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before the

House Committee on Financial Services

Subcommittee on Oversight and Investigations

"Who is Too Big to Fail: Does Title II of the Dodd-Frank Act Enshrine Taxpayer Funded Bailouts?"

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Chairman McHenry, Ranking Member Green and Members of the Subcommittee:

Thank you for inviting me to testify on the important topic of Title II's effectiveness in ending "Too Big to Fail". Before I begin my discussion of the limitations and failures of Title II, I should express my concern that my criticism will be used as an argument for repeal of a flawed rule before a workable replacement or fix is created. That is not my intent.

Recent passage, in this body, of bills that eliminate unworkable Dodd Frank rules, without first proffering the replacements necessary to correct failures has resulted in a renewed and inappropriate deregulatory push. This type of response must be avoided if Congress choses to accept the reality that Title II does not address the "too big to fail" problem or its implications for future taxpayer funded bailouts. It is also important to recognize many of the failures of Title II result less from the legislation than from the failure of regulators to promulgate rules, and to vigorously pursue goals on Title I, that are consistent with congressional intent.

Before addressing specific key failures of Title II, it is important to highlight some of the problems that exist with Title I and its implementation. The clear intention of Title I was to legislate a process under which all too-big-to-fail firms would be small enough and simple enough to be unwound through a standard bankruptcy regime. Recognizing the impossibility of achieving such an end without forcing designated firms to alter their structures, the official sector is writing off the effectiveness of Title I. To do so without ever really having tried to fully implement it is a clear violation of legislative intent.

Today, the effect of Title I and Title II of Dodd-Frank is to re-create a class of special public companies that, because of their ties to the government, receive the benefit of

a GSE-like "implied government guarantee". For background, for the better part of the first decade of this millennium, market participants were increasingly convinced the GSEs (Fannie and Freddie) could become unstable. Nevertheless domestic and foreign bondholders and foreign central banks viewed the companies as low credit risks. It was assumed that if they got into trouble they would be bailed out with taxpayer dollars and without significant losses being forced upon bondholders. As a result, the GSEs had a significantly lower cost of capital than their non-"special" and fully private competitors. They also benefit from a government-imposed monopoly on the best credits in the mortgage sector, leaving the subprime world to private lenders.

No matter how frequently Treasury, the Fed, the White House or Congress said that the government did not stand behind the obligations of the GSEs, the markets did not accept that view. When push came to shove in September 2008, the GSEs were taken over by the government, placing taxpayers on the hook for any potential GSE losses. GSE creditors walked away from the accident and even equity holders, who had always been paid to take the first loss, were not wiped out.

So, are we expected to believe that today's TBTF institutions are not provided a lower cost of capital, by the markets and rating agencies, based on the understanding that the government will always stand ready to fund their losses? Moreover, from where in history can we draw comfort that when a macro crisis hits, regulators and policymakers will assess to other TBTF institutions the realized losses rather than arguing that that might lead to a contagion risk?

As witnessed in this crisis, a withdrawal of liquidity from one systemically risky institution can lead to both a withdrawal of liquidity to its peers and also a contagious decline in asset values leaving all undercapitalized at the same time. Nearly three years after its passage, Dodd-Frank, and especially Title II, have done almost nothing to mitigate the TBTF problem. In fact, Title II operates under the completely implausible and economically unsound notion that in a crisis, TBTF firms will be taxed to fund losses at other failing TBTF firms.

If there is a positive to the GSE model and the "implied government guarantee" it is for the Washington political class. TBTF companies will provide all legislators, regardless of their political affiliation, with a constant stream of lobbying dollars in return for help in stymieing regulators. Washington welcomes the lobbying and campaign dollars spent by TBTF banks to convince officials that their derivatives books were never at risk and their credit trends are stronger. One of the ironies of Dodd-Frank is that is discourages banks from making mortgage loans, but encourages derivatives trading and investment banking activities. The ongoing failure to proactively create a banking system where all firms are small and simple enough to be managed through the bankruptcy process is a testament to Washington's love affair with the campaign financing provided by large financial firms. There is still a massive lobbying dollar hole left by the withdrawal of the largess that accompanied the collapse of Fannie and Freddie.

