RESOLVING TOO-BIG-TO-FAIL IN THE UNITED STATES

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Big banks have grown much bigger and have become increasingly complex since the financial crisis of 2007–09, which was the impetus for the Dodd-Frank Act. This development has focused attention on the need to resolve the too big to fail problem. In "Resolving Too-Big-to-Fail in the United States" James Barth and Apanard Prabha focus on the new orderly liquidation authority (OLA) granted to the Federal Deposit Insurance Corporation (FDIC) under the Dodd-Frank Act, assessing the adequacy of the post-crisis reform. The OLA allows the FDIC to serve as receiver for big banks, whose failure poses a significant risk to financial stability. The FDIC's new resolution authority, if it works as intended, is expected to eliminate the TBTF problem; however, it may fall short of its goal. It is important for policy makers to monitor the incremental and as yet untested reforms and make adjustments as their impact becomes clear.

BACKGROUND

The belief that some banks are too big to be allowed to fail underlaid the response of regulators to the financial crisis of 2007–09, when some of the biggest banks in the country were bailed out by the federal government. The 2010 Wall Street Reform and Consumer Protection Act (Dodd-Frank) included a provision that allowed the Federal Deposit Insurance Corporation to act as a receiver for big banks, whose failure poses a significant risk to the financial stability of the United States, with the intent of eliminating the possibility of future bailouts of banks deemed "too big to fail."

HISTORY

The FDIC was created in 1933 to guarantee bank deposits, up to a limit, and to reduce the incentive of depositors to make panicked withdrawals, therefore reducing the risk of bank runs and bank insolvency. The deposit insurance system is meant to be self-sustaining by levying assessments on the insured institutions to cover losses.

- The FDIC guaranteed 45 percent of deposits at its inception, reached a peak of 82 percent in 1990, declined to 73 percent in 2000, and once again climbed to 79 percent following the 2007–09 crisis.
- The FDIC has confronted three episodes of failures: the first during the Great Depression, the second during the Savings and Loan crisis of the 1980s, and the third during the 2007–09 housing market bubble and meltdown. The ten largest failed depository institutions all did so in 1988 or afterwards.
- There were three years when the FDIC's losses exceeded its reserves, the most recent being during the 2007–09 financial crisis. In each case, the FDIC restored its solvency through the assessments it levies on the insured institutions.

THE FDIC'S ROLE IN RESOLVING BANK FAILURES

- Prior to 1950, the FDIC could resolve bank failures by choosing the less expensive of two options: (1) liquidating the bank and paying off insured depositors, or (2) arranging for acquisition by a healthy bank.

- In 1950, Congress authorized the FDIC to infuse funds to keep a bank open when the bank's continued operation was considered "essential" to the community.
- In 1991, the FDIC was granted a "systemic risk exception" which allowed the FDIC to provide assistance to a troubled institution, even if was the more expensive option, if failure of the bank would have serious adverse effects on the economy or financial stability.
- In 2008, under the Troubled Asset Relief Program, 707 banks received capital injections amounting to $245 billion from the government; 86 percent of TARP funds went to 20 big banks.
- After 2009, reforms driven by Dodd-Frank and the new Basel requirements attempt to prevent a bank from failing by (1) restricting the size of banks, (2) restricting scope of bank activities, and (3) requiring higher capital requirements for big banks. Dodd-Frank provides for orderly liquidation if a big bank fails, with the hope of preventing the recurrence of the "too-big-to-fail" problem.

THE ORDERLY LIQUIDATION AUTHORITY

The OLA is meant to prevent any future government bailouts by imposing costs on both owners and creditors.

- The FDIC can put taxpayer funds in the bank once the orderly liquidation authority is invoked to keep the bank afloat for a defined time. The government is not allowed to bear the costs of liquidation without further congressional authorization.
- This could leave bondholders picking up the tab for any government losses, depending on how the FDIC structures the resolution, such as imposing a debt for equity swap. This could be potentially destabilizing, as it increases the incentive for bondholders to flee at the first hint of trouble.

AN INADEQUATE SOLUTION

Banking regulations and regulators have proliferated after each crisis, but this has not led to fewer and less costly banking crises.

- The problem was the regulatory authorities' failure to enforce existing regulations.
- A big bank can still fail. With many changes still evolving and untested, the outcomes are unclear.
- Monitoring reforms and making adjustments as their impact becomes clear is important to prevent history from repeating itself.

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