I am delighted to attend the Wharton Conference on Financial Regulation. The conference brings together scholars, practitioners, and policymakers to discuss leading issues in financial regulation. In that vein, I would like to share some thoughts on the financial stability risks posed by large banks. I hope to add to the active and robust academic discourse on this topic by offering a practitioner’s perspective.

**A Practitioner’s Perspective**

My views are those of a battle-scarred financial regulator.

In the 2000s I had a front row seat to the rapid rise and sudden fall of the investment banks. I was there in March 2008 when a failing Bear Stearns was bought by JPMorgan, facilitated by a lending facility established by the Federal Reserve Bank of New York. I was there in September when Lehman collapsed and filed for bankruptcy.

I saw the bailout of American International Group (AIG) up close. I helped oversee the unwind of its toxic derivatives portfolio and to structure Treasury’s second recapitalization of the firm in the spring of 2009.

After the crisis, I led the development of the framework for assessing the “living wills” of the eight U.S. global systemically important banks (GSIB).

I have been involved in some way in every fire drill involving a systemically important financial institution since 2008—from the Greek debt crisis to the London Whale to Archegos, and many in between.
In short, the financial stability risks posed by too-big-to-fail (TBTF) firms are not a theoretical matter for me. I view them through the lens of having had to work through difficult situations—supporting hard decisions during times of uncertainty, as well as dealing with the cleanup and mistrust in the aftermath of TBTF events.

Financial Stability and Resolvability

When one imagines financial instability, the fourth quarter of 2008 comes to mind: a sharp sell-off and illiquidity in financial markets, a sudden re-rating of counterparties, the freezing up of interbank lending, dislocations in short-term wholesale funding, runs, and the cutting of credit and liquidity lines—basically panic and a significant loss of confidence in the financial system. This is what happened after Lehman failed.

What one does not imagine—but should—are the “near misses.” Bank of America’s acquisition of Countrywide and later Merrill Lynch. Wells Fargo’s acquisition of Wachovia. JPMorgan’s acquisitions of Bear Stearns and Washington Mutual Bank. The bailout of AIG. To some, these were deals that helped avoid financial instability and were suboptimal but necessary to avoid even worse outcomes.

Although that was certainly true in the moment, I believe it is a mistake analytically. For the purposes of policy analysis, financial stability should be considered from a broader, longer-term perspective, not only in terms of the immediate consequences of a large bank failure or in terms of the consequences avoided with an acquisition or bailout. The extraordinary government support that was provided to firms such as AIG in the financial crisis to avoid further chaos and damage has had enormous long-term consequences on the erosion of trust in regulators and government and on the stringency of large bank regulations today. The net present value of those long-term consequences is significant and, in some cases, could rival the short-term consequences of the financial dislocations of a large bank failure.

Thus, when considering the financial stability profile of a large bank, we should not think solely in terms of the disruptive effects on financial markets and counterparties should that bank fail. (Note, this is how the GSIB scoring framework is set up.) We should also ask: “How might the failed bank be resolved? And what would be the long-term consequences of that?”
A Gap in Large Bank Resolvability

For the largest U.S. banks, answering that question today reveals a gap.

The eight U.S. GSIBs—Bank of America Corporation, Citigroup Inc., JPMorgan Chase & Co., Wells Fargo & Company, the Goldman Sachs Group Inc., Morgan Stanley, the Bank of New York Mellon Corporation, and State Street Corporation—are subject to heightened resolvability expectations under Title I of the Dodd–Frank Wall Street Reform and Consumer Protection Act. This is logical. These firms have been deemed systemically important and, as such, need to abide by a host of heightened prudential and resolution-related standards.

The largest non-GSIB banks—what I will call “large regionals”—are not subject to the full panoply of those heightened standards, consistent with the statutory mandate for tailoring. This is also logical, as the large regionals are not as big, complex, or interconnected as the GSIBs and thus do not need to be held to GSIB standards to be safe and sound.

Based on the financial stability perspective I laid out earlier, however, we have a problem. Today, four large regionals have total consolidated assets greater than $500 billion. If one were to fail, how would it be resolved?

For most failed banks, the preferred resolution option is a purchase and assumption (P&A) transaction, in which an acquiring institution takes all or a substantial part of the failed bank. For example, between 2008 and 2013 the FDIC resolved nearly 95 percent of bank failures through the use of P&A transactions. When the FDIC cannot resolve a failed bank through a P&A transaction, the FDIC has to establish a bridge bank to manage the orderly failure of the institution. This happened in 2008 when IndyMac Bank, a $32 billion thrift, failed and resulted in the largest loss to the Deposit Insurance Fund in the FDIC’s history.1

Who today could absorb a failing large regional bank? I am not an investment banker, but it seems fairly clear that the GSIBs are the only firms with the financial resources and capacity to do so. In other words, if a large regional bank were to fail today, the only viable option would be to sell it to one of the GSIBs. This is precisely what happened in 2008 when the FDIC resolved

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1 IndyMac was resolved through a conservatorship because the FDIC’s authority at that time to establish a bridge bank did not apply to thrifts. The conservatorship was functionally equivalent to a bridge bank.
the failed Washington Mutual Bank, with approximately $300 billion in assets, through a P&A transaction with JPMorgan Chase & Co.

From a traditional financial stability perspective, this would not be a terrible outcome. Markets would continue to function. A bank run would be avoided. Contagion would be contained.