Title I – Congressional Intent Ignored

Title I, specifically mandates firms designated as "systemically important" create, and submit to the Federal Reserve, "living wills" that detail how they can be resolved through the Bankruptcy Code. If legislators and regulators followed through on this mandate and ensured that these firms could be resolved under the Bankruptcy Code, as intended by law, a special liquidation authority under Title II would be entirely unnecessary.

I should also point out that Dodd-Frank has no method to deal with cross-border insolvencies. The Federal Reserve Board knows this, and this is why they have proposed the intermediate holding company structure for foreign banks operating in the US. Only with the subsidy of the Treasury funding through the "Orderly Liquidation Fund" (OLF) does an international resolution have hope of success. While various jurisdictions have entered into memorandums of understanding those are unworkable and would likely fail in crisis given the various jurisdictional prohibitions on backstops and support.

Because various cross-border legal regimes exist, the management of these problems should not wait to be dealt with in the next crisis nor should they be left to unelected officials within the regulatory community. There are some examples of cooperation in cross-border resolution during insolvencies, including the MF Global collapse but these examples are not evidence against the significant and unavoidable conflicts. Governments must abide by applicable local insolvency laws, regardless of problems that may result in other countries in which a multi-national company operates. Title I should be proactively and specifically implemented to manage the shrinking of these firms to reduce the complexity of insolvencies so they create no future risks to taxpayers.

We absolutely need to eliminate the problems posed by the anti-competitive, market distorting, highly complex, highly interconnected and highly correlated too-big-to-fail firms. Title II is seriously flawed in that it provides significant benefits to designated firms, benefits that exist even prior to the point at which the "Orderly Liquidation Authority" (OLA) is invoked.

Title II – Undermining any Resolution to Too Big to Fail

Section 165(d) of Title I could work if Title II didn't exist – the problem is that the very existence of the FDIC's single point of entry approach in Title II obviates any need to require that "systemically important" companies become smaller or less complex. That is a key reason why these systemically risky banks support Title II – it purports to fix the problem that 165(d) was intended to fix. In reality it is little more than a new form of bailout.

Title II is supposed to define an OLA, a backup plan if a firm cannot be resolved under bankruptcy. Congress could have named it "Orderly Restructuring Authority" but chose not to. It, therefore, is clear that intended it to be a very distasteful, unpleasant exercise that results in resolution, not reform, of failed firms. Because of

the explicit and implicit subsidies, created by its design, the industry prefers it to bankruptcy.

Those who argue that Title II provides no subsidy should be asked to answer they question of why it should not be available to all companies. The answer is clear; allowing every company access to government financed dip financing is absurd and would eliminate the need for prudence by banks and investors. Based on the possibility they would have access to the Treasury's OLF if it became insolvent value accrues even to healthy firms that are designated as "systemically important". The fact that this financing is available to only a few firms is unfair.

As a result, Title II authority must be eliminated if we are to give Title I the chance to work. The financial crisis made clear that the resolution of large financial firms under bankruptcy would have been disorderly. This is not because of flaws in the bankruptcy process; it is due to certain parts of the financial institution – most notably the trillion-dollar derivatives books – that create interconnectivity among the largest financial institutions.

Title II - Uncertainty and Subsidy

While a true liquidation would result in the replacement of management, in the FDIC's proposed regime, key management of failed operating subsidiaries would be able to continue to manage the newly recapitalized firm. Although the FDIC claims they would replace personnel there is no requirement to do so. Their decisions will be arbitrary and driven by both the perceptions of regulators and market realities. The risk remains that, even in instances in which it is clear that management should be replaced there may be a lack of a deep bench of available industry management. This was the reality during the past crisis. Artificial enrichment of personnel responsible for corporate failure is only one of the major problems with Title II.

