IX. Too-Big-To-Fail and the Financial Stability Oversight Council

A. Introduction

The 2008 financial crisis exposed the U.S. financial system's vulnerability to "systemic risk," the danger that the dissolution of a financial company will produce negative macro—economic effects. The crisis was unique among financial disasters because "nonbank financial companies"—securities firms and other investment banks—produced much of the systemic risk.[1] Politicians feared that the failure of certain large and interconnected nonbank financial companies would bankrupt its creditors and counterparties. To preserve the stability of the financial system, the federal government "bailed out" several companies that were regarded as too-big-to-fail.[2] Multi-billion dollar loans[3] and coerced acquisitions[4] epitomized this trend and the public outcry reached a fever pitch after Congress established the Troubled Asset Relief Program, committing $700 billion toward future bailouts.[5]

On July 21, 2010, President Barack Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Act seeks to reduce systemic risk by establishing the Financial

---

[1] *See* Alison M. Hashmall, Note, *After the Fall: A New Framework to Regulate "Too Big to Fail" Non-Bank Financial Institutions*, 85 N.Y.U. L. REV. 829, 836 (2010) ("The failure of "non-bank" financial institutions, such as hedge funds and investment banks, can also pose serious systemic risk to the financial system.").

[2] *See e.g. id.* at 837-38 (stating that the J.P. Morgan's acquisition of Bear Stearns "effectively protected Bear Stearns's creditors and counterparties from losses they would have otherwise incurred in bankruptcy, which helped mitigate systemic risk.").

[3] *See e.g.* Matthew Karnitschnig et al., *U.S. to Take Over AIG in $85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up*, WALL ST. J., Sept. 17, 2008, at A1 (describing the Federal Reserve's loan of $85 billion to American International Group).

[4] *See e.g.* Louise Story & Jo Becker, *Bank Chief Says U.S. Pushed Merrill Deal*, N.Y. TIMES, June 12, 2009, at B1 (describing the congressional testimony of Ken Lewis, the former CEO of Bank of America, in which he "maintained that federal officials pressured him to keep the merger alive, and acknowledged that his job [would be] at risk if he did not").

[5] *See generally* David M. Herszenhorn, *Bailout Plan Wins Approval; Democrats Vow Tighter Rules*, N.Y. TIMES, Oct. 4, 2008, at A1.

Stability Oversight Council ("FSOC" or "the Council"). Critics of the FSOC argue that the Council will simply perpetuate the use of bailouts, however.[6] This article challenges this criticism by proposing that the FSOC will actually decrease the reliance on bailouts by reducing uncertainty, repudiating too-big-to-fail and removing incentives for unstable growth.

B. The Financial Stability Oversight Council

The Dodd-Frank Act authorizes the FSOC to oversee financial stability and subject particularly risky companies to supervision by the Federal Reserve. The FSOC's oversight role is explicit in the Council's stated purposes, which include "identify[ing] risks to the financial stability of the United States" and "respond[ing] to emerging threats to the stability of the United States financial system."[7] Notably, the FSOC also should "promote market discipline, by eliminating expectations on the part of shareholders, creditors and counterparties of [financial] companies that the Government will shield them from losses in the event of failure."[8] The FSOC's duties also evoke supervisory responsibilities, including "monitor[ing] the financial services marketplace," "recommend[ing] . . . supervisory priorities and principles," and "identify[ing] gaps in regulation."[9]

Most significantly, the FSOC can subject a nonbank financial company to supervision by the Federal Reserve.[10] Federal Reserve supervision is appropriate if two-thirds of the FSOC, including its chairperson, determine that the company poses a risk to financial stability.[11] To analyze systemic risk, the FSOC will consider, *inter alia*, the company's liabilities, assets, off-balance sheet exposure and any other "risk-related factors."[12]

---

[6] *See* Peter J. Wallison, *The Dodd-Frank Act: Creative Destruction, Destroyed*, A.E.I. FINANCIAL SERVICES OUTLOOK (July-Aug. 2010), 3, *available at* http://www.aei.org/outlook/100983 ("The real danger is that the Fed will implement 'too big to fail' privately, outside public view, through its new powers under the [Dodd-Frank Act].").
[7] Dodd-Frank Wall Street Reform and Consumer Protection Act § 112, 12 U.S.C.A. § 5322 (2010).
[8] *Id.*
[9] *Id.*
[10] *Id.*
[11] *Id.* § 5323.
[12] *Id.*

