Backgrounder

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Using Bankruptcy and Capital Standards to Address Financial Institutions That Are "Too Big to Fail"

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Abstract: *The Obama Administration's proposal for financial regulatory reform is unrealistic and would give government regulators almost unlimited powers to take over or micromanage financial institutions. The better choice would be to amend U.S. bankruptcy law to create an open, expedited bankruptcy process in which an impartial court would oversee the restructuring or closure of large and complex financial firms. In addition, increasing financial institutions' capital requirements would reduce risk to the system and limit losses if a financial crisis occurs.*

One of the worst aspects of the financial meltdown of 2008 was watching the government give billions of dollars to distressed financial institutions because, unlike most other types of businesses in the United States, there was no system for the orderly restructuring of a failing large financial institution. Rather than allow the financial system to collapse, firms ranging from AIG to Citibank to Bank of America received hundreds of billions of tax dollars in capital infusions and loans—much of which has been lost for good. To ensure against a reoccurrence, Congress needs to modernize bankruptcy laws to create an expedited method to restructure and close such large and complex financial firms. Congress should also increase capital standards in a way that discourages financial firms from reaching the point that their failure could endanger the entire financial system.

Talking Points

- The Obama Administration and others have proposed financial regulatory reforms that are unrealistic and would give regulators almost unlimited powers to take over or micromanage financial institutions.
- Instead, Congress should modernize bankruptcy laws to create an expedited method to restructure and close large and complex financial firms. Current bankruptcy laws are not designed for modern financial firms. Otherwise, the government will again find itself bailing out this type of firm when the next financial crisis hits.
- Congress also needs to create capital standards that discourage financial firms from reaching the point that their failure could endanger the entire financial system.

This paper, in its entirety, can be found at: *www.heritage.org/Research/Regulation/bg2343.cfm*

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Large, complex firms comprise a significant portion of the world's financial industry. These businesses are so tightly interconnected that the failure of one could cause the others to fail. Of these, a few "too big to fail" firms are so large that one failure could bring down the entire financial system. Normally, large firms that fail can be handled through the bankruptcy process, but the current law is unsuitable for today's large financial services firms because the value of their assets is determined as much by faith in the financial system as by more traditional measures. Their assets can become worthless within minutes or hours, as can similar assets held by other financial entities.

In 2008, the failure of Lehman Brothers and the general uncertainty about what would happen next caused markets to crash and drove major firms to the brink of failure because no one really knew what certain assets were worth. Further, the interconnectedness of firms meant that losses in one would spread to others that held similar assets or that had major business relationships with each other. Faced with a looming catastrophe and lacking any mechanisms suitable to address the scale of the problems, regulators literally made up solutions as they attempted to respond to each new crisis. It quickly became clear that just letting the firms fail would cause an even wider panic and cascading effects could threaten the entire financial system. Although collapse was avoided, the strain was far worse than most experts expected.

This problem should not be ignored and left to chance. Otherwise, the next time could cause the entire financial system to collapse. Much of the chaos in 2008 came from uncertainty about what would happen next. Preventing the next crisis should therefore begin with establishing a clearly understood mechanism that enables orderly resolution of a failing large financial institution. A properly structured resolution mechanism would tell the market what to expect and prevent taxpayer-funded rescues. Equally important, its presence would signal to investors and managers that they cannot base their business strategy on the expectation that the government will bail out their firms. The second element of the solution involves reducing the risk from such firms by encouraging them to engage in less risky behavior and requiring them to have assets available to absorb losses in a crisis.

The Obama plan is much more likely to increase taxpayer bailouts of major financial institutions than to curb them.

A number of different solutions have been proposed, but most of them look better on paper than they would in reality. This includes the Obama Administration proposal to give resolution authority to the Federal Deposit Insurance Corporation (FDIC), which assumes that dealing with a distressed and complex multinational nonbank is comparable to handling a small bank failure. Sadly, the Obama plan is much more likely to increase taxpayer bailouts of major financial institutions than to curb them.

