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**STATEMENT OF**

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**on**

# REGULATING AND RESOLVING INSTITUTIONS CONSIDERED "TOO BIG TO FAIL"

**before the**

**COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS**
**U.S. SENATE**

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Chairman Dodd, Ranking Member Shelby and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) on the need to address the issue of systemic risk and the existence of financial firms that are deemed "too big to fail."

It has been a difficult 18 months since the financial crisis began, but despite some long weekends and tense moments, government and industry have worked together to take extraordinary measures to maintain the stability of our financial system. The FDIC has been working with other federal agencies, Congress, and the White House to protect insured depositors and preserve the stability of our banking system. We have sought input from the public and the financial industry about our programs and how to structure them to produce the best results to turn this crisis around. There are indications that progress is being made in the availability of credit and the profitability of financial institutions. As we move beyond the liquidity crisis of last year, we must examine how we can improve our financial system for the future.

The financial crisis has taught us that many financial organizations have grown in both size and complexity to the point that, should one of them become distressed, it may pose systemic risk to the broader financial system. The managers, directors and supervisors of these firms ultimately placed too much reliance in risk management systems that proved flawed in their operations and assumptions. Meanwhile, the markets have funded these organizations at rates that implied they were simply too big to fail. In addition, the difficulty in supervising these firms was compounded by the lack of an effective mechanism to resolve them when they became troubled in a way that controlled the potential damage their failure could bring to the broader financial system.

In a properly functioning market economy there will be winners and losers, and some firms will become insolvent and should fail. Actions that prevent firms from failing ultimately distort market mechanisms, including the market's incentive to monitor the actions of similarly situated firms. Unfortunately, the actions taken during the past crisis have reinforced the idea that some financial organizations are too big to fail. The most important challenge now is to find ways to impose greater market discipline on systemically important financial organizations.

My testimony will examine whether large institutions posing systemic risk are necessary for the efficient functioning of our financial system -- that is, whether they promote or hinder competition and innovation among financial firms. I also will focus on some specific changes that should be undertaken to limit the potential for excessive risk in the system, including identifying systemically important institutions, creating incentives to reduce the size of systemically important firms and ensuring that all portions of the financial system are under some baseline standards to constrain excessive risk taking.

In addition, I will explain why an independent, special failure resolution authority is needed for financial firms that pose systemic risk and describe the essential features of such an authority. Finally, independent of the systemic risk issue, I will discuss the benefits of providing the FDIC with a statutory structure under which we would have authority to resolve a non-systemic failing or failed bank or thrift holding company, and how this authority would improve the ability to effect a least cost resolution for the depository institution or institutions it controls.

**Do We Need Financial Firms That Are Too Big to Fail?**

Before policymakers can address the issue of "too big to fail", it is important to analyze the fundamental issue of whether there are economic benefits to having institutions that are so large and complex that their failure can result in systemic issues for the economy. Because of their concentration of economic power and interconnections through the financial system, the management and supervision of institutions that are large and complex has proven to be problematic. Unless there are clear benefits to the financial system that offset the risks created by systemically important institutions, taxpayers have a right to question how extensive their exposure should be to such entities.

Over the past two decades, a number of arguments have been advanced about why financial organizations should be allowed to become larger and more complex. These reasons include being able to take advantage of economies of scale and scope, diversifying risk across a broad range of markets and products, and gaining access to global capital markets. It was alleged that the increased size and complexity of these organizations could be effectively managed using new innovations in quantitative risk management techniques.  Not only did institutions claim that they could manage these new risks, they also argued that often the combination of diversification and advanced risk management practices would allow them to operate with markedly lower capital buffers than were necessary in smaller, less-sophisticated institutions.

Indeed many of these concepts were inherent in the Basel II Advanced Approaches, resulting in reduced capital requirements.  In hindsight, it is now clear that the international regulatory community over-estimated the risk mitigation benefits of diversification and risk management when they set minimum regulatory capital requirements for large, complex financial institutions.

Notwithstanding expectations and industry projections for gains in financial efficiency, the academic evidence suggests that benefits from economies of scale are exhausted at levels far below the size of today's largest financial institutions.  Also, efforts designed to realize economies of scope have not lived up to their promise.  In some instances, the complex institutional combinations permitted by the Gramm-Leach-Bliley (GLB) Act were unwound because they failed to realize anticipated economies of scope.  Studies that assess the benefits produced by increased scale and scope find that most banks could improve their cost efficiency more by concentrating their efforts on improving core operational efficiency.