But from a broader financial stability perspective, a GSIB would be forced through a shotgun marriage to be made significantly more systemic, with minimal due diligence and limited identification of integration challenges, which for firms of this size are significant. In addition, with the resulting increase in the concentration of banking—of making one of the biggest firms even bigger and more systemic—trust in the resolution process and in the government’s ability to proactively manage such situations would likely erode, just as it did over the course of 2007 when a series of such shotgun marriages were carried out.

There needs to be a better way. The failure of a large regional should not automatically create a more systemic GSIB. We need options. The experience with making U.S. GSIBs more resolvable provides clues as to how to achieve that.

Optionality

What makes U.S. GSIBs more resolvable today than before the 2008 financial crisis? This question has a long answer, but I want to highlight three elements that are most relevant to this discussion.

First, GSIBs rely on a single-point-of-entry (SPOE) resolution strategy. One way to think about SPOE is to contrast it with the failure of Lehman. Lehman was a multiple-point-of-entry (MPOE) resolution. On September 15, 2008, when Lehman Brothers filed for bankruptcy, that triggered cross defaults across all of its legal entities. Each was resolved through a separate proceeding, resulting in a sudden cessation of all operations and a lot of chaos. In an SPOE resolution, only the parent holding company is supposed to file for bankruptcy or be taken into receivership; all of the material subsidiaries are expected to continue to operate and function, thus avoiding the chaos of multiple proceedings.
Second, to make an SPOE work without a taxpayer bailout, there needs to be enough long-term debt at the parent to be “bailed in” to absorb the kinds of losses that could cause a bank to fail. In the United States, under the total loss absorbing capital (TLAC) requirement, GSIBs are required to hold a minimum amount of long-term debt at the parent. This serves as an important buffer, so that if the firm fails, private investors absorb the firm’s losses and are “bailed in” instead of taxpayers footing the bill for a bailout, as was the case for AIG twice.

Third, under the Title I guidance, GSIBs are expected to be “separable.” To meet this expectation, they must identify lines of business and/or large portfolios that can be sold quickly in stress or in receivership, and operate them so that such a sale can be effectuated quickly, ideally over a weekend. In other words, the firm must be able to be broken up. In most large financial groups, this is not a given. Business lines or portfolios that seem naturally separable are often structured and operated in ways that make it quite difficult to sell them quickly for value. To meet the Title I separability expectation, GSIBs must operate each line of business or portfolio in a way that avoids those impediments.

Large regionals today do not have SPOE resolution strategies, are not subject to the TLAC minimum long-term debt requirement, and are not separable. This is not their fault. When the Title I framework was being developed, it made sense to focus it just on the GSIBs. The large regionals were significantly smaller and less complex then. For instance, in 2011 the largest non-GSIB bank had approximately $330 billion of total consolidated assets. Today, however, that bank has $550 billion (which is not too much smaller than Lehman when it failed). Pending mergers would push that number even higher.

If a large regional adopted SPOE, had sufficient TLAC, and was separable, the government would have more options should the regional fail. If necessary, we would be able to break the bank up and keep its operations running, while allocating any unexpectedly large losses to private creditors instead of taxpayers. We would not be limited to simply folding it into a GSIB.

Today’s large regionals are not nearly as complex or global as the GSIBs. The vast majority of their assets are in the insured depository institution (IDI). As such, they do not need to be subject to the full set of resolvability requirements for GSIBs in order to be resolvable. The status quo, however, leaves a gap in our financial stability defenses. The failure of a large
regional would necessarily lead to a more systemic GSIB and signal that we had not, in fact, ended TBTF, eroding trust in the resolution regime more generally.

Conclusion

The financial system today is substantially more protected from financial instability than before the 2008 financial crisis, because of the extraordinary efforts of Congress, the federal banking agencies, bodies such as the FSOC and FSB, and large banks themselves. Despite this progress, there is a gap with regards to large regional banks, which have grown in size and complexity and are at risk of becoming the new TBTF firms.

Fortunately, the elements of a solution to this problem are known and familiar. By adopting a single-point-of-entry resolution strategy, by holding sufficient bail-in-able long-term debt at the parent, and by ensuring the separability of major business lines and/or portfolios, the resolvability of large regional banks can be significantly enhanced and associated financial stability risks defeased.

Many of the reforms needed to effectuate those changes on a permanent basis would have to be done by the Federal Reserve and FDIC and would require rulemakings. That will take time.

In the meantime, the bank merger pipeline is active, including for large banks. The OCC has a significant role in many of those mergers, particularly amongst the largest banks. Without the resolvability safeguards discussed today, I have concerns that such mergers could result in new TBTF firms, which would add to financial stability risk. At the same time, prohibiting such mergers could shield the GSIBs from competition, potentially helping to solidify their dominance in various markets.

In the near term, one way to reconcile both of these challenges—of mitigating the risk of new TBTF and of promoting large bank competition—might be to condition approval of a large bank merger on actions and credible commitments to achieving SPOE, TLAC, and separability. This approach is something that we are currently reviewing and contemplating at the OCC. We

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2 Refer to Tarullo, Daniel K., “Regulators Should Rethink the Way They Assess Bank Mergers,” Brookings Institution (March 16, 2022), which notes the need for the regulators to further develop their analysis under the financial stability factor.

3 Ibid. The article calls for a bank competition analysis that differentiates by product or service and takes into account a richer set of factors than just the Herfindahl–Hirschman Index.
would welcome thoughts and ideas from the academic community and other stakeholders on this
and the broader issue of financial stability and large bank resolvability. Thank you.