The FDIC recognized that a "liquidation" authority would be deleterious to financial markets in a moment of crisis. Restructuring a firm, not liquidating a firm, is the proven way to preserve an institution's value. So the FDIC revised the Orderly Liquidation Authority to fund a corporate restructuring through a single point of entry method. Bankruptcy has and should continue to be the preferred means to restructure the assets of failed firms. Instead, OLA is effectively a cram down that requires a huge amount of debtor-in-possession (DIP) financing from the Treasury.

This financing is a taxpayer-funded and anti-competitive subsidy. It supports the continuation of a banking system in which "All animals are equal but some animals are more equal than others". This is perhaps the easiest way to understand that these companies are far too large; the system simply can't fund them in bankruptcy.

Furthermore, it is easy to imagine non-"systemically important" firms innovating to provide services and functions better than "systemically important" financial institutions. Evidence of this can be found in the development of standalone investment banking partnerships, monoline mortgage originators (such as

Household International, Beneficial Mortgage and Quicken Loans), monoline credit card lenders (American Express and Capital One) and asset managers.

Unfortunately, innovation has been stifled by the protections and benefits afforded to our largest bank holding companies. The barriers to entry provided by Title II will only serve to further reduce competition. Specifically, under the FDIC's single entry method, all operating subsidiaries (which include some very large banks and broker dealers) would remain open and operating while the top tier holding company would be subjected to an OLA resolution. Effectively, this means that creditors of these subsidiaries face greatly diminished chances of losses in a bankruptcy because the FDIC has declared that these subsidiary banks and broker dealers will probably never face insolvency proceedings. Why would potential creditors choose to do business with a company that faces normal market discipline and bankruptcy when they could deal with a company that can offer subsidized pricing and assurances from the FDIC that it would probably never fail? Taking it a step further, how could any smaller firm enter a market that a "systemically important" firm is in? The "systemically important" firm will have an artificially low cost of capital because the FDIC has signaled that it will likely not face bankruptcy. This feature promises to stifle innovation in financial services to only the things that behemoth companies choose to provide. It's un-American, and it's happening because of Title II and other unwarranted benefits we provide to overly influential firms.

Because of the FDIC's "single point of entry" and the fact that it will aggregate losses to the holding company while seeking to preserve the operating companies, the ability of the holding company to remain a source of strength to the subsidiaries, including the bank, will be imperiled. It creates incentives for management and creditors to starve the holding companies of needed funding and to, instead, raise capital at the operating company level. This will further weaken the ability of the holding company to act as a source of strength.

Regulatory capital requirements are intended to ensure that there are adequate levels of capital to prevent insolvency, but without requiring significant amounts of stable capital to serve as a buffer in case of insolvency, investors will become increasingly uncomfortable buying the debt of the holding company. The Federal Reserve has yet to issue rules defining the amount of 'buffer' capital that will be required but it appears likely it will require far less than the 20-30% of equity and unsecured debt relative to assets that should be required.

Moreover, it appears, from comments made by several members of the Board of Governors, that they will support the use of contingent capital instead of long-term debt. Contingent capital, such as "Trups" and "CoCos" are neither contingent nor capital. Equity is equity and there is no substitute. As long as the Federal Reserve retains any "13.3" emergency powers, one must expect that when a TBTF institution is imperiled or required to convert their contingent debt to contingent equity, the "too big to fail" institution will hold legislators and regulators hostage to the notion that such a conversion would cause a market panic and lead counterparties to pull

secured lines and withdrawing liquidity. This is not a hypothetical argument but is a reality we suffered in the crisis.

In addition, unless there are clear prohibitions against banks investing in each other's "contingent capital notes", the use of contingent capital will increase systemic risk by engendering precisely the entanglement and interconnectedness that defines systemic risk. We have witnessed the problem of interconnectedness in this last crisis in at least two situations; banks and insurers investing in each other's trust preferred securities (TRUPS) and becoming exposed to not only declines in the equity value of their TRUPS but also to losses on their investments in other banks' TRUPS. We have also seen the damage caused by regional banks outsized exposure to GSE preferreds. Lastly, unless market participants saw through the contingent capital notion and considered it to carry an "implied government guarantee", the cost of issuance of the notes would be at a prohibitively high rates. Given the failures in the "CoCo" and "Trups" markets during the crisis this is an inappropriate and unstable form of funding.

