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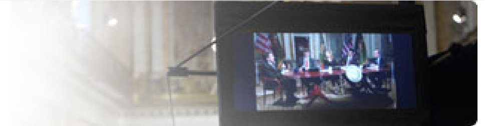


Remarks of Under Secretary Miller at the Hyman P. Minsky Conference

4/18/2013

REMARKS OF MARY JOHN MILLER, UNDER SECRETARY OF THE TREASURY HYMAN P. MINSKY CONFERENCE

As prepared for delivery

NEW YORK - Thank you for inviting me to join you tonight. It looks like you have heard from an impressive group of panelists and speakers during the past two days. I am honored to participate in this event.

I would like to focus this evening on a subject of considerable recent attention – financial institutions that some have called "too big to fail." This seems like a particularly fitting topic given the conference title of "Building a Financial Structure for a More Stable and Equitable Economy.

In fact, those two objectives – a stronger and fairer system – would be a good way to describe the overarching purpose of the reforms put in place in the wake of the financial crisis through the Dodd-Frank Wall Street Reform and Consumer Protection Act and through international efforts such as the Basel capital accords. And while these reforms reach far more broadly than just addressing risks posed to the system by the largest financial institutions, they provide extremely important tools to both reduce the risks presented to the financial system by these companies and level the playing field for their smaller competitors.

But before we go any further, I think it is important to be clear about what people mean when they talk about financial institutions that are too big to fail. The too-big-to-fail catchphrase appears to mean different things to different people. A common use of the too-big-to-fail shorthand is the notion that the government will bail a company out if it is in danger of collapse because its failure would otherwise have too great a negative impact on the financial system or the broader economy.

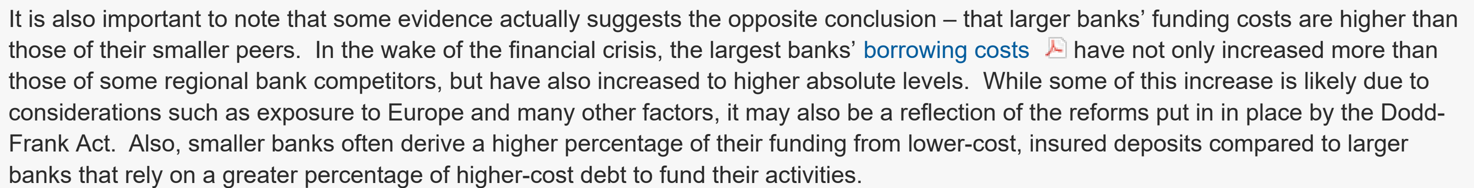
With respect to this understanding of too-big-to-fail, let me be very clear: it is wrong. I will discuss this issue in more detail later in my remarks, but as a result of the comprehensive reforms passed by Congress and signed into law by President Obama, no financial institution, regardless of its size, will be bailed out by taxpayers again. Shareholders of failed companies will be wiped out; creditors will absorb losses; culpable management will not be retained and may have their compensation clawed back; and any remaining costs associated with liquidating the company must be recovered from disposition of the company's assets and, if necessary, from assessments on the financial sector, not taxpayers.

Too-big-to-fail is also used as a way of discussing whether or not large financial institutions benefit from lower borrowing costs because of their size. If creditors believe that a company is so big or interconnected that the government will step in to keep it from failing and limit creditors' exposures to losses, they will not have sufficient incentives to demand appropriate compensation for lending the company money. As a result, any company that is perceived by lenders as being too big to fail might enjoy a funding advantage compared to other companies that do not benefit from such a perception.

While the Dodd-Frank Act makes it very clear that the government cannot bail out a failing financial company, the evidence is mixed whether market participants, specifically lenders to bank holding companies, nonetheless provide any funding advantage to the biggest financial companies based on some belief that the government would bail them out if necessary. In addition to the question of whether the market provides any such funding advantage, it is also important to ask why the market would continue to do so in light of the law's clarity that taxpayer support will not be forthcoming and thus whether any funding advantage might be attributable to other reasons.

Although some commentators have suggested that the largest bank holding companies do receive a funding advantage by virtue of their perceived too-big-to-fail status, some of the evidence they rely on predates the financial crisis and Dodd-Frank's reforms. We must therefore determine whether and to what extent such an advantage might persist. It is also quite hard to isolate exactly what factors could contribute to a lower cost of funding for a larger institution than for smaller competitors.

