cost of the risks they impose on the financial system.

Through tougher prudential regulation, we aim to give these firms a positive incentive to shrink, to reduce their leverage, their complexity, and their interconnectedness. And we aim to ensure that they have a far greater capacity to absorb losses when they make mistakes.

The third key element of our response to the moral hazard problem is to emphasize that being among the largest, most interconnected firms does *not* come with any guarantee of support in times of stress. Indeed, the presumption should be the opposite: shareholders and creditors should expect to bear the costs of failure.

That presumption needs to have real weight. That means the financial system must be able to handle the failure of any firm. In this last crisis, it clearly was not.

Leading up to the recent crisis, the shock absorbers that are critical to preserving the stability of the financial system – capital, margin, and liquidity cushions in particular – were inadequate to withstand the force of the global recession.

While the largest firms should face higher prudential requirements than other firms, standards need to be increased system-wide. We've proposed to raise capital and liquidity requirements for all banking firms and to raise capital charges on exposures between financial firms.

We've also laid out principles that we believe should guide regulators in setting capital requirements in the future. The core principle is that capital and other regulatory requirements must be designed to ensure the stability of the financial system as a whole, not just the solvency of individual institutions.

Beyond that, we've called for a greater focus on the *quality* of capital. We've called for capital requirements that are more forward-looking and reduce pro-cyclicality. We've called for explicit *liquidity* requirements. And we've called for better rules to measure risk in banks' portfolios.

As part of our proposal, we've called for firms to prepare what some have called "living wills." We would require major financial firms to prepare and regularly update a credible plan for their rapid resolution in the event of distress. Supervisors will make this a key component of regulatory oversight, both domestically and internationally as has been agreed in the G20. This requirement will leave us better prepared to deal with a firm's failure – and will provide another incentive for firms to simplify their organizational structures and improve risk management.

We've also called for measures to strengthen financial markets and the financial market infrastructure. For example, we've proposed to strengthen supervision and regulation of critical payment, clearing, and settlement systems and to regulate comprehensively the derivatives markets.

Our plan would require all standardized derivatives to be centrally cleared and traded on an exchange or trade execution facility – substantially reducing the build-up of bilateral counterparty credit risk between our major financial firms. We would require all customized OTC derivatives to be reported to a trade repository, making the market far more transparent. We would provide for strong and consistent prudential regulation of all OTC dealers and all other major players in the OTC markets, including robust capital and initial margin requirements for derivative transactions that are not centrally cleared.

We should never again face a situation – so devastating in the case of AIG – where the potential failure of a virtually unregulated major player in the derivatives market can impose risks on the entire system.

Taken together, the significance of these reforms should be clear: by building up capital and liquidity buffers throughout the system, and by increasing transparency in key markets, our plan will make it easier for the system to absorb the failure of any given financial institution. The stronger the system, therefore, the clearer it will be that there is *no such thing* as an implicit government guarantee.

Threats to Financial Stability

In most circumstances, these precautions will be enough. More comprehensive oversight, combined with stronger capital and liquidity standards and the other measures we've proposed, will minimize the risk that the largest financial institutions will face failure. Moreover, in the event that they do fail, we believe that these actions will minimize the risk that any individual firm's failure will pose a danger to broad financial stability, which is why bankruptcy proceedings will remain the dominant option for handling the failure of a non-bank financial institution, even very large ones.

The last two years, however, have shown that the U.S. government simply does not have the tools to respond effectively when failure could threaten financial stability. That is why our plan permits the government, in very limited circumstances, to resolve the largest and most interconnected financial companies outside of the traditional bankruptcy regime and consistent with the approach long taken for bank failures.

This is the final step in addressing the problem of moral hazard. To make sure that we have the capacity – as we do now for banks and thrifts – to break apart or unwind major non-bank financial firms in an orderly fashion that limits collateral damage to the system.

Bankruptcy is and will remain the primary method of resolving a non-bank financial firm. But as Lehman's collapse has showed quite starkly, and as I will discuss in some detail today, there are times when the existing options under the Bankruptcy Code are simply not adequate to deal with the insolvency of large financial institutions in times of severe crisis.

The resolution authority we have proposed allows the government to impose losses on shareholders and creditors without exposing the system to a sudden, disorderly failure that puts everyone else at risk.

To be clear, in those limited circumstances, the objectives of the resolution regime will differ from those of the Bankruptcy Code. The express purpose of the bankruptcy code is to reorganize or liquidate a failing firm "for the benefit of its creditors". Our proposed resolution regime is structured to manage the failure of a financial firm in a manner that protects taxpayers and the broader economy and promotes stability in the financial system. This purpose is explicitly different than the purposes of the Bankruptcy Code, but that is why the Administration's proposal is narrowly tailored to situations in which there are exceptional threats to financial stability. It is not intended to replace bankruptcy in any but the rarest circumstances.

In order for a company to find itself subject to our proposed resolution regime, the Secretary of the Treasury must determine, in consultation with the President, that: (1) the financial company is in default or in danger of default; (2) the failure of the financial company would have serious adverse effects on financial stability, and (3) use of the proposed regime would avoid or mitigate such adverse effects.

