The New York Times

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October 26, 2009

Trying to Rein In ‘Too Big to Fail’ Institutions

By STEPHEN LABATON

WASHINGTON — Congress and the Obama administration are about to take up one of the most fundamental issues stemming from the near collapse of the financial system last year — how to deal with institutions that are so big that the government has no choice but to rescue them when they get in trouble.

A senior administration official said on Sunday that after extensive consultations with Treasury Department officials, Representative Barney Frank, the chairman of the House Financial Services Committee, would introduce legislation as early as this week. The measure would make it easier for the government to seize control of troubled financial institutions, throw out management, wipe out the shareholders and change the terms of existing loans held by the institution.

The official said the Treasury secretary, Timothy F. Geithner, was planning to endorse the changes in testimony before the House Financial Services Committee on Thursday.

The White House plan as outlined so far would already make it much more costly to be a large financial company whose failure would put the financial system and the economy at risk. It would force such institutions to hold more money in reserve and make it harder for them to borrow too heavily against their assets.

Setting up the equivalent of living wills for corporations, that plan would require that they come up with their own procedure to be disentangled in the event of a crisis, a plan that administration officials say ought to be made public in advance.

“These changes will impose market discipline on the largest and most interconnected companies,” said Michael S. Barr, assistant Treasury secretary for financial institutions. One of the biggest changes the plan would make, he said, is that instead of being controlled by creditors, the process is controlled by the government.

Some regulators and economists in recent weeks have suggested that the administration's plan does not go far enough. They say that the government should consider breaking up the biggest banks and investment firms long before they fail, or at least impose strict limits on their trading activities — steps that the administration continues to reject.

Mr. Frank, Democrat of Massachusetts, said his committee would now take up more aggressive legislation on the topic, even as lawmakers and regulators continue working on other problems highlighted by the financial crisis, including overseeing executive pay, protecting consumers and regulating the trading of derivatives.

Illustrative of the mood of fear and anger over the huge taxpayer bailouts was Mr. Frank's recent observation that critics of the administration's health care proposal had misdirected their concerns — Congress would not be adopting death panels for infirm people but for troubled companies.

The administration and its Congressional allies are trying, in essence, to graft the process used to resolve the troubles of smaller commercial banks onto both large banking conglomerates and nonbanking financial institutions whose troubles could threaten to undermine the markets.

That resolution process gives the government far more sweeping authority over the institution and imposes major burdens on lenders to the companies that they would not ordinarily face when companies go into bankruptcy instead of facing a takeover by the government.

Deep-seated voter anger over the bailouts of companies like the American International Group, Citigroup and Bank of America has fed the fears of lawmakers that any other changes in the regulatory system must include the imposition of more onerous conditions on those financial institutions whose troubles could pose problems for the markets.

Some economists believe the mammoth size of some institutions is a threat to the financial system at large. Because these companies know the government could not allow them to fail, the argument goes, they are more inclined to take big risks.

Also, under the current regulatory structure, the government has limited power to step in quickly to resolve

problems at nonbank financial institutions that operate like the failed investment banks Lehman Brothers and Bear Stearns, and like the giant insurer A.I.G.

As Wall Street has returned to business as usual, industry power has become even more concentrated among relatively few firms, thus intensifying the debate over how to minimize the risks to the system.

Some experts, including Mervyn King, governor of the Bank of England, and Paul A. Volcker, the former chairman of the Federal Reserve, have proposed drastic steps to force the nation's largest financial institutions to shed their riskier affiliates.

In a speech last week, Mr. King said policy makers should consider breaking up the largest banks and, in effect, restore the Depression-era barriers between investment and commercial banks.

"There are those who claim that such proposals are impractical. It is hard to see why," Mr. King said. "What does seem impractical, however, are the current arrangements. Anyone who proposed giving government guarantees to retail depositors and other creditors, and then suggested that such funding could be used to finance highly risky and speculative activities, would be thought rather unworldly. But that is where we now are."

The prevailing view in Washington, however, is more restrained. Daniel K. Tarullo, an appointee of President Obama's, last week dismissed the idea of breaking up big banks as "more a provocative idea than a proposal."

At a meeting Friday at the Federal Reserve Bank of Boston, the Federal Reserve chairman, Ben S. Bernanke, said in response to a question by a former Bank of England deputy governor that he would prefer "a more subtle approach without losing the economic benefit of multifunction, international firms."

Republican and Democratic lawmakers generally agree that the "too big to fail" policy of taxpayer bailouts for the giants of finance needs to be curtailed. But the fine print — how to reduce the policy and moral hazards it has encouraged — has provoked fears on Wall Street.

Even before Mr. Frank unveils his latest proposals, industry executives and lawyers say its approach could make it unnecessarily more expensive for them to do business during less turbulent times.

"Of course you want to set up a system where an institution dreads the day it happens because management gets whacked, shareholders get whacked and the board gets whacked," said Edward L. Yingling, president of the American Bankers Association. "But you don't want to create a system that raises great uncertainty and changes what institutions, risk management executives and lawyers are used to."

T. Timothy Ryan, the president of the Securities Industry and Financial Markets Association, said the market crisis exposed that "there was a failure in the statutory framework for the resolution of large, interconnected firms and everyone knows that." But he added that many institutions on Wall Street were concerned that the administration's plan would remove many of the bankruptcy protections given to lenders of large institutions.

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