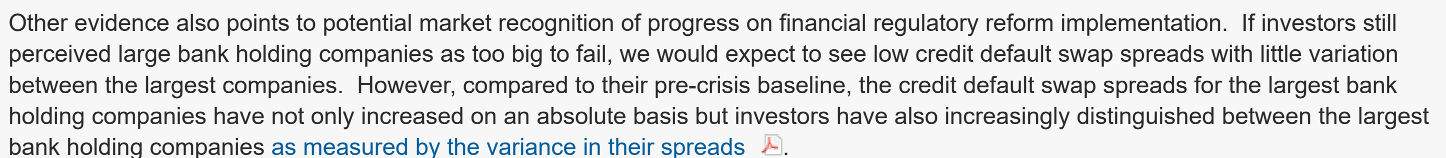
Financial institutions' borrowing costs are determined by a large number of factors, including their creditworthiness, the amount of debt they issue, their business mix, their exposure to different markets, and many other considerations. Larger companies that issue more debt benefit from features such as greater liquidity, a greater pool of potential investors, more research analyst coverage, and a more diversified funding base than their smaller competitors. Research shows that large non-financial corporations enjoy a similar funding advantage over their smaller and less-diversified peers. In other words, funding advantages that larger companies enjoy may be a function of these factors rather than market perceptions of the probability that they would receive government support.



It is also important to note that some evidence actually suggests the opposite conclusion – that larger banks' funding costs are higher than those of their smaller peers. In the wake of the financial crisis, the largest banks' borrowing costs have not only increased more than those of some regional bank competitors, but have also increased to higher absolute levels. While some of this increase is likely due to considerations such as exposure to Europe and many other factors, it may also be a reflection of the reforms put in in place by the Dodd-Frank Act. Also, smaller banks often derive a higher percentage of their funding from lower-cost, insured deposits compared to larger banks that rely on a greater percentage of higher-cost debt to fund their activities.

One of the pieces of evidence that the largest bank holding companies benefit from their perceived too-big-to-fail status stems from the ratings uplift that credit rating agencies provide to these companies based on the expectation that they would receive government support in the event of financial distress. In the immediate aftermath of the crisis, the largest bank holding companies received as much as a seven-notch uplift to their credit rating compared to their underlying fundamental creditworthiness. This was based on the rating agencies' assumption that the government would provide emergency assistance if necessary.

Following enactment of the Dodd-Frank Act, the rating agencies indicated that they would monitor the impact of financial reform implementation on the largest financial companies and adjust their ratings as appropriate. Since then, the rating agencies have removed as much as six notches of uplift attributable to expectations of government support. One rating agency has also recently indicated it may further reduce or eliminate its remaining ratings uplift assumptions by the end of 2013. So to the extent the largest financial companies have been benefiting from a funding advantage based on their ratings, that uplift has been declining and appears to be continuing to go away as implementation of the Dodd-Frank Act progresses.



Other evidence also points to potential market recognition of progress on financial regulatory reform implementation. If investors still perceived large bank holding companies as too big to fail, we would expect to see low credit default swap spreads with little variation between the largest companies. However, compared to their pre-crisis baseline, the credit default swap spreads for the largest bank holding companies have not only increased on an absolute basis but investors have also increasingly distinguished between the largest bank holding companies as measured by the variance in their spreads.

Another interesting wrinkle to this data point is that the credit default swap spreads for these companies have recently been declining. While spreads remain higher and more varied between different firms than pre-crisis levels, the recent trend could be caused by multiple factors. It could reflect market recognition of the substantial progress to make these companies more resilient than they were before the crisis, reduced concerns about their exposure to Europe, renewed attention to the too-big-to-fail debate, or a combination of all of the above and other reasons.

The foregoing discussion demonstrates above all else that the evidence on both sides of the argument is mixed and complicated, making it hard to attribute the existence or absence of a funding cost advantage to any single factor, including a market perception of a too-big-to-fail subsidy. The bottom line is simply that it is important to acknowledge the difficulty of making these assessments and to be cautious about drawing conclusions in either direction. We will continue to carefully consider the developments and the work in this area, remaining mindful that our financial system is dynamic and that we need to remain vigilant to evolving risks.

In the meantime, we must continue to work hard to reduce the risks posed by large financial companies and keep putting in place the measures to wind such companies down with minimal impact on the rest of the economy if the need arises. To the extent the largest bank holding companies enjoy any funding cost advantage based on a perceived too-big-to-fail status, these efforts should help wring it the rest of the way out of the market. And most importantly, this work is making our financial system safer and a stronger, more reliable engine for providing credit to help our economy grow.

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I think about financial regulatory reforms following the crisis in three categories. First, we are putting in place a comprehensive set of reforms to make firms stronger and safer, reducing the chance that they will fail. Second, a number of measures are designed to reduce risks and improve market transparency and investor protections, which also help make the financial system safer. Third, if a financial company does fail, provisions including the Dodd-Frank Act's living wills requirements and its orderly liquidation authority give regulators important tools they lacked before the crisis to resolve a failing company while limiting the fallout to the rest of the financial system and the economy.