The Federal Reserve must apply stricter supervision than normally applied to nonbank financial companies.[13] Additionally, the Federal Reserve's supervision must "increase in stringency" if a company becomes more risky.[14] This supervision can include regulation authored by the Federal Reserve or recommended by the FSOC.[15] The Federal Reserve may impose limits on risk-based capital, leverage, liquidity, concentration of assets, contingent capital, short-term debt and "overall risk."[16] Upon a two-thirds vote from the FSOC, the Federal Reserve may restrict a nonbank financial company's ability to engage in mergers, acquisitions or financial activities.[17] Finally, if these restrictions are insufficient, the Federal Reserve may force the company to sell assets or terminate activities.[18]

A key component of the Federal Reserve's supervision is the ability to conduct stress tests,[19] and require resolution[20] and early remediation plans.[21] The FSOC also may require regulatory agencies with representation on the FSOC and the Office of Financial Research to submit data regarding systemic risk.[22]

C. The Too-Big-to-Fail Problem

Whether a company is bailed out hinges on the level of uncertainty surrounding the company's dissolution.[23] A company may be too-big-to-fail if the company holds significant assets, and if the company's bankruptcy would severely impact its counterparties and pose a significant administrative burden.[24] Predicting the macro-

---

[13] *Id.* § 5365.
[14] *Id.*
[15] *Id.* § 5330.
[16] *Id.* § 5325.
[17] *Id.* § 5331.
[18] *Id.*
[19] *Id.* § 5365.
[20] *Id.* § 5325.
[21] *Id.* § 5366.
[22] *Id.* § 5322.
[23] *See* GARY H. STERN & RON J. FELDMAN, TOO BIG TO FAIL: THE HAZARDS OF BANK BAILOUTS 111 (2004) (arguing that the inability to predict the impact of a large bank's dissolution is the "primary motivation for bailouts").
[24] *See* Ann Graham, *Bringing to Heel the Elephants in the Economy: The Case for Ending "Too Big To Fail"*, 8 PIERCE L. REV. 117, 122 (2009)

economic effects of such a large, interconnected and complex financial company's dissolution is virtually impossible. Because of the great *potential* damage that a bankruptcy could cause, the government adopts the more risk-averse strategy of a bailout:

> The underlying reality . . . is that the imminent failure of a large institution, whether in the banking sector of the economy or in some other sector, presents the government with great uncertainties. The possible impacts on economic activity in general, on employment, on related and not-so-related industries are of such magnitudes as to make nonaction by government authorities a difficult course to follow. Hardships are threatened, and governments are in the business of mitigating hardships.[25]

Bailouts can therefore be understood as a product of market uncertainty. Faced with potential widespread economic failure, the government will adopt a low-risk, albeit politically unpopular, strategy of rescuing the distressed company.

Too-big-to-fail poses significant problems, however. When applied consistently, bailouts create moral hazard problems. Moral hazard exists when a company interprets the government's willingness to prevent its bankruptcy as an implicit government guarantee. The company then will assume greater risk because it expects the government to bear the costs of the company's activities.[26] However, the application of too-big-to-fail during the 2008 financial crisis was inconsistent. The government's $85 billion loan to American International Group, just days after allowing

---

("Size is not the sole criterion for TBTF. The institutions marked for government bailout to prevent failure are described as 'too big to liquidate' and 'too interconnected to fail.'").

[25] DAVID S. HOLLAND, WHEN REGULATION WAS TOO SUCCESSFU—THE SIXTH DECADE OF DEPOSIT INSURANCE 47 (1998); *see also* William K. Sjostrom, Jr., *The A.I.G. Bailout*, 66 WASH. & LEE L. REV. 943, 979 (2009) ("The bottom line is that nobody knew for certain the scope of damage that would result from an AIG bankruptcy. Because of AIG's size and interconnectedness, and the fact that financial markets were already under serious distress, it was feared that AIG's failure would lead to the collapse of the entire financial system. The federal government was unwilling to take this risk and, therefore, bailed out AIG.").

[26] Hashmall, *supra* note 1, at 832.

Lehman Brothers Holding Inc. to file the largest bankruptcy in U.S. history, exemplifies this trend.[27] The seemingly arbitrary use of bailouts highlights the lack of a bright-line rule to determine which companies are too-big-to-fail.[28] The resulting uncertainty chills market participants and imposes significant economic costs.[29] Consequently, bailouts have the perverse effect of creating more systemic risk, an irony that is wholly incompatible with financial reform.

D. Enhanced Supervision and Too-Big-to-Fail

The FSOC may be the Dodd-Frank Act's most divisive contribution. A central criticism is that the FSOC's authority to require Federal Reserve supervision will facilitate bailouts.[30] These critics argue that the responsibility to supervise risky financial companies will instill in the Federal Reserve a vested interest in a financial company's wellbeing.[31] The Federal Reserve therefore is more likely to bailout companies through unfavorable acquisitions and federal loans, instead of suffering embarrassment from a supervised company's bankruptcy.[32] Predictably, the government

---

[27] Karnitschnig et al., *supra* note 3.

