Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

Barnett Sivon & Natter P.C.
ATTORNEYS at LAW
WASHINGTON, DC

Does Dodd-Frank End Too Big to Fail?*

Raymond Natter

July, 2011

One of the primary purposes of the Dodd-Frank Act is to end the "too big to fail" (TBTF) doctrine. This doctrine has been used to justify Federal assistance to financial companies on the theory that the failure of the company would result in serious harm to the U.S. economy. As stated by the Treasury Department in a recent Congressional hearing, under Dodd-Frank:[1]

> No firm will be protected from failure. No firm will benefit from the perception that taxpayers will be there to break their fall. Dodd-Frank makes clear that taxpayers must not be asked to bear the costs of a financial firm's failure.

However, it is not clear to many that TBTF is completely gone. This article will discuss some of the problems that may prevent the realization of this goal when the next financial crisis occurs.

I. Why Are Some Institutions Too Big to Fail?

In order to understand "too big to fail", it is important to first discuss the role of financial institutions in our economy. Our economy runs on credit. Retailers use credit to purchase inventory and pay salaries, and they receive income to repay these debts as the inventory is sold. Manufacturers use credit to procure the raw materials and repay these debts when their finished goods are sold. Farmers borrow to buy planting supplies and repay their

*The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

[1] Testimony of Acting Assistant Secretary Tim Massad Before the House Committee on Oversight and Government Reform, March 29, 2011.

debts when the crops are sold. And consumers use credit to purchase the consumer goods that have become vital to our economic growth. If credit is not available the economy will shut down, stores and factories will close, and unemployment will skyrocket.

Financial institutions play a critical role in providing the credit necessary for our economy. Banks, securities firms, investment houses and other financial companies transfer funds from those that have excess capital to those that need capital to operate their business, or to consumers who need the cash to purchase goods. When the market perceives that a financial company is healthy, those companies with excess funds will lend to that financial company for a low rate of interest, and often on an unsecured basis. This provides relatively low cost funds that the financial company can re-lend to the businesses that need the funds to operate. When the health of a financial company is in question, those with excess cash will expect a higher rate of return to lend to that financial company. If the questions about the company's health are serious enough, it might be shut out of the credit markets altogether.

Many of the flows of cash are between two or more financial companies. An insurance company that has surplus cash might lend to a large banking organization, which in turn, might lend funds to several community banks. These interconnections are necessary to provide an efficient flow of funds from one sector of the economy to another and the fact that transactions are occurring between well respected and regulated institutions lower the costs for all of the parties, including consumers.

The TBTF problem results from these interrelationships among financial companies. If a financial company lends a significant amount of money to a second financial company, the failure of the second company could bring down both companies. If it turns out that many financial companies have lent to that one company, the failure of that company could now bring down tens or even hundreds of companies. And the failure of these companies could, in turn, bring down hundreds if not thousands of additional companies. Very quickly credit would become unavailable and businesses would have to stop production and lay off their workers.

As we recently saw, the same result can occur without an actual failure, if the markets lose faith in the solvency of a financial company. Following the Lehman Brothers closure, the uncertainty about the condition of other financial companies led the flow of credit to slow to the point that the Government had to intervene. Not in order to save any company, but to restore the belief that it was safe to lend to financial companies, so that they in turn had funds to lend to U.S. businesses and consumers. TBTF is not about saving a company, or protecting shareholders, it is about providing the confidence that allows money to flow in our economy.

II. How the Dodd-Frank Act Deals with TBTF

1. Enhanced Regulation

The Dodd-Frank Act deals with the TBTF problem through two approaches. First, it provides a new, and enhanced regulatory structure for systemically important financial institutions as well as all banking organizations with $50 billion or more in consolidated assets (whether or not the banking organization is systemically important).

There are a number of problems with this approach as a means to end TBTF. Basically, it is an attempt to end TBTF by preventing financial institution failures. Increasing capital levels, limiting activities, and raising underwriting standards will no doubt make financial institutions safer. But it will come at a cost to society in terms of less credit availability, slower economic growth, and less efficient financial products. It will also likely lead to less opportunities for economic advancement for disadvantaged populations, since it will be more difficult to "take a chance" on an individual or small business needing funding for a new venture.