There also are practical limits on an institution's ability to diversify risk using securitization, structured financial products and derivatives.  Over-reliance on financial engineering and model-based hedging strategies increases an institution's exposure to operational, model and counterparty risks.

Clearly, there are benefits to diversification for smaller and less complex institutions, but the ability to diversify risk is diminished as market concentration rises and institutions become larger and more complex. When a financial system includes a small number of very large, complex organizations, the system cannot be well-diversified. As institutions grow in size and importance, they not only take on a risk profile that mirrors the risk of the market and general economic conditions, but they also concentrate risk as they become the only important counterparties to many transactions that facilitate financial intermediation in the economy. These flaws in the diversification argument become apparent in the midst of financial crisis when large, complex financial organizations -- because they are so interconnected -- reveal themselves as a source of risk to the system.

**Creating a Safer Financial System**

A strong case can be made for creating incentives that reduce the size and complexity of financial institutions as being bigger is not necessarily better. A financial system characterized by a handful of giant institutions with global reach and a single regulator is making a huge bet that those few banks and their regulator over a long period of time will always make the right decisions at the right time.

Reliance solely on the supervision of these institutions is not enough. We also need a "fail-safe" system where if any one large institution fails, the system carries on without breaking down. Financial firms that pose systemic risks should be subject to regulatory and economic incentives that require these institutions to hold larger capital and liquidity buffers to mirror the heightened risk they pose to the financial system. In addition, restrictions on leverage and the imposition of risk-based premiums on institutions and their activities would act as disincentives to growth and complexity that raise systemic concerns.

In contrast to the standards implied in the Basel II Accord, systemically important firms should face additional capital charges based on both their size and complexity. To address pro-cyclicality, the capital standards should provide for higher capital buffers that increase during expansions and are drawn down during contractions. In addition, these firms should be subject to higher Prompt Corrective Action (PCA) limits under U.S. laws. Regulators also should take into account off-balance-sheet assets and conduits as if these risks were on-balance-sheet.

One existing example of statutory limitations placed on institutions is the 10 percent nationwide cap on domestic deposits imposed in the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. While this regulatory limitation has been somewhat effective in preventing concentration in the U.S. system, the Riegle-Neal constraints have some significant limitations. First, these limits only apply to interstate bank mergers. Also, deposits in savings and loan institutions generally are not counted against legal limits.  In addition, the law restricts only domestic deposit concentration and is silent on asset concentration, risk concentration or product concentration.  The four largest banking organizations have slightly less than 35 percent of the domestic deposit market, but have over 45 percent of total industry assets.[1]  As we have seen, even with these deposit limits, banking organizations have become so large and interconnected that the failure of even one can threaten the financial system.

In addition to establishing disincentives to unchecked growth and increased complexity of institutions, two additional fundamental approaches could reduce the likelihood that an institution will be too big to fail.  One action is to create or designate a supervisory framework for regulating systemic risk.  Another critical aspect to ending too big to fail is to establish a comprehensive resolution authority for systemically significant financial companies that makes the failure of any systemically important institution both credible and feasible.  A realistic resolution regime would send a message that no institution is really too big to ultimately fail.

**Regulating Systemic Risk**

Our current system has clearly failed in many instances to manage risk properly and to provide stability.  While U.S. regulators have broad powers to supervise financial institutions and markets and to limit many of the activities that undermined our financial system, there are significant gaps that led to the current crisis.  First, there were gaps in the regulation of specific financial institutions that posed significant systemic risk -- most

[1] FDIC, Call Report data, 4th Quarter 2008

notably very large insurance companies, private equity and hedge funds, and differences in regulatory leverage standards for commercial and investment banks. Second, there were gaps in the oversight of certain types of risk that cut across many different financial institutions. A prime example of this was the credit default swap (CDS) market which was used to both hedge and leverage risk in the structured mortgage finance market. Both of these aspects of oversight and regulation need to be addressed.