Furthermore, rules promulgated by the FDIC create further distortions of capital markets and of existing debt contracts by allowing regulated entities, under the guise of protecting critical functions, to justify dissimilar treatment of similarly situated creditors. Given the interconnectedness of these firms it is likely that, to stave off the risk of contagion at the time a large firm approaches insolvency, they would choose to favor other large and correlated firms over less "systemically important" firms.

As market participants become concerned about the potential failure of a "systemically important" firm they will likely exacerbate the firm's troubles and increase systemic risk by selling their holdings into an increasingly illiquid market to avoid the potential that they are treated unfairly relative to other, similarly situated, creditors. It paradoxically provides benefits to any company or claimant that can convince regulators of its systemic importance.

Uncertainty among creditors about which regime, Title II or the Bankruptcy Code, will be used to address the failing of a "systemically important" firm as it approaches insolvency, will only serve to increase the role of regulators. It is very problematic, for creditors, if the same institution has the possibility of going into two different insolvency regimes, depending on the whim of regulators. Returns to creditors are different under each regime (and somewhat unknowable in the Title II regime), making it difficult for creditors to make investment decisions. All institutions must be required to fail through the same legal process; otherwise institutions that go through the special Title II process will always be deemed "too big to fail".

From the perspective of market participants, the regulatory discretion in Title II will make it difficult for creditors to hold any claims against the institution at the moment that market participants believe it's in distress. This too will create a self-fulfilling downward spiral where creditors will quickly sell their positions (if they

can sell them at all) at very deep discounts, dramatically raising the cost of capital of the institution and ensuring a quicker-than-normal demise.

These uncertainties will extend beyond the largest and designated firms. If investors believe that a large and complex non-designated firm is at risk of failure there would be a natural basis for concern that regulators could decide that a heretofore non-designated firm must be designated so on an emergency basis. The result would be increasing capital flight at precisely the time regulators would need to be able to operate in a stable environment.

Each of these distortions will compound. Because counterparties will be less prudent if they think creditors of the holding company are on the hook, and the government stands behind the holding company market monitoring will go down leading to further distortions in capital market functioning.

Perhaps the greatest impact of using Title II as a restructuring regime, rather than as an intended orderly liquidation regime is that there will be no cost of failure and no clear process to move assets from weaker hands to stronger and better-managed hands.

Simply stated, Title II creates further subsidies for a handful of firms that will be costly to taxpayers and bestow further advantages to systemically important financial institutions (SIFIs) relative to non-SIFI firms. I expect that based on the precedent from 2008, in a future crisis, a CEO from a large banking company that has been very aggressive in taking on badly managed risks will call his friends and former colleagues at the Federal Reserve Board and Treasury to get access to cheap OLF financing. The company will be bigger and more complicated than it was in 2008 because 165(d) will have been long since forgotten. He may have funding options, but none on terms as favorable as the OLF. They will band together to spin a tale of looming systemic crisis, and will force a reluctant FDIC to join them in approving the use of OLA. The OLF will be cheap and will provide great benefit – only the non-systemically holding company creditors will take losses, and the company will emerge from OLA much as it entered, to do it all again. We can't allow this to happen – OLA rewards companies for becoming "systemically important" and overly influential, it hurts smaller companies, and stifles innovation. The government created it and the government can and should take it away.

Under 210(n)5 of the Dodd-Frank Act, the bridge borrows from the FDIC, and the FDIC borrows from Treasury at treasuries plus a spread over treasuries for average corporate bond yields. Nowhere in Dodd-Frank does it state which index should be used for determining these bond yield. As a result, if the FDIC chooses to index to a "AAA" corporate average, funding may be at rates that the market confers on only the healthiest institutions. How does one begin to value an option to obtain funding, at any price, when all other funds providers have abandoned an institution? It is far larger than the spread between junk and whichever index the FDIC uses because without it the firm is dead. This subsidy has value all the time (not just upon failure), because "systemically important firms" and their creditors understand that, in good

times, you get to play fast and loose in search of returns, without fear of the Treasury, as the fund provider of last resort, abandoning you.