Moreover, that determination may only be made after such a finding has been recommended by both the Federal Reserve Board and the appropriate federal regulator (either the FDIC or the SEC). Furthermore, those recommendations may only be made with the consent of two-thirds of the Federal Reserve Board and two-thirds of the Board or Commission of the appropriate federal regulator.

This strict mechanism for invoking the resolution regime would require significant consensus. Moreover, inherent in the determination that use of this authority is necessary is that the ripple effects of the potential losses will go far beyond the immediate creditors and counterparties of the affected firm. In those instances, therefore, it is appropriate that a broader set of tools are available to prevent widespread harm to the financial system and the real economy.

Claims Priorities and Existing Models

Our approach is modeled on the long standing regime for bank failure. There are significant and tested safeguards in place modeled on the bank failure law to protect creditor rights.

The claims disposition process under the Administration's proposal will protect secured creditors, as under bank failure and bankruptcy laws.

For unsecured claims, the priority system contained in the legislation is also generally modeled after those contained in the Federal Deposit Insurance Act and under the Bankruptcy Code with one exception. To protect the interests of taxpayers and to guard against moral hazard on the part of unsecured creditors and shareholders in the covered bank holding company, claims of the United States are given priority over these stakeholders, just as the Bankruptcy Code gives some preference to unsecured claims of the government over unsecured creditors and shareholders, for certain types of taxes and penalties, as well as to parties providing credit to a debtor during the period of its administration under the Bankruptcy Code.

Finally, creditors in the resolution process are protected by the same system of judicial review that has existed for the FDIC (and its predecessors) for its receivership and conservatorship authorities for more than 75 years. Our proposal seeks to respect the Bankruptcy Code's fundamental principles of fairness and equity among similarly situated stakeholders. As is the case under the Bankruptcy Code's best-interests test and under the model in place for bank resolution, in the limited circumstances where we permit deviation from those principles our proposal expressly guarantees that stakeholders will be made no worse off by a regulator's use of resolution authority than would be the case in a liquidation. The legislation also maintains the right of an affected company to seek judicial review following the appointment of a receiver or conservator and a claimant's right to challenge a regulator's disallowance of its claim.

As with any new proposal, the first and most central questions are: how would this work? How would it be different than what is possible today? So let me close with a brief overview of how these authorities could come together if the U.S. government were once again faced with situations like those of last September.

First, firms would have prepared a "living will" embodying a resolution strategy. Second, such firms would have large capital buffers in the event of failure, and stringent conditions imposed on the use of "hot" money funding. Regulators would have the authority to supervise the firm for system-wide risks and to impose tough prudential measures. But we need to have some humility about the future and our ability to predict and prevent every systemic failure of a major financial firm. In a severe crisis, if major firms fail, and prudential measures and capital buffers prove inadequate such that bankruptcy is not an option, special resolutions should be available.

A conservatorship or receivership under this authority would have four essential elements that would improve execution and outcomes relative to the tools that were available last fall: (i) swifter replacement of board and senior management with new managers selected by the FDIC; (ii) a temporary stay of counterparty termination and netting rights to mitigate the adverse consequences to the company's liquidity, avoiding the cross defaults and cascades that otherwise, create a vicious cycle leading ultimately to financial collapse; (iii) the ability to provide the firm with secured financing to fund its liquidity and capital needs during the conservatorship or receivership to mitigate the "knock on" effects of any firm's failure and to fund its operations, pending its sale or winding down.; and (iv) the creation of one or more bridge bank holding companies in the case of a receivership to preserve the business franchise, deal with counterparty claims, and protect viable assets of stronger subsidiaries pending their sale. This would end the firm – wind it down – without contributing to system-wide failure.

In 1933, following an uncomfortably familiar chain of events, the failure of one bank bred panic and market disruption so great that Congress sought to insure that such events would not be repeated. In its wisdom, Congress created the FDIC and endowed it with the authority to resolve troubled banking institutions with the swiftness necessary to maintain the stability of the financial system of the time. Again in the wake of the thrift and bank failures of the late 1980s, Congress enacted reforms to enhance the FDIC's ability to manage the unprecedented scale, scope and complexity of modern bank failures. Our proposal does little more than apply to covered bank holding companies, under rare circumstances, the same model that Congress has developed, that the FDIC has executed, and that courts have respected, over the course of more than three-quarters of a century.

Our proposals represent a comprehensive, coordinated answer to the moral hazard challenge posed by our largest, most interconnected financial institutions: strong, accountable supervision; the imposition of costs, both to deter excessive risk and to force firms to better protect themselves against failure; a strong, resilient, well-regulated financial system that can better absorb failure. The proposals for resolution authority borrow from established law and practice and are narrowly tailored to the extraordinary needs of the financial system and the economy during periods of crisis. The plan protects taxpayers and enables shareholders and creditors to take losses.

Together, these proposals give us a clear and credible argument that, as the President said two weeks ago in New York, "Those on Wall Street cannot resume taking risks without regard for consequences, and expect that next time, American taxpayers will be there to break their fall."

Thank you.

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