A distinction should be drawn between the direct supervision of systemically-significant financial firms and the macro-prudential oversight of developing risks that may pose systemic risks to the U.S. financial system. The former appropriately calls for a single regulator for the largest, most systemically-significant firms, including large bank holding companies. The macro-prudential oversight of system-wide risks requires the integration of insights from a number of different regulatory perspectives -- banks, securities firms, holding companies, and perhaps others. Only through these differing perspectives can there be a holistic view of developing risks to our system. As a result, for this latter role, the FDIC would suggest creation of a systemic risk council (SRC) to provide analytical support, develop needed prudential policies, and have the power to mitigate developing risks.

*Systemic Risk Regulator*

With regard to the regulation of systemically important entities, a systemic risk regulator (SRR) should be responsible for monitoring and regulating their activities.

Centralizing the responsibility for supervising institutions that are deemed to be systemically important would bring clarity and focus to the efforts needed to identify and mitigate the buildup of risk at individual institutions.  The SRR could focus on the adequacy of complex institutions' risk measurement and management capabilities, including the mathematical models that drive risk management decisions.  With a few additions to their existing holding company authority, the Federal Reserve would seem well positioned for this important role.

While the creation of a SRR would be a significant improvement over the current system, risks that resulted in the current crisis grew across the financial system and supervisors were slow to identify them and limited in our ability to address these issues. This underscores the weakness of monitoring systemic risk through the lens of individual financial institutions, and argues for the need to assess emerging risks using a system-wide perspective.

*Systemic Risk Council*

One way to organize a system-wide regulatory monitoring effort is through the creation of a systemic risk council (SRC) to address issues that pose risks to the broader financial system.  Based on the key roles that they currently play in determining and addressing systemic risk, positions on this council should be held by the U.S. Treasury, the FDIC, the Federal Reserve Board and the Securities and Exchange Commission.  It may be appropriate to add other prudential supervisors as well.

The SRC would be responsible for identifying institutions, practices, and markets that create potential systemic risks, implementing actions to address those risks, ensuring effective information flow, completing analyses and making recommendations on potential systemic risks, setting capital and other standards and ensuring that the key supervisors with responsibility for direct supervision apply those standards.  The standards would be designed to provide incentives to reduce or eliminate potential systemic risks created by the size or complexity of individual entities, concentrations of risk or market practices, and other interconnections between entities and markets.

The SRC could take a more macro perspective and have the authority to overrule or force actions on behalf of other regulatory entities.  In order to monitor risk in the financial system, the SRC should also have the authority to demand better information from systemically important entities and to ensure that information is shared more readily.

The creation of a comprehensive systemic risk regulatory regime will not be a panacea.  Regulation can only accomplish so much.  Once the government formally establishes a systemic risk regulatory regime, market participants may assume that the likelihood of systemic events will be diminished.  Market participants may incorrectly discount the possibility of sector-wide disturbances and avoid expending private resources to safeguard their capital positions.  They also may arrive at distorted valuations in part because they assume (correctly or incorrectly) that the regulatory regime will reduce the probability of sector-wide losses or other extreme events.

To truly address the risks posed by systemically important institutions, it will be necessary to utilize mechanisms that once again impose market discipline on these institutions and their activities. For this reason, improvements in the supervision of systemically important entities must be coupled with disincentives for growth and complexity, as well as a credible and efficient structure that permits the resolution of these entities if they fail while protecting taxpayers from exposure.

**Resolution Authority**

The most important challenge in addressing the issue of too big to fail is to find ways to impose greater market discipline on systemically important institutions. The solution must involve, first and foremost, a legal mechanism for the orderly resolution of these institutions similar to that which exists for FDIC insured banks. The purpose of the resolution authority should not be to prop up a failed entity indefinitely, but to permit the swift and orderly dissolution of the entity and the absorption of its assets by the private sector as quickly as possible. Creating a resolution regime that applies to any financial institution that becomes a source of systemic risk should be an urgent priority.

The ad-hoc response to the current banking crisis was inevitable because no playbook existed for taking over an entire complex financial organization. There were important differences in the subsequent outcomes of the Bear Stearns and Lehman Brothers cases, and these difference are due, in part, to issues that arise when large complex financial institutions are subjected to the bankruptcy process. Bankruptcy is a very messy process for financial organizations and, as was demonstrated in the Lehman Brothers case, markets can react badly. Following the Lehman Brothers filing, the commercial paper market stopped functioning and the resulting decrease in liquidity threatened other financial institutions.