[28] *See* Vern McKinley & Gary Gegenheimer, CATO INST., POLICY ANALYSIS NO. 637, BRIGHT LINES AND BAILOUTS: TO BAIL OR NOT TO BAIL, THAT IS THE QUESTION 1 (Advance copy, 2009) (stating that "the bailouts over the past year do not reflect a well-defined, transparent, and verifiable policy justification.").

[29] *See id.* at 24 (suggesting that arbitrary bailouts "froze" the economy) (quoting AMITY SHLAES, THE FORGOTTEN MAN: A NEW HISTORY OF THE GREAT DEPRESSION 9 (2007)); Hashmall, *supra* note 1, at 832 ("[A] policy of constructive ambiguity . . . reduces the problem of moral hazard, but at the cost of creating uncertainty and panic, which can exacerbate systemic risk.").

[30] *See* Wallison, *supra* note 6, at 3 (arguing that the Federal Reserve will "implement 'too big to fail' privately, outside public view").

[31] *See* Chester S. Spatt, *Regulatory Conflict: Market Integrity vs. Financial Stability*, 71 U. PITT. L. REV. 625, 632 (2010) (arguing that systemic regulators will have a vested interest in the outcome of its activities).

[32] Wallison, *supra* note 6, at 3; *see also* Spatt, *supra* note 31, at 632 (arguing that the vested interests of systemic regulators will cause the regulators to coerce unwise corporate transactions to preserve systemically risky companies).

rejects this criticism.[33] The question therefore is whether the FSOC will be an effective alternative to too-big-to-fail.

As previously discussed, the reliance on too-big-to-fail is the product of the inability to accurately predict and quickly respond to financial instability in large, interconnected and complex financial companies. By enacting regulation to address the causes of this reliance, the government can establish policies that are less likely to create moral hazard and market uncertainty. Professor Ann Graham of Texas Tech University School of Law has suggested three methods.[34] First, the government should establish regulation that seeks to minimize uncertainty by providing for systemic risk oversight and rapid response plans in the event of financial instability.[35] Second, the government must issue a clear statement that it will not bail out any financial companies.[36] Third, the government should enact regulation that discourages financial interconnectedness and growth.[37] Each of these strategies is present in the Dodd-Frank Act, suggesting that the Act addresses the underlying causes of too-big-to-fail.

1. Reducing Uncertainty

The Federal Reserve's ability to require stress tests, early remediation plans and living wills, along with the FSOC's authority to gather financial data, reduces uncertainty and facilitates rapid responses to financial crises. These measures are effective for two reasons. First, the stress tests, remediation plans and living wills enable the Federal Reserve to detect systemic risk before it causes

---

[33] *See, e.g.*, Donna Borak, *FCIC: Will Dodd-Frank Stop Future Bailouts?*, AM. BANKER, Sept. 3, 2010, at 1 (quoting Sheila Bair, Chairman of the Federal Deposit Insurance Corporation, stating that "bailouts are just not acceptable going forward").

[34] Graham, *supra* note 24.

[35] *Id.* at 141 ("We must restructure our regulatory framework to add an independent entity charged with macro-prudential oversight, which means keeping an eye on the big picture and having the tools to identify and contain systemic risk *before* an uncontrollable economic result swamps global financial systems again.").

[36] *See id.* at 151 (arguing that the government should make a "clear, emphatic, and unequivocal statement" against too big to fail).

[37] *See id.* at 134 (suggesting that previous legislation was ineffective because it failed "to address economic incentives for financial institution growth and interconnectedness").

financial instability.[38] The FSOC's evaluation of financial data fulfills a similar predictive function.[39] This combination of Federal Reserve supervision and FSOC analysis will enable the government to predict the impact of a too-big-to-fail company's dissolution. Second, by establishing a centralized overseer in the FSOC, the government closes regulatory gaps and prevents financial companies from circumventing regulation and creating unexpected risk.[40] The FSOC therefore limits uncertainty by establishing a regulatory framework that includes an *ex ante* analytical function that predicts systemic risk prior to its realization.