The Dodd-Frank Act and the international Basel capital reforms contain a number of important provisions to make financial institutions stronger and less likely to fail during periods of stress. First and foremost, capital requirements have increased significantly in terms of both quality and quantity and provide a significant buffer to make banks more resilient. Other important reforms include the Volcker Rule, which limits the ability of banks that have access to the federal safety net to make risky trading bets and invest in speculative funds, and limits on exposures to particular counterparties to reduce interconnectedness in the financial system.

The new capital requirements include surcharges that increase based on institutions' size and complexity, which should not only reduce the chance that they fail but also have the ancillary effect of helping offset the benefit, if any, that the largest, most complex institutions receive in the funding markets.

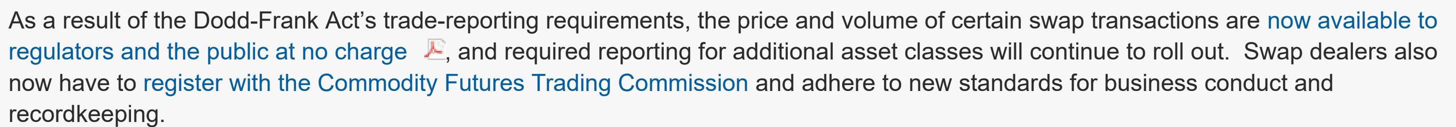
The 18 largest bank holding companies that are subject to the Federal Reserve's Comprehensive Capital Analysis and Review stress-testing process roughly doubled the amount of their tier 1 common equity capital over the last four years from approximately $400 billion to almost $800 billion at the end of 2012. This substantial amount of additional capital gives these companies a much stronger ability to withstand a future downturn. As Federal Reserve Chairman Bernanke noted in a speech earlier this month, after being subjected to a severely adverse stress scenario, the highest quality capital at these 18 companies was more than two percentage points higher than at the end of 2008.

The financial crisis also taught us that companies' liquidity and funding models matter a great deal as well. The Basel Committee on Banking Supervision's Liquidity Coverage Ratio and Net Stable Funding Ratio requirements constitute key parts of the Basel III reforms. When these provisions are implemented in the United States, they will contribute significantly to improving the stability of the financial system and making it less vulnerable to the destabilizing runs that we experienced during the crisis. While much work remains to be done in these areas, liquidity in the U.S. banking system is much better than it was before the crisis. Banks' holdings of cash and highly-liquid securities now exceed $2.5 trillion, more than double the amount at the end of 2007.

We are also working to reduce the risks to the financial system posed by the largest nonbank financial companies. The Financial Stability Oversight Council is in the final stages of evaluating an initial set of nonbank financial companies to determine which companies will be supervised by the Federal Reserve Board and subject to prudential standards including capital and liquidity requirements. For the first set of companies, the Council is nearing the end of the process.

The Dodd-Frank Act also contains a number of provisions that are designed to reduce risks in the system, increase transparency, and strengthen investor protections. Collectively, these measures help make financial institutions and the financial system as a whole safer and stronger.

Comprehensive reform of the over-the-counter derivatives market, which was largely unregulated prior to the crisis, provides examples of important reforms in each of these areas. Last month, mandatory central clearing of certain swap transactions began. More categories of swaps and an expanded universe of financial institutions will be subject to central clearing requirements as the year progresses, reducing risks to the financial system and to the financial institutions engaging in these transactions.



As a result of the Dodd-Frank Act's trade-reporting requirements, the price and volume of certain swap transactions are now available to regulators and the public at no charge, and required reporting for additional asset classes will continue to roll out. Swap dealers also now have to register with the Commodity Futures Trading Commission and adhere to new standards for business conduct and recordkeeping.

The reforms I have just discussed, along with many other provisions of the Dodd-Frank Act, go a long way towards making financial companies safer and stronger and reducing the likelihood that they will fail. But in the event that a financial company does fail, the Dodd-Frank Act provides important new tools to facilitate its resolution while limiting the negative impact on the rest of the financial system and the economy. Two provisions of the Dodd-Frank Act are particularly important in this respect: its living wills requirement and the orderly liquidation authority.

It is helpful to think of the living wills requirement and the U.S. Bankruptcy Code as providing a first-line defense to deal with a failing financial company. The largest bank holding companies and any designated nonbank financial companies are required to submit comprehensive plans for their rapid and orderly resolution to the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC). These plans, or living wills, can be used by regulators as a roadmap for an orderly resolution of the company under the Bankruptcy Code, if the need arises.