One explanation for the freeze in markets was that the Lehman failure shocked investors because, following Bear Stearns, they had assumed Lehman was too big too fail and its creditors would garner government support. In addition, many feel that the bankruptcy process itself had a destabilizing effect on markets and investor confidence. While the underlying causes of the market disruption that followed the Lehman failure will likely be debated for years to come, both explanations point to the need for a new resolutions scheme for systemically important non-bank financial institutions which will provide clear, consistent rules for all systemically important financial institutions, as well as a mechanism to maintain key systemic functions during an orderly wind down of those institutions.

Under the first explanation, investors found it incredible that the government would allow Lehman, or firms similar to Lehman, to declare bankruptcy. Because the protracted proceedings of a Chapter 11 bankruptcy were not viewed as credible prior to the bankruptcy filing, investors were willing to make “moral hazard” investments in the high-yielding commercial paper of large systemic institutions. Had a credible resolution mechanism been in place prior to the Lehman bankruptcy, investors would not have made these bets, and markets would not have reacted so negatively to the shock of a bankruptcy filing.

Under the second explanation, the legal features of a bankruptcy filing itself triggered asset fire sales and destroyed the liquidity of a large share of claims against Lehman. In this explanation, the liquidity and asset fire sale shock from the Lehman bankruptcy caused a market-wide liquidity shortage.

Under both explanations, we are left with the same conclusion -- that we need to develop a new credible and efficient means for resolving a distressed large complex non-bank institution. When the public interest is at stake, as in the case of systemically important entities, the resolution process should support an orderly unwinding of the institution in a way that protects the broader economic and taxpayer interests, not just private financial interests, and imposes losses on stakeholders in the institution.

Unlike the clearly defined and proven statutory powers that exist for resolving insured depository institutions, the current bankruptcy framework available to resolve large, complex non-bank financial entities and financial holding companies was not designed to protect the stability of the financial system. This is important because, in the current crisis, bank holding companies and large non-bank entities have come to depend on the banks within their organizations as a source of strength. Where previously the holding company may have served as a source of strength to the insured institution, these entities now often rely on a subsidiary depository institution for funding and liquidity, but carry on many systemically important activities outside of the bank that are managed at a holding company level or non-bank affiliate level.

In the case of a bank holding company, whether systemically significant or not, the FDIC has the authority to take control of only the failing bank subsidiary, thereby protecting the insured depositors. However, in some cases, many of the essential services for the bank's operations lie in other portions of the holding company and are left outside of the FDIC's control, making it difficult to operate and resolve the bank. When the bank fails, the holding company and its subsidiaries typically find themselves too operationally and financially unbalanced to continue to fund ongoing commitments. In such a situation, where the holding company structure includes many bank and non-bank subsidiaries, taking control of just the bank is not a practical solution.

While the depository institution could be resolved under existing authorities, the resolution would likely cause the holding company to fail and its activities would then be unwound through the normal corporate bankruptcy process. Putting the holding company through the normal corporate bankruptcy process may create additional instability as claims outside the depository institution become completely illiquid under the current system. Without a system that provides for the orderly resolution of activities outside of the depository institution, the failure of a large, complex financial institution includes the risk that it will become a systemically important event.

If a bank holding company or non-bank financial holding company is forced into, or chooses to enter, bankruptcy for any reason, the following is likely to occur. In a Chapter 11 bankruptcy, there is an automatic stay on most creditor claims -- with the exception of specified financial contracts (futures and options contracts and certain types of derivatives) that are subject to immediate termination and netting provisions. The automatic stay renders illiquid the entire balance of outstanding creditor claims. There are no alternative funding mechanisms, other than debtor-in-possession financing, available to remedy this problem. On the other hand, the bankrupt's financial market contracts are subject to immediate termination -- and cannot be transferred to another existing institution or a temporary institution, such as a bridge bank. In bankruptcy, without a bridge bank or similar type of option, there is really no practical way to provide continuity for the holding company's or its subsidiaries' operations. Those operations are based principally on financial agreements dependent on market confidence and require continuity through a bridge bank mechanism to allow the type of quick, flexible action needed. The automatic stay and the uncertainties inherent in the judicially-based bankruptcy proceedings further impair the ability to maintain these key functions.. As a result, the current bankruptcy resolution options available -- taking control of the banking subsidiary or a bankruptcy filing of the parent organization -- make the effective resolution of a large, systemically important financial institution, such as a bank holding company, virtually impossible. This has forced the government to improvise actions to address individual situations, making it difficult to address systemic problems in a coordinated manner and raising serious issues of fairness.