A better approach would be to add a new chapter to the bankruptcy code that is explicitly designed to meet the special circumstances of "too big to fail"[1] financial institutions. Properly structured, the new chapter would allow large financial firms to be closed in an orderly way that reduces the potential for systemic risk. It would not give regulators virtually unlimited powers and would free the process from political interference by giving control to an unbiased court system that already has extensive experience with complex modern firms.

Meanwhile, higher capital standards would both discourage growth above a certain point in all but the most efficiently managed firms and provide an extra cushion for times of economic stress. Capital standards should differentiate among assets by risk and by size of institution.

The Obama Proposal

The Obama Administration[2] has proposed giving the FDIC emergency authority over nonbank

1. Despite the wording "too big to fail," size alone does not necessarily determine how much risk a financial firm could impose on the overall financial system. The composition of a large firm's assets is actually more important to deciding whether the failure of a financial institution poses a systemic risk.

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financial institutions that are "too big to fail" and allowing the Secretary of the Treasury to designate the FDIC[3] as the conservator or receiver of failing financial institutions. The original Obama Administration proposal was released on July 23, 2009, and was revised by a draft bill[4] proposed by House Financial Services Committee Chairman Barney Frank (D–MA) on October 29. If the Financial Services Committee approves it, the draft will be introduced as the Financial Stability Improvement Act of 2009 (H.R. 3996).

Financial institutions subject to the "too big to fail" regime would include bank holding companies and their nonbank subsidiaries.[5] It would also include "tier 1 financial services holding companies," a new designation intended to cover large financial services firms that do not own a depository institution, but that could cause systemic risk to the financial system if they failed. In theory, this new designation would allow the regulators to extend their reach to any large financial institution and its subsidiaries regardless of how it is organized, what it owns, or how it is operated. While there is a need to deal with failing financial companies that could cause systemic risk regardless of how they are organized, the Administration's approach seems geared more toward facilitating future bailouts and justifying additional intervention.

The Three Major Parts. As originally announced in July and revised in October, the Obama resolution plan has three major parts:

- **Determination.** First, to initiate the process, the Treasury Department would need to determine that failure of a specific firm would cause systemic risk[6] and two-thirds of the members of the Federal Reserve Board and either the FDIC or the Securities and Exchange Commission boards would need to vote in support of using the mechanism.
- **Intervention.** After the determination, the FDIC with the approval of the Treasury Secretary could take a wide variety of actions ranging from loans to the failing company, purchasing equity stakes in the company, assuming or guaranteeing obligations of the firm, or purchasing the company's assets either directly or through an entity established by the FDIC.
- **Conservatorship or Receivership.** Alternately, the Treasury secretary could appoint the FDIC as the conservator or receiver, after which the agency could essentially take control of the company and run it.

According to Assistant Treasury Secretary Michael Barr:

> A conservatorship or receivership under this authority would have four essential elements that would improve execution and outcomes relative to the tools that were available last fall: (i) swifter replacement of board and senior management with new managers selected by the FDIC; (ii) a temporary stay of counterparty termination and netting rights to mitigate the adverse consequences to the

2. The Obama plan would also create a systemic risk regulator. For a discussion of this, see David C. John, "Financial Systemic Risk Regulators: Congress Is Asking the Wrong Questions," Heritage Foundation *WebMemo* No. 2471, June 8, 2009, at *http://www.heritage.org/Research/Regulation/wm2471.cfm*.
3. The Securities and Exchange Commission may be appointed as conservator or receiver in certain cases in which the firm's largest subsidiary is a registered broker-dealer. Only a few financial institutions would qualify at this point.
4. For the October draft, see Financial Stability Improvement Act of 2009, committee print, Committee on Financial Services, U.S. House of Representatives, October 29, 2009, at *http://financialservices.house.gov/Key_Issues/Financial_Regulatory_Reform/FinancialRegulatoryReform/Discussion_Drafts/Committee_Print_titleI102904.pdf* (November 4, 2009).
5. The bank subsidiaries of bank holding companies are already subject to existing FDIC resolution authority and thus need not be included in the new plan.
6. To start the process of applying the resolution regime to a specific entity, the Treasury Department must determine that (a) the company is at risk of default, (b) failure of the firm would seriously and adversely affect financial stability or the economy, and (c) government action could at least mitigate the adverse effects.