Adding to these subsidies, but less often considered, is that the government has the authority to leave behind as much debt as it wants, potentially engendering a massive debt crisis. The funding needs for some of these firms could reasonably be expected to be in the 10s of billions of dollars, with the need at larger companies being close to 100 billion dollars. At the high end of this range it can begin to strain even the Treasury's ability to access funds, this is the basis of the preference for guarantees over cash borrowing. Moreover, if they overdo it, they are able to turn the worst capitalized bank in the world into the best. This could be pretty destabilizing and inflict great damage to relatively healthy companies that should have the ability to compete on a level playing field.

The proper approach to ending the too-big-to-fail problem would be to consider fairness, which is at the core of the TBTF problem. It is essential that large firms be subject to the same insolvency regime that smaller firms are: the Bankruptcy Code. Making these firms small enough and simple enough to fail, through standard bankruptcy is clearly the best path forward. Not only would such an approach reinforce market discipline and eliminate the Orwellian approach to equality, it would reduce the risks of capital market uncertainty, reduce risk of capital market flight in times of crisis and would support the FDIC's intended mission as deposit insurer to the narrow banking sector.

Finally, it can be expected that those arguing against a more proactive reduction in risk and size of TBTF institutions will revert to an argument that strikes a natural chord in every American's heart: 'Doing so would put our institutions at a disadvantage among international competitors.' Level playing fields are a worthy goal, but this is not a relevant argument. Instead, this tired bromide must be resoundingly dismissed on several counts:

- Those countries with the largest banks as a percentage of GDP (Iceland, Ireland, Switzerland) demonstrated that a concentration of banking power can cause significant sovereign risk and tilt global economic playing fields away from that country.

- The likely breakups of ING, Lloyds and KBC suggest that it is we who seek to support an unleveled playing field where we subsidize our TBTF banks while other nations recognize the policy failures of moral hazard. If we continue down this path we will likely be at risk of violating international fair trade regimes.

- When the "unleveled playing field" argument is cited, in the name of protecting big banks from governmentally- subsidized international competition, keep in mind this reasoning supports the disadvantaging of 7,000+ community banks relative to our largest banks.

- There is no longer any evidence that, beyond a cost of capital advantage that comes with implied government support, there are sustainable and tangible economies of scale arising from being the largest firm. The financial supermarket concept has been proven a failure. The only ones who benefit are top-level executives. The notion that you need large banks to finance global companies is false. For centuries, syndicates of banks have financed trade and finance quite effectively. More banks involved in providing credit helps to better understand and diversify risk.

- We must demand that our legislators no longer allow unelected officials at the Federal Reserve to sign international accords created by the TBTF banks through supra-national bodies like the Basel Committee. This accord should be subject to the advice and consent of the Senate.

- Are we to believe that if we did not have such large and globally dominant firms, US borrowers might be paying more that the 29% interest that several of the TBTF firms now charge to their credit card customers? Perhaps we should think about what, if any advantages American consumers have received as a result of our financial institutions being such a large part of our economy.

- Since when did we accept a national strategy of following rather than leading? When we do what is right, others follow. As example, consider the bank secrecy havens – they made money for a bit. Now, even the Swiss and the Cayman authorities are coming around to our view.

- We are already at a disadvantage given that the largest foreign banks operate in the US with very little Tier 1 capital, yet most large foreign banks have not built a bricks and mortar presence here. Nobody screams about their undercapitalization nor has that undercapitalization caused deposits to migrate to foreign banks.

By getting out of the TBTF game, we will have a more robust and economically competitive economy where no players have a governmentally-conferred advantage or subsidy. Such a leveled playing field will begin the process of reinstating credible markets and attracting stable foreign capital. Let other nations pursue misguided policies of protecting uneconomic and anti-competitive businesses. Such an approach will allow our taxpayers to avoid having to be part of the next banking bailout crisis. The fact remains that most of the companies and functions that claim to be “systemically important” really are not. They simply claim to be because the government supports those claims and rewards them mightily as a result.