*Addressing Risks Posed By the Derivatives Markets*

One of the major risks demonstrated in the current crisis is the tremendous expansion in the size, concentration, and complexity of the derivatives markets. While these markets perform important risk mitigation functions, financial firms that rely on market funding can see it dry up overnight. If the market decides the firm is weakening, other market participants can demand more and more collateral to protect their claims. At some point, the firm cannot meet these additional demands and it collapses. In bankruptcy, current law allows market participants to terminate and net out derivatives and sell any pledged collateral to pay off the resulting net claim. During periods of market instability -- such as during the fall of 2008 -- the exercise of these netting and collateral rights can increase systemic risks. At such times, the resulting fire sale of collateral can depress prices, freeze market liquidity as investors pull back, and create risks of collapse for many other firms.

In effect, financial firms are more prone to sudden market runs because of the cycle of increasing collateral demands before a firm fails and collateral dumping after it fails. Their counterparties have every interest to demand more collateral and sell it as quickly as possible before market prices decline. This can become a self-fulfilling prophecy -- and mimics the depositor runs of the past.

One way to reduce these risks while retaining market discipline is to make derivative counterparties keep some “skin in the game” throughout the cycle. The policy argument for such an approach is even stronger if the firm's failure would expose the taxpayer or a resolution fund to losses. One approach to addressing these risks would be to haircut up to 20 percent of the secured claim for companies with derivatives claims against the failed firm if the taxpayer or a resolution fund is expected to suffer losses. This would ensure that market participants always have an interest in monitoring the financial health of their counterparties. It also would limit the sudden demand for more collateral because the protection could be capped and also help to protect the taxpayer and the resolution fund from losses.

*Powers*

The new resolution entity should be independent of the institutional regulator. In creating a new resolution regime, we must clearly define roles and responsibilities and guard against creating new conflicts of interest. No single entity should be able to make the determination to resolve a systemically important institution. The resolution entity should be able to initiate action, but the final decision should involve other affected regulators. For example, the current statute requires that decisions to exercise the systemic risk authorities for banks must have the concurrence of several parties. Yet, Congress also gave the FDIC backup supervisory authority, recognizing there might be conflicts between a primary regulator's prudential responsibilities and its willingness to recognize when an institution it supervises needs to be closed. Once the decision to resolve a systemically important institution is made, the resolution entity must have the flexibility to implement this decision in the way that protects the public interest and limits costs.

This new resolution authority should also be designed to limit subsidies to private investors by assisting a troubled institution. If financial assistance outside of the resolution process is granted to systemically important firms, the process should be open, transparent and subject to a system of checks and balances that are similar to the systemic-risk exception to the least-cost test that applies to insured depository institutions. No single government entity should be able to unilaterally trigger a resolution strategy outside the defined parameters of the established resolution process.

Clear guidelines for this process are needed and must be adhered to in order to gain investor confidence and protect public and private interests. First, there should be a clearly defined priority structure for settling claims, depending on the type of firm. Any resolution should be subject to a cost test to minimize any public loss and impose losses according to the established claims priority. Second, the process must allow continuation of any systemically significant operations. Third, the rules that govern the process, and set priorities for the imposition of losses on shareholders and creditors should be clearly articulated and closely adhered to so that the markets can understand the resolution process with predicable outcomes.

The FDIC's authority to act as receiver and to establish a bridge bank to maintain key functions and sell assets offers a good model. A temporary bridge bank allows the government to prevent a disorderly collapse by preserving systemically significant functions. The FDIC has the power to transfer needed contracts to the bridge bank, including the financial market contracts, known as QFCs, which can be crucial to stemming contagion. It enables losses to be imposed on market players who should appropriately bear the risk. It also creates the possibility of multiple bidders for the bank and its assets, which can reduce losses to the receivership.