> company's liquidity, avoiding the cross defaults and cascades that otherwise, create a vicious cycle leading ultimately to financial collapse; (iii) the ability to provide the firm with secured financing to fund its liquidity and capital needs during the conservatorship or receivership to mitigate the "knock on" effects of any firm's failure and to fund its operations, pending its sale or winding down; and (iv) the creation of one or more bridge bank holding companies in the case of a receivership to preserve the business franchise, deal with counterparty claims, and protect viable assets of stronger subsidiaries pending their sale. This would end the firm—wind it down—without contributing to system-wide failure.[7]

The Plan's Flaws. The Obama plan has several major failings. First, it is extremely open-ended and "tier 1 financial services holding company" is so broadly defined that it could apply to almost any financial firm in any circumstance.[8] Once so designated, a company would be subject to a wide variety of Federal Reserve regulations and oversight that are equally poorly defined and open-ended. As amplified by the October draft,[9] the regulators would have such broad and encompassing powers that they could essentially draft any financial firm into the federal financial regulatory system and subject it to a wide variety of restrictions. Further, at any point, the regulators could compel large financial firms to sell off portions of themselves, drop lines of business, break up, or otherwise reduce the "risk" that the regulators believe they may impose on the financial system.

This unlimited power and scope is extremely unwise and would almost certainly face constitutional challenges. Even worse, it would almost certainly be applied to newer lines of business and products instead of traditional ones, thus reducing domestic financial innovation and drive innovative international products offshore.

Second, depending on the rules and the market's interpretation of the rules, the special designation of firms could distort the credit markets, possibly giving designated firms advantages unavailable to undesignated firms or creating special weaknesses. The idea that a designation could be kept secret is exceedingly naïve because any qualified analyst could easily replicate the list by watching the actions of the regulators and examining the balance sheets of large financial services firms. In fact, any experienced financial reporter could create an accurate list from memory. On the other hand, a public list would certainly cause distortions because the market would know that certain financial institutions are "too big to fail" and price their debt to reflect the perceived lower risk. As in the cases of Fannie Mae and Freddie Mac, repeated disclaimers that there was no government guarantee of their debt did nothing to counteract the market's assumption that such a guarantee existed.

Further, a publicly designated tier 1 firm that is then delisted could be exposed to severe adverse

7. Michael Barr, written testimony before the Subcommittee on Commercial and Administrative Law, Committee on the Judiciary, House of Representatives, October 22, 2009, p. 6, at *http://judiciary.house.gov/hearings/pdf/Barr091022.pdf* (November 16, 2009).

8. As described in July, "This section amends the Bank Holding Company Act of 1956 to allow for the designation by the Board of United States financial companies as Tier 1 financial holding companies if the effect of material financial distress at the companies could pose a threat to global or United States financial stability or the global or United States economy and of foreign financial companies if that effect could pose a threat to United States financial stability or the United States economy. This designation is subject to reevaluation, rescission, notice, and an opportunity to be heard." For a summary of the proposed legislation, see Committee on Financial Services, U.S. House of Representatives, "Title II—Bank Holding Company Modernization Act of 2009: Section-by-Section Analysis," at *http://financialservices.house.gov/Key_Issues/Financial_Regulatory_Reform/FinancialRegulatoryReform/Section-by-Section/title_II_sec_by_sec_7_22_2009_fnl.pdf* (October 23, 2009).