If the Federal Reserve and FDIC determine that the plans are not credible or adequate to facilitate the orderly resolution of the company in bankruptcy, they can take the following steps. First, they can require a company to submit a revised living will that fixes any shortcomings identified by the regulators. These resubmissions can include proposed changes in the company's business operations and corporate structure to facilitate an orderly resolution in bankruptcy. If the Federal Reserve and FDIC determine that the revised plan is still insufficient, they can impose other remedies including stricter capital, leverage, and liquidity requirements and restrictions on the company's growth, activities, and operations.

The living wills clearly provide an important tool for regulators, but it is worth noting that they also provide an important tool for the companies that have to prepare them. Companies are forced to closely examine their structure and activities, determine what risks they might present, and how they could be resolved in an orderly manner should the need arise. If companies use the living wills process to simplify their legal structures and improve the management of their businesses, it will not only help facilitate their orderly resolution but also help prevent that need from ever arising.

If living wills and the bankruptcy process are the first-line defense to protect against the failure of a financial institution, then the Dodd-Frank Act's orderly liquidation authority can be thought of as the second-line defense. While the Bankruptcy Code should be the first

resort to resolve a failing company, the orderly liquidation authority provides a new and important backstop for the FDIC to liquidate a failing financial company that cannot otherwise be resolved without serious adverse effects on U.S. financial stability.

There are a number of requirements that must be satisfied in order to use the orderly liquidation authority and that govern its use, but I want to reiterate that it must be used to wind down a failing company, not bail it out. The statute is clear that any company put into receivership pursuant to this authority must be liquidated. As I mentioned before, creditors and shareholders must bear the losses of the company. Any funds spent to liquidate the company must be recovered from the disposition of the company's assets and, if necessary, from assessments on the broader financial sector.

Some have expressed concern that we cannot know how effective the orderly liquidation authority will be until we actually put it to use. While it is true that we may not be able to fully test this framework until an actual failure, the regulatory community and the private sector have engaged in a substantial amount of important work to prepare for the potential use of this authority. Treasury, the Federal Reserve Board, the FDIC, and other financial regulatory agencies have made extensive preparations and conducted planning exercises to be fully prepared to wind down a company whose failure could threaten the stability of our financial system. The private sector has been conducting similar planning exercises.

We have also been actively engaged with our international regulatory counterparts to strengthen our collective ability to resolve large cross-border firms both through forums like the Financial Stability Board and on a bilateral basis where appropriate. The close collaboration between the FDIC and the Bank of England to develop coordinated approaches to resolution is particularly important, given the significant percentage of U.S. financial institutions' overseas operations that are located in the United Kingdom. The FDIC has also recently launched a joint working group with the European Commission to coordinate on resolution planning. Continuation of these efforts will be essential to making the Dodd-Frank Act's orderly liquidation authority as effective a tool as possible to mitigate threats to U.S. financial stability.

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We will not know the full impact of these reforms until they are fully implemented and tested in practice. In some cases, such as capital and liquidity requirements, reforms will not be fully in place for several more years. But given the headway that we have already made and the additional work that remains to be done, we need to finish the course that we set in 2010 and focus on getting existing reforms fully implemented. It is important to consider the totality of what the Dodd-Frank Act and Basel reforms do and give existing reforms time to take both shape and effect.

Having said that, we must never lose sight of the need to remain vigilant. We have a dynamic financial system. Constant evolution in the financial system and in the behavior and activities of financial institutions will require regulators to be flexible, to be willing to consider new threats to the financial system, and to stand ready to pursue new solutions to address emerging threats.

The question of what the role of government should be in maintaining financial stability is not new. In preparing for this talk, I visited the Treasury library to look at some of Hyman Minsky's work. It was fascinating to read Minsky's original typewritten manuscript from 40 years ago on the topic of financial instability and economic disasters. He started his paper with the following observation: "A striking characteristic of economic experience in the United States is the repeated occurrence of financial crises – crises that usher in deep depressions and periods of low-level economic stagnation." We saw all too vividly in the most recent crisis the economic harm that financial crises can inflict as measured by the trillions of dollars of lost wealth and millions of lost homes and jobs.

Minsky also commented on the rapid evolution of the financial sector in his paper, in terms of both financial institutions and practices. While the scale of financial institutions was not a focus at the time Minsky wrote that paper, the fundamental questions faced by policymakers and regulators today are not so different. How do we strike the proper balance of safety and risk in the financial system? How can we provide a level playing field that does not confer advantages on different participants in the financial markets? How can we preserve investors' confidence in the financial system so that it can provide the services and credit that the economy needs to prosper and grow? There are no easy answers to these questions, and the menu of solutions must be much broader than merely thinking about size and scope. What we do know is that we need to keep working hard to implement rules of the road that are appropriate not just for the financial system that we have today but also the system we will have in the future. I hope my remarks tonight have provided a fuller understanding of our approach and the significant progress we have made.

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