The FDIC has the authority to terminate contracts upon an insured depository institution's failure, including contracts with senior management whose services are no longer required. Through its repudiation powers, as well as enforcement powers, termination of such management contracts can often be accomplished at little cost to the FDIC. Moreover, when the FDIC establishes a bridge institution, it is able to contract with individuals to serve in senior management positions at the bridge institution subject to the oversight of the FDIC. The new resolution entity should be granted similar statutory authority as in the current resolution of financial institutions.

These additional powers would enable the resolution authority to employ what many have referred to as a "good bank -- bad bank" model in resolving failed systemically significant institutions. Under this scenario, the resolution authority would take over the troubled firm, imposing losses on stockholders and unsecured creditors. Viable portions of the firm would be placed in the good bank, using a structure similar to the FDIC's bridge bank authority. The nonviable or troubled portions of the firms would remain behind in a bad bank and would be unwound or sold over time. Even in the case of creditor claims transferred to the bad bank, these claims could be made partially liquid very quickly using a system of "haircuts" tied to FDIC estimates of potential losses on the disposition of assets.

*Who Should Resolve Systemically Significant Entities?*

As the only government entity regularly involved in the resolution of financial institutions, the FDIC can testify to what a difficult and contentious business it is. Resolution work involves making hard choices between competing interests with very few good options. It can be delicate work and requires special expertise.

In deciding whether to create a new government entity to resolve systemically important institutions, Congress should recognize that it would be difficult to maintain an expert and motivated workforce when there could be decades between systemic events. The FDIC experienced a similar challenge in the period before the recent crisis when very few banks failed during the years prior to the current crisis. While no existing government agency, including the FDIC, has experience with resolving systemically important entities, probably no agency other than the FDIC currently has the kinds of skill sets necessary to perform resolution activities of this nature.

In determining how to resolve systemically important institutions, Congress should only designate one entity to perform this role. Assigning resolution responsibilities to multiple regulators creates the potential for inconsistent resolution results and arbitrage. While the resolution entity should draw from the expertise and consult closely with other primary regulators, spreading the responsibility beyond a single entity would create inefficiencies in the resolution process. In addition, establishing multiple resolution entities would create significant practical difficulties in the effective administration of an industry funded resolution fund designed to protect taxpayers.

*Funding*

Obviously, many details of a special resolution authority for systemically significant financial firms would have to be worked out. To be truly credible, a new systemic resolution regime should be funded by fees or assessments charged to systemically important firms. Fees imposed on these firms could be imposed either before failures, to pre-fund a resolution fund, or fees could be assessed after a systemic resolution.

The FDIC would recommend pre-funding the special resolution authority. One approach to doing this would be to establish assessments on systemically significant financial companies that would be placed in a "Financial Companies Resolution Fund" (FCRF). A FCRF would not be funded to provide a guarantee to the creditors of systemically important institutions, but rather to cover the administrative costs of the resolution and the costs of any debtor-in-possession lending that would be necessary to ensure an orderly unwinding of a financial company's affairs. Any administrative costs and/or debtor-in-possession lending that could not be recovered from the estate of the resolved firm would be covered by the FCRF.

The FDIC's experience strongly suggests that there are significant benefits to an industry funded resolution fund. First, and foremost, such a fund reduces taxpayer exposure for the failure of systemically important institutions. The ability to draw on the accumulated reserves of the fund also ensures adequate resources and the credibility of the resolution structure. The taxpayer confidence in the Deposit Insurance Fund (DIF) with regard to the resolution of banks is a direct result of the respect engendered by its funding structure and conservative management.

The FCRF would be funded by financial companies whose size, complexity or interconnections potentially could pose a systemic risk to the financial system at some point in time (perhaps the beginning of each year). Those systemically important firms that have an insured depository subsidiary or other financial entity whose claimants are insured through a federal or state guarantee fund could receive a credit for the amount of their assessment to cover those institutions.

It is anticipated that the number of companies covered by the FCRF would be fluid, changing periodically depending upon the activities of the company and the market's ability to develop mechanisms to ameliorate systemic risk. Theoretically, as companies fall below the threshold for being potentially systemically important, they would no longer be assessed for coverage by the FCRF. Similarly, as companies undertake activities or provide products/services that make them potentially more systemically important, they would fall under the purview of the FCRF and be subject to assessment.