9. For more detail on these powers and how they could be abused, see Peter J. Wallison, "On Systemic Regulation, Prudential Matters, Resolution Authority, and Securitization," statement before the Committee on Financial Services, U.S. House of Representatives, October 29, 2009, at *http://www.house.gov/apps/list/hearing/financialsvcs_dem/wallison_-_aei.pdf* (November 12, 2009).

consequences as the market reacts to the news. Of course, a designated firm would receive advantages in credit costs whether or not the list is public.

The Obama plan would virtually guarantee more federal bailouts of large financial firms by creating a funding mechanism that is so open-ended that it could be used in almost any situation.

Third, the Obama plan would virtually guarantee more federal bailouts of large financial firms by creating a funding mechanism that is so open-ended that it could be used in almost any situation. Most press reports focus on proposals to advance tax dollars to a failing company that would be repaid through a fee imposed on firms with over $4 billion in assets. The alternative, proposed by the FDIC and endorsed by Chairman Frank (after he had earlier supported assessments after a crisis), would be to create a type of "super FDIC" fund that would be funded in advance by charging regular insurance fees to large and complex financial institutions.[10]

Better Alternatives. Instead of establishing a new unlimited authority, the Administration could meet its objectives more effectively through less intrusive means. Stricter capital requirements would reduce the potential risk to the economy from large financial institutions. Similarly, adding a new section to the bankruptcy code would enable the courts to resolve failing large financial institutions.

Closing down multinational financial firms is not easy. The collapse of Lehman Brothers caused about 92 subsidiaries to go into bankruptcy, of which only 20 subsidiaries were located in the U.S. and came under American jurisdiction. Even today, there are disputes about whether assets located in the United States belong to international subsidiaries.

Clearly, a receiver or conservator that can operate at least certain subsidiaries until they can be sold or closed in an orderly way is necessary to maximize returns to debtors. However, the Administration's implicit assumption that the FDIC could resolve complex financial giants is seriously misguided. While the FDIC has broad experience with resolving failed smaller banks, it has no experience with the broader financial activities that almost certainly would be part of failing large financials. If cast in this new role, the agency would likely discover that its procedures cannot handle the challenges of such a distressed firm, and its efforts would cause the same systemic shock that the new authority is designed to prevent.

Other Proposed Solutions That Will Not Work

The Obama proposal is just one approach to dealing with the risk to the financial system from the potential failure of financial institutions. As the events of 2008 showed, the failure of important financial institutions can change the real and perceived value of assets to the point that other entities totter on the verge of failure. Unchecked, this type of shock to the financial system can spread internationally from firm to firm and threaten the entire financial system. This type of global catastrophe came so close to reality that changes are clearly needed. However, most of the proposed solutions fail to address the underlying issues. Many focus on distinctive aspects of the financial industry, mistakenly assuming that changing them will reduce systemic risk.

The problem of "too big to fail" financial institutions is neither a small nor simple issue. While the proposals address aspects of systemic risk, none is comprehensive or fully practical.

Separating Out Risky Activities. The head of the Bank of England and others want to separate depository functions from the risky parts of financial institutions, such as those that deal in innovative financing methods and derivatives. However, separating traditional depository activities from their riskier cousins—even if this is possible—solves only part of the problem. Presumably, the risky parts would be allowed to fail, while the deposit-taking parts would essentially become util-

10. Barney Frank, interviewed by Al Hunt, *Political Capital with Al Hunt*, Bloomberg Television, transcript, at *http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aUwq0DliFzdY* (November 16, 2009).

ities with very limited and safe activities. The depositary remnants would not be in danger of failing because of their limited nature and would be rescued if they ever did.

In the U.S., this proposal would restore the old Glass–Steagall Act, which arbitrarily separated banking and finance after the Depression. In assuming that the non-depository entities can safely fail, supporters are forgetting that the failures of the non-depository investment houses Bear Stearns and Lehman Brothers and the potential failure of the global insurance company AIG helped to trigger the 2008 crisis. They are also forgetting that financial firms found ways to circumvent many of the Glass–Steagall restrictions by the time it was repealed. Explicit prohibitions on risk taking or selling high-risk products are an invitation to firms to find loopholes that defeat the purpose of such laws and raise the cost of financial products to the eventual consumers.