2. Rejecting Too-Big-to-Fail

A clear repudiation of too-big-to-fail increases market certainty and reduces moral hazard by reducing expectations that the government will bailout certain companies.[41] The Dodd-Frank Act rejects bailouts by describing the FSOC's purpose as the "promot[ion of] market discipline, by eliminating expectations on the part of shareholders, creditors and counterparties of [financial] companies that the Government will shield them from losses in the event of failure."[42] Additionally, government representatives have stated that the FSOC will not use bailouts.[43] Admittedly, the veracity of such statements will be uncertain until the government actively rejects too-big-to-fail. However, in lieu of such action, the Dodd-Frank Act and corresponding government statements have communicated a strong message rejecting the use of bailouts. If the government

---

[38] *See* STERN & FELDMAN, *supra* note 23, at 113 ("Because stress testing and scenario planning can reduce supervisors' uncertainty about the riskiness of banks and banking sectors, they should play a role in the management of too big to fail. . . . Simulations also should help supervisors to take steps now to make such resolutions less likely in the first place.").
[39] *See supra* Part II (referencing the purposes and duties of the FSOC).
[40] *See* Sewell Chan et al., *Reform Bill Adds Layers of Oversight*, N.Y. TIMES, Mar. 16, 2010, at B1 (observing that, prior to Dodd-Frank, regulatory responsibilities were divided among multiple regulators, creating gaps in regulation and preventing consistent, cohesive action).
[41] Graham, *supra* at note 24, at 151.
[42] 12 U.S.C.A. § 5322.
[43] *See, e.g.,* Borak, *supra* note 33, at 1 (quoting Sheila Bair, Chairman of the Federal Deposit Insurance Corporation, and Ben Bernanke, the Chairman of the Federal Reserve, rejecting the future use of bailouts).

continues to convey this message, it will take a step toward increasing market certainty and reducing the risk of moral hazard.

3. Encouraging "Small Enough to Fail"

The Federal Reserve's enhanced supervision will counteract incentives that encourage nonbank financial companies to become too-big-to-fail. Although the size, complexity and interconnectedness of some companies are attributable to natural business growth, many companies reach too-big-to-fail status due to less benign factors. In particular, too-big-to-fail companies pay lower interest rates because the companies have an implied government guarantee, resulting in the functional equivalent of a taxpayer "subsidy" worth billions of dollars.[44] Meanwhile, these companies do not bear a proportionate share of the costs that they impose on the financial system.[45] The government can counteract the incentive to become too-big-to-fail by enacting regulation that forces companies to internalize the costs of systemic risk.[46] The Federal Reserve's "stringent" supervision imposes a heavy burden on too-big-to-fail companies: in addition to liquidity, credit, debt, leverage and off-balance sheet limits, the Federal Reserve can prohibit activities and transactions outright.[47] This authority forces too-big-to-fail companies to comply with costly regulation, thereby counteracting incentives to become too-big-to-fail. Consequently, Federal Reserve supervision will discourage too-big-to-fail growth, which creates the uncertainty at the root of bailouts.

---

[44] *See* Graham, *supra* note 24, at 145 ("[I]t is inarguable that becoming one of the protected TBTF entities results in substantially lower costs of funds. Smaller banks are charged a higher interest rate when they borrow funds because they lack the TBTF implicit federal government guarantee . . . ."; *see also* Gretchen Morgenson, *The Cost of Saving These Whales*, N.Y. TIMES, Oct. 4, 2009, at BU1 (referring to a study by the Center for Economic and Policy Research that found that the total annual subsidy of all too-big-to-fail banks was $34.1 billion).

[45] *See* Hashmall, *supra* note 1, at 839 (explaining that the collapse of Lehman Brothers illustrated the external costs caused by the failure of a too-big-to-fail nonbank financial company).

[46] *See id.* at 855 (arguing that forcing too-big-to-fail companies to internalize costs is one of the strengths of the Obama administration's proposal for financial regulation).

[47] 12 U.S.C.A. §§ 5325, 5331.

E. Conclusion

This article contends that the establishment of the FSOC eliminates the underlying catalysts of too-big-to-fail and thereby establishes a preferable form of systemic risk regulation. The criticism that the FSOC will facilitate too-big-to-fail policies therefore appears flawed.

Admittedly, certain sections of the Dodd-Frank Act appear to permit bailouts. In particular, the Act authorizes the use of Federal Deposit Insurance Corporation funds to make loans and purchase the debt obligations of companies that pose a risk to financial stability.[48] However, the predictive function of the FSOC is likely to minimize these bailouts. The ability to foresee systemic risk will reduce uncertainty and facilitate *ex ante* regulation, thereby allowing the government to avoid politically unpopular bailouts.

During the 2008 financial crisis, the government relied on bailouts due to its inability to accurately predict the macro-economic consequences of a large financial company's dissolution. The FSOC eliminates this uncertainty by analyzing the systemic risk of nonbank financial companies, reducing the expectation that certain companies will receive bailouts and counteracting incentives for unstable growth. The absence of this uncertainty will allow the government to reduce its reliance on bailouts. Indeed, if the FSOC is any indication, the days of bailouts may be numbered.

Emerich Gutter[49]

---

[48] *See id.* § 5384 ("[T]he [Federal Deposit Insurance Corporation] may make available . . . funds for the orderly liquidation of the covered financial company.").

[49] Student, Boston University School of Law (J.D. 2012).