Further, these reforms are backwards looking, and probably will not prevent the next financial crisis. No one knows today what the financial crisis of tomorrow will look like. When I was a bank regulator, bank investments in highly rated mortgage-backed securities were encouraged as a safe and sound investment. No doubt, there will be a new safe and sound investment in the future that will eventually burst. History shows that there will be booms and busts in our economy, and enhanced regulation is unlikely to prevent the next one.

2. New Resolution Process

The second approach to end TBTF in the Dodd-Frank Act is the establishment of a new resolution process, outside of the bankruptcy code. This new process is intended to deal with the failure of a financial company (other than an insurance company). A company will be subject to the new structure if the Secretary of the Treasury, in consultation with the President, determines that the resolution of the company under the bankruptcy laws would have serious adverse effects on financial stability in the United States. Any financial company (other than an insurance company) may be resolved under these new procedures, even if the company has not been designated as systemically significant for purposes of enhanced regulatory oversight.

If a company is forced into this resolution process, the FDIC will be appointed as the receiver, and will be given wide latitude in winding down the affairs of the company and paying off creditors. The FDIC will have the ability to provide preferential treatment to certain creditors or classes of creditors. Any losses that the FDIC incurs are to be made up through assessments on large financial institutions.

If a company is truly TBTF, and if there is a concern about the stability of the U.S. economy if the company does not honor its debts, it is highly unlikely that the Government will not find a way to honor those debts. As we saw during the last fiscal crisis, if the potential impact is serious enough, Government officials and regulatory agencies will provide the assistance necessary.

The resolution process in the Dodd-Frank Act provides flexibility for the FDIC to protect creditors and make them whole. In the event of a TBTF institution, any question about debtors not being paid in full could easily result in a loss of confidence in the financial markets. That is a result that the Government cannot afford. In order to prevent this calamity, taxpayer funds might have to be advanced.

The Dodd-Frank Act is aware of that possibility, and mandates that large financial institutions would be assessed to recoup the costs to the Government. However, the resolution process in Dodd-Frank will only come into play when there is an extremely significant problem. The amount of the assessment will likely be very large, and the financial institutions to be assessed may well be challenged. In this situation, the goal of the Government will be to strengthen these companies and not to assess them for mistakes made by others. In addition, these assessments will reduce credit availability, since it will reduce the capital base of the assessed companies. As a practical matter, the Government may take action to avoid these assessments rather than acerbate poor economic conditions or cause another failure. Time will tell how these procedures work in an actual crisis.

Finally, the new resolution procedures may have the unintended consequence of raising the cost of funding for many financial companies. As noted, the procedures are not limited to companies identified as systemically important, so it is possible that any large financial company could be placed into receivership. The uncertainty that results from these new procedures could result in higher funding costs for these companies. Funding costs could also rise because the FDIC, as receiver, may be perceived as having a conflict of interest. Insured banks are likely to be creditors of the failed company, as well as non-banks. Non-bank creditors might view the FDIC's interest in protecting the bank insurance fund as being in conflict with the interests of other creditors.

III. Conclusion

The Dodd-Frank Act attempts to end the "too big to fail" doctrine through a stringent new regulatory system and by establishing a new resolution process for companies whose failure would have a serious adverse impact on the economy of the United States. There is debate about whether or not these provisions will actually end TBTF.

The TBTF doctrine results from legitimate concerns that the failure of a large and interconnected financial company could bring down many other financial companies and erode the market's faith in the financial system. As a result, credit would stop flowing and businesses would shut down. To prevent this catastrophe, the Government has stepped in a number of times to pay off creditors of companies deemed too big to fail.

The Dodd-Frank Act attempts to end TBTF by enhancing supervision and regulation of systemically important companies, and by providing an alternative resolution process for companies, if the failure of the company would cause significant adverse effects on financial stability in the U.S.

It is uncertain how effective these provisions will be in ending TBTF. If a company is, in fact, TBTF, the Government may be faced with a choice of complying with statutory limitations or allowing the country to fall into a recession or depression. In the past, the Government has taken action to prevent or mitigate the potential for economic disaster. We will have to await the next crisis to determine if the Dodd-Frank Act provides the tools to allow for the Government to deal with a crisis without the use of taxpayer funds.

Raymond Natter is a partner with the law firm of Barnett Sivon & Natter, P.C.