Reducing the Size of Financial Institutions. Another plan is to limit the size of financial institutions and to require firms that exceed a particular size to shrink or sell portions of themselves. This proposal sounds better in theory than it would work in practice. The idea is that the best way to deal with such financial institutions is to reduce their size and scope to the point that they no longer pose any risk. As with the proposal to separate risky activities from depository functions, all major financial institutions are so intertwined that reducing the size of this or that entity does not really reduce risk. The asset and investment mix of a smaller financial institution can be just as dangerous as those of larger institutions. For instance, when the hedge fund Long Term Capital Management failed in 1998, its asset size made it much smaller than many commercial banks were at the time, but the firm posed much greater risk because of its large investment in derivatives issued by dozens of other financial institutions. Merely reducing its size would not have changed those connections.

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Advance Plan for Handling a Failure. A third proposal would require financial institutions that could pose a systemic risk to prepare a “living will” that preplans what would happen if the firm failed. There is a potential value to requiring larger firms to have a living will that specifies how to handle specific liabilities and subsidiaries if it fails, but such an approach has serious limitations. Perhaps the greatest benefit of such an approach is that it would force management to consider the firm’s operations from a different perspective and would provide initial guidance in the event of an emergency. The British government and the U.S. Treasury Department strongly support the idea, believing that such an exercise would cause a financial institution to simplify their structures to facilitate dealing with a potential failure. However, the proposal is only likely to work if the plan is reviewed and/or approved by the firm’s regulators, a move that opens the door to government micromanagement.

For a living will to limit systemic risk in a more fundamental fashion, the market must fully understand what will happen to different subsidiaries and products if the firm fails. This requires a failure plan that is explicitly detailed, constantly updated, and easily available. It may even be necessary for the firm to disclose this information on legal documents and in marketing material. In addition, because virtually all “too big to fail” institutions have extensive international operations, they would need to factor in the different laws of each country in which they operate. This is a massive task because it is often difficult to define exactly where products are sold, where those products are legally located, and where cash assets are deposited. Finally, if a failure proceeds differently due to unforeseeable circumstances (as is likely), the presence of a “living will” or similar plan could increase the firm’s legal liability.

Simply put, a living will would likely prove nothing more than a wasted planning exercise that could open the door to regulatory micromanagement before a failure and lawsuits afterward.

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A Comprehensive Approach to Prevent Systemic Shocks

Preventing another serious financial crisis requires both a method to deal with "too big to fail" financial firms that are actually failing and a way to significantly reduce the threat that such a firm poses to the financial system in advance of a crisis. Given the problems revealed in 2008 with both the current financial regulatory system and the bankruptcy code as it might apply to such financial firms, new provisions dealing with large financials are required. Simply assigning the FDIC or another federal agency to solve the problem, as proposed by the Obama Administration, will almost certainly lead to new bailouts and managerial scandals as inexperienced personnel attempt to deal with complex situations that are well beyond their competence level. The best way to resolve these firms in an orderly manner and to avoid regulatory excesses like those of 2008 is to create a special chapter of the bankruptcy code for "too big to fail" companies.

However, dealing with firms only when they fail is insufficient. Prevention requires reducing the systemic risk that they could pose to the financial system in advance. Using escalating capital requirements to limit a firm's exposure to risky activities would be much more effective than imposing artificial limits on a firm's size and activities, which good legal counsel could easily evade, or attempting to have bureaucrats micromanage major financial firms. Capital standards could also limit all but the most efficiently managed financials from growing above a certain level.

Dealing with Large Failing Firms. Regardless of the steps taken to reduce the firm size and risk, one or more "too big to fail" financial institutions will inevitably either fail or nearly fail. As 2008 showed, the government currently does not have an effective way to resolve these entities. The Administration plans to fill this need by giving the FDIC new authority.