Assessing institutions based on the risk they pose to the financial systems serves two important purposes. A strong resolution fund ensures that resolving systemically important institutions is a credible option which enhances market discipline. At the same time, risk-based assessments are an important tool to affect the behavior of these institutions. Assessments could be imposed on a sliding scale based on the increasing level of systemic risk posed by an entity's size or complexity.

**Resolution of Non-Systemic Holding Companies**

Separate and apart from establishing a resolution structure to handle systemically important institutions, the ability to resolve non-systemic bank failures would be greatly enhanced if Congress provided the FDIC the authority to resolve bank and thrift holding companies affiliated with a failed institution. The corporate structure of bank and thrift holding companies, with their insured depositories and other subsidiaries, has become increasingly complex and inter-reliant. The insured depository is likely to be dependent on affiliates that are subsidiaries of its holding company for critical services, such as loan and deposit processing, loan servicing, auditing, risk management and wealth management. Moreover, in many cases the non-bank affiliates themselves are dependent on the bank for their continued viability. It is not unusual for many business lines of these corporate enterprises to be conducted in both insured and non-insured affiliates without regard to the confines of a particular entity.  Examples of such multi-entity operations often include retail and mortgage banking and capital markets.

Atop this network of corporate relationships, the holding company exercises critical control of its subsidiaries and their mutually dependent business activities.  The bank may be so dependent on its holding company that it literally cannot operate without holding company cooperation.  The most egregious example of this problem emerged with the failure of NextBank in northern California in 2002.  When the bank was closed, the FDIC ascertained that virtually the entire infrastructure of the bank was controlled by the holding company.  All of the bank personnel were holding company employees and all of the premises used by the bank were owned by the holding company.  Moreover, NextBank was heavily involved in credit card securitizations and the holding company threatened to file for bankruptcy, a strategy that would have significantly impaired the value of the bank and the securitizations.  To avert this adverse impact on the DIF, the FDIC was forced to expend significant funds to avoid the bankruptcy filing.

As long as the threats exists that a bank or thrift holding company can file for bankruptcy, as well as affect the business relationships between its bank and other subsidiaries, the FDIC faces great difficulty in effectuating a resolution strategy that preserves the franchise value of the failed bank and so protects the DIF.  Bankruptcy proceedings, involving the parent or affiliate of a bank, are time-consuming, unwieldy, and expensive.  The FDIC as receiver or conservator occupies a position no better than any other creditor and so lacks the ability to protect the receivership estate and the DIF. The threat of bankruptcy by the BHC or its affiliates is such that the Corporation may be forced to expend considerable sums propping up the holding company or entering into disadvantageous transactions with the holding company or its subsidiaries in order to proceed with a bank's resolution. The difficulties are particularly egregious where the Corporation has established a bridge bank to preserve franchise value, protect creditors (including uninsured depositors), and facilitate disposition of the failed institution's assets and liabilities. By giving the FDIC authority to resolve a failing or failed bank's holding company, Congress would provide the FDIC with a vital tool to deal with the increasingly complicated and highly symbiotic business structures in which banks operate in order to develop an efficient and economical resolution.

The purpose of the authority to resolve non-systemic holding companies would be to achieve the least cost resolution of a failed insured depository institution. It would be used to reduce costs to the DIF through a more orderly and comprehensive resolution of the entire financial entity. If the current bifurcated resolution structure involving resolution of the insured institution by the FDIC and bankruptcy for the holding company would produce the least costly resolution, the FDIC should retain the ability to use that structure as well. Enhanced authorities that allow the FDIC to efficiently resolve failed depository institutions that are part of a complex holding company structure will provide immediate efficiencies in bank resolutions result in reduced losses to the DIF and not require any additional funding.

**Conclusion**

The current financial crisis demonstrates the need for changes in the supervision and resolution of financial institutions, especially changes relative to large, complex organizations that are systemically important to the financial system. The choices facing Congress in this task are complex, made more so by the fact that we are trying to address problems while dealing with one of the greatest economic challenges we've seen in decades. While the need for some reforms is obvious, such as a legal framework for resolving systemically important institutions, others are less clear and we would encourage a thoughtful, deliberative approach. The FDIC stands ready to work with Congress to ensure that the appropriate steps are taken to strengthen our supervision and regulation of all financial institutions -- especially those that pose a systemic risk to the financial system.

I would be pleased to answer any questions from the Committee.