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Thank you for the opportunity to address the committee this morning.

The Dodd-Frank Act contains many well-considered prudential standards aimed at reducing the systemic risk of U.S. financial institutions and by extension the systemic risk of the U.S. financial system. Some of these safeguards tighten up existing prudential standards, while others impose brand new prudential standards. These measures touch on nearly every risk function at modern banking companies, and the list is a long one.

From my perspective, these measures can be dividing relatively neatly into two separate categories.

On one side we have *ex ante* measures that try to limit banks' exposures to and/or contributions to systemic macroeconomic events. Some salient examples include higher capital and liquidity ratios aimed at making bank balance sheets more resilient to systemic events, and regulatory stress tests designed to monitor the resiliency of bank balance sheets. On the other side we have *ex post* measures that try to limit the amplification of systemic events (contagion) caused when banks default on their financial obligations to creditors, borrowers, other banks or financial counterparties. This approach centers on the FDIC's orderly liquidation authority, which is complemented by new stores information made available to the FDIC *via* resolution plans (living wills) and price discovery *via* exchange traded derivatives positions.

It is my observation that we pay most of our attention to the *ex ante* systemic risk prevention measures—i.e., setting rules and limits for banks—and we tend to have relatively less

confidence in *ex post* measures to contain systemic risk. The explanation for this, I think, is two-fold. First, we understand intuitively that for every dollar of risk that we can prevent beforehand, we will have one less dollar of risk to contain afterwards. And second, we are skeptical that regulators will take strong actions to seize and liquidate large insolvent banks during a deep recession or financial crisis. Given our intuition and our skepticism, we tend to stress *ex ante* risk prevention.

Minimum equity capital standards are the backbone of our *ex ante* risk prevention framework. The idea is that by increasing a bank's capital buffer, it will have enough resources to continue operating during an economy-wide financial event and to emerge from the crisis financially solvent. But such a world requires extremely high levels of bank capital. My research (with Allen Berger, Mark Flannery, David Lee and Özde Öztekin) shows that in 2006, the average U.S. commercial banking company had nearly double the risk-weighted capital ratios necessary to be deemed well-capitalized by bank regulators, and that 95% of all banking companies cleared the adequately-capitalized threshold by at least 300 basis points. As we know, these outsized stores of equity capital were not large enough to prevent hundreds of bank insolvencies in the years that immediately followed. The lesson here is that relying on *ex ante* regulations to reduce bank failure risk—whether this means more capital, more liquidity, more lending restrictions, etc.—will impose non-trivial costs on banks, and these costs will in turn result in non-trivial reductions in financial services.

In the shadow of the financial crisis, this may seem like a wise tradeoff—less lending and slower economic growth in exchange for a reduction in the severity of the next systemic financial event. But the orderly liquidation powers in Dodd-Frank provide us with an historic opportunity to avoid having to accept this tradeoff. OLA should allow us to not only limit the

contagious after-effects of a systemic crisis, but also to establish a newly credible regulatory regime devoid of the too-big-to-fail that have for so long fostered systemic risk in our financial system.

Indeed, this is a big claim. But the economic story is straightforward: when investors become convinced that large complex banks will be seized upon insolvency—with shareholders losing everything and bondholders suffering losses—then credit markets and equity markets will more fully price bank risk-taking; profit-seeking banks will then face clear incentives to reject high-risk investments *ex ante*.

The political story, however, is far from straightforward. OLA requires bank regulators to credibly establish that they can and will seize, unwind and eventually liquidate large complex insolvent banks. The FDIC's "single point of entry" plan for implementing OLA is a workable plan. Nevertheless, in my discussions with scores of banking and regulatory economists across the U.S., I meet with a near uniform skepticism that the FDIC will be permitted to exercise its resolution authority during a financial crisis in which multiple large banking companies are nearing insolvency. Essentially, their belief is that the deeper is the financial crisis, the greater is the probability that OLA will be suspended.

In my opinion, the most important actions that Congress and the Administration can take to limit systemic risk in the U.S. financial system is to strongly and repeatedly enunciate their support of OLA and to pledge that they will not stand in the way of its implementation during a deep financial crisis. Our banking system is most effective when scarce economic resources are moved from poorly managed banks to well-managed banks. Hence, we don't want a banking system that is devoid of bank failure. Rather, we want a banking system that is resilient to bank failure. OLA is the key to this resiliency.

Thank you for your time this morning. I hope that my remarks have been useful. I look forward to your questions.