A far better choice would be to add a new chapter of bankruptcy law to accommodate the special problems of resolving massive financial services firms. A bankruptcy court applying bankruptcy law could more effectively avoid disorderly failures of large financial institutions than the FDIC using nearly unlimited new powers. Moreover, bankruptcy courts have experience with large and complex cases, the ability to manage the hiring and supervision of financial and legal experts, and the objectivity that a court brings to such proceedings.

A bankruptcy court applying bankruptcy law could more effectively avoid disorderly failures of large financial institutions than the FDIC using nearly unlimited new powers.

Today's bankruptcy laws are inadequate to meet the special needs of large and complex financial institutions, their creditors, and the financial systems within which they operate. They were intended to deal with firms that have physical assets, such as factories and inventories, not financial firms with major assets, such as client lists and instruments, which have value as determined by the reputation of the issuer. At the first sign of terminal distress, the value of both types of assets could quickly disappear.

While details will be especially important to creating an appropriate bankruptcy procedure suited to the special needs of multinational financial institutions,[11] bankruptcy courts could easily be empowered to appoint receivers and conservators to take over failing firms, continue to operate viable subsidiaries until they can be sold, quickly close and sell unviable portions of the firm, and resolve its outstanding liabilities. The key changes to the bankruptcy statutes would be to give the court the ability to deal with a very different asset mix than is found in traditional companies and to act very quickly to preserve asset value in the face of clauses in lending contracts that allow the lender to take immediate possession of firm assets upon a bankruptcy filing without going through a legal process

11. Title I of H.R. 3110, a comprehensive financial reform bill, addresses many of the specific issues that need to be considered. These include picking an appropriate venue for the proceeding and allowing the firm to seek the advice of the court, the appropriate functional regulators, and others before deciding whether to file for bankruptcy.

to do so. The court should be given a clear goal of resolving the firm as quickly as possible to minimize the impact on the financial system, but it should have the flexibility either to liquidate the firm totally or to restructure and sell it. A key responsibility of the court would be to encourage the receiver or conservator to remove failing management and replace it with better qualified professionals.

Today's bankruptcy laws are inadequate to meet the special needs of large and complex financial institutions, their creditors, and the financial systems within which they operate.

Handling this process through bankruptcy rather than with regulators has two additional advantages. First, the courts already have experience with large and complex bankruptcies. There would be no learning curve or grant of extraordinary new powers to a bureaucracy. Second and equally important, the courts will be impartial and free of the inevitable politicization that would accompany a government agency's involvement in the process.

Another consideration is that a firm should be allowed to seek the advice of the court, appropriate functional regulators, and others before deciding whether to file for bankruptcy. These consultations should be held in strictly confidential proceedings that are publicized only after the firm seeks the protection of a bankruptcy court or is brought before the court by regulators. Likewise, to reduce systemic risk as much as possible, the court should be empowered to consult with financial regulators, officials of the affected firm, and others in advance of any filing. Regulators should be allowed to initiate a court proceeding that would place a "too big to fail" firm under the control of a bankruptcy court, but the firm should also be able to appeal such a move. These proceedings would also be held strictly confidential until and unless the bankruptcy court decides to take control of the company. By placing such a move under the oversight of the bankruptcy court, questions about whether a regulator has moved against a particular firm for political motivations should be easily resolved.

As in other bankruptcy proceedings, the process should not include public funding. The failing institution's investors and creditors should bear any losses. Additional funds necessary to resolve the failing financial institution come from other private-sector providers, whether in the form of secured loans or the proceeds of the sale of certain parts of the failing firm.

Using Capital Standards to Reduce the Risk. The other critical element to resolving "too big to fail" financial institutions is to reduce the risk that they pose to the overall financial system while they are still healthy. The most effective approach to reducing this risk, and one that is gaining support across the political spectrum, is through stronger capital and liquidity standards on larger financial institutions, regardless of whether they are banks or other types of institutions that might be exempt from such standards.

Higher capital standards should be structured to reduce both the risk imposed by a large financial institution on the overall financial system and the risk that could result from a concentration of high-risk assets in that firm. All financial institutions above a certain size, as determined by a proportion of overall financial services assets, should be required to hold increasingly higher amounts of capital as they grow in size. This additional capital would both reduce the likelihood that such a financial institution would fail and reduce the risk to the financial system if it did. Exceptionally efficient and well-managed firms could still grow, but others would find it less profitable to grow and may even choose to shrink or split. It is important to note that a financial services firm is not necessarily dangerous just because of its size, but a large firm is more likely to pose a systemic risk than a smaller firm.

However, capital holdings based merely on size could fail to reduce systemic risk unless large financial services firms are also subject to a second standard based on the risk of their assets. Some smaller firms may be much riskier to the overall economy than much larger firms that mainly deal in more conventional financial instruments. For instance, in 1998, the hedge fund Long Term Capital Management had total assets of about $129 billion, but had

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derivatives positions with a notional value of approximately $1.25 trillion. That same year, the merger of Citibank and the Travelers Group created an institution with $700 billion in assets. Thus, just as is done with bank capital requirements, specific types of financial products and investments should be subject to still higher capital standards, with a firm's overall capital requirement being based on meshing the two separate standards.

Together, the two capital standards should create the appropriate incentives to sharply reduce the leverage of the financial services firm. Leverage is a measure of the ratio of capital that is available to cover losses to the assets of the financial institution. A low leverage ratio implies a higher probability that the institution will have sufficient capital to cover potential losses. On the other hand, a high leverage ratio increases the profits available to investors because those profits are divided among fewer shareholders. When it failed, Long Term Capital Management had capital of $4.72 billion and assets of $124.5 billion, a 25–1 leverage ratio ($25 of assets for each $1 of capital). Once the firm lost $4.6 billion because of a Russian financial crisis, it was bankrupt. Because of its investments in high-risk derivatives, it was very susceptible to a sudden drop in the value of those assets.

Higher capital standards will not imperil the competitive position of U.S. banks.

With borrowings, large financial firms have routinely reached leverage rations in excess of 20–1 and even 50–1. The new standards should force the largest and riskiest firms to maintain ratios closer to 4–1 on assets added to their portfolios after they reach a certain size. Such low ratios would require firms to be exceptionally well managed and efficient to grow any larger.

Higher capital standards will not imperil the competitive position of U.S. banks. There is a growing international movement to develop international capital standards through the Bank for International Settlements (BIS), a grouping of international central banks that has worked to foster monetary and financial cooperation since 1930. Currently, BIS administers Basel II, a June 2004 international agreement on the appropriate level of bank reserves. A similar international agreement on capital standards to reduce systemic risk will likely be developed in the next few years. However, the U.S. should not wait for an international agreement before implementing tougher capital requirements, nor subordinate its own interests to those of other countries.

To succeed, these capital levels will need to apply to any financial firm operating under U.S. jurisdiction. One of the first instances of realized systemic risk, the 1998 Federal Reserve supervised bailout of the hedge fund Long Term Capital Management, shows that such risk is not limited to traditional types of financial services firms. However, rather than simply giving regulators the open-ended ability to designate any firm as potentially posing a systemic risk, Congress should meet its responsibilities by clearly defining which types of firms would be subject to the requirement and by regularly revisiting that definition with input from the regulators. This would both limit the power of regulators and clarify that the blame for any resulting problems would rest with Congress.

In addition to improved capital standards, Congress needs to impose liquidity requirements for exceptionally large financial institutions. Liquidity differs from capital in that it is a measure of readily available cash or cash equivalents that can be rapidly converted into cash. One cause of Bear Stearns's failure was its inability to repay its lenders in a timely manner. Increased capital requirements will only work if affected firms have enough reserves to meet losses and can quickly raise enough cash to meet demands. One will not work without the other.

Increased capital standards can also be used to impose yet another level of market discipline on financial firms by requiring them to hold a substantial amount of contingent capital in the form of bonds that could be converted into equity at a set and predetermined rate if the firm runs into financial trouble. Such a move would immediately spread the risk of losses to a class of bondholders, who have been largely exempt from that possibility. Although companies will complain that this would sharply increase their cost of borrowing, it would in

What Is Capital?

Capital is the reserve of money or other assets owned by the financial institution that it can draw on to cover losses. Legal definitions vary, but it generally includes money raised by the sale of a firm's stock to the public and retained earnings from past activities that have not been paid as dividends or used for other purposes. Other types of capital include increases in the value of assets owned by the firm, funds set aside in anticipation of losses that have not actually occurred, and certain types of long-term debt that will not need to be repaid before the scheduled date when the loan or bond expires.

Typically, bank capital requirements depend in part on the types of assets that the bank holds. Extremely safe assets, such as cash and government debt, do not require capital to be held against them because they can be used as is or sold in the market at close to full value. Riskier assets that might lose value require higher amounts of capital to be held against them. In addition, banks must meet capital requirements equal to a lower percentage of their total assets regardless of how risky they are. In practice, banks must calculate their capital requirements twice—once against their total assets and again based on the apparent riskiness of those assets—and hold the higher amount of the two calculations. For example, if a bank had $500 million in assets, of which only $400 million is considered risky, it might need to hold the higher of either 4 percent of its total assets of $500 million ($20 million) or 6 percent of its $400 million worth of riskier assets ($24 million). In this example, the bank must hold at least $24 million in capital. Of course, real world examples are far more complex.

reality cause potential bondholders to research and monitor the risk levels of the company more vigilantly. However, these problems can be offset to some extent because well-capitalized companies should find that the market rewards their prudence with somewhat lower borrowing costs.

Moving Toward Real Financial Regulatory Reform

Hopefully, the financial crisis of 2008 was a one-time event, but basing policy on that assumption would be irresponsible. The crisis definitively proved that existing methods of dealing with failing firms are inadequate and that too many financial institutions pose a serious level of systemic risk to the overall financial system. Faced with such a crisis, regulators resorted to making up policy and solutions as they went along, responding to each new shock individually without considering whether their reactions and the precedents they were setting would cause even greater problems in coming years. Further, they showed a regrettable tendency to simply throw increasing amounts of money at the problems as the situation worsened.

Taxpayers should never again be forced repeatedly to bail out financial services firms like AIG because a company poses a risk to the entire financial system and regulators lack the necessary tools to close the company safely. Policymakers have made a number of sincere proposals to deal with this problem, but most of their proposals are unrealistic or would give government agencies unacceptably broad powers to intervene at will.

Regrettably, the Obama proposal exhibits both flaws by assigning the FDIC a role that it is unprepared to play and giving the Federal Reserve and other regulators such broad powers that a constitutional challenge would be inevitable. Far from a solution, the Obama plan practically guarantees that regulators will need to back up their poor decisions with massive taxpayer bailouts of firms that followed regulators' directives and got into serious trouble anyway.

A better approach to preventing another crisis is to modify U.S. bankruptcy law to accommodate the special problems of resolving huge financial firms and to allow the courts to appoint receivers with the

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specialized knowledge necessary to best deal with their failure. By creating an open process controlled by an impartial judiciary guided by established statutory rules, financial firms, investors, taxpayers, and others would have the advance knowledge that large financial firms that were once known as "too big to fail" can now be closed if necessary without risking disaster. In addition, requiring all larger financial services firms to hold significant amounts of capital to cover losses would greatly reduce the systemic risk that they could pose to the financial system. Higher capital levels would enable many firms that would fail under today's capital levels to survive a crisis, saving shareholders and bondholders their investments, employees their jobs, and taxpayers billions of dollars in federal bailouts. Congress and the Administration need to learn and heed the lessons of 2008, or a repeat crisis will just be a matter of time.

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