Congressional Research Service
Informing the legislative debate since 1914

IN FOCUS

September 5, 2024

"Too Big to Fail" Financial Institutions: Policy Issues

Some financial institutions are perceived to be "too big to fail" (TBTF), meaning that their failure would trigger financial instability. Although the term TBTF is a popular shorthand, "too interconnected to fail" is considered to be a more apt phrase to describe these firms because they are the key participants in a certain market or because their failure would cause counterparties to fail. Size is a primary—but not the sole—factor influencing interconnectedness. The federal government does not recognize any firm as TBTF, as it does not want to imply that it would provide assistance to prevent the firm's failure. But it does recognize some firms as posing systemic risk.

TBTF has been a long-standing policy concern. Events in 2008 illustrated the systemic risk posed by TBTF institutions, as the failure or near failure of several caused a severe financial crisis and deep economic recession. Both banks and nonbank financial institutions—including investment banks Bear Stearns and Lehman Brothers, insurer AIG, and government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac—proved to be TBTF in 2008. The Treasury, the Federal Reserve (Fed), and the Federal Deposit Insurance Corporation (FDIC) provided these firms (with the exception of Lehman Brothers) with so-called bailouts—exclusive ad hoc financial assistance backed by taxpayers to prevent their failure or facilitate their (voluntary or involuntary) takeovers by solvent firms. This eventually restored financial stability by giving financial markets confidence that more large firms would not fail.

In 2023, the failure of three banks with over $100 billion in assets (whereas the very largest banks have over $1 trillion in assets) triggered bailouts: The FDIC used emergency authority to guarantee the uninsured deposits of Silicon Valley Bank (SVB) and Signature Bank. As this case illustrates, some creditors (uninsured depositors) may receive bailouts, but others (bondholders) or the banks themselves—which were liquidated—may not.

TBTF raises concerns about fairness and reduces economic efficiency if it causes moral hazard—the concept that an actor will be more reckless if shielded from risk. In this case, firms have an incentive to increase expected profits by taking riskier positions—thereby increasing systemic risk—if they believe the government will bail them out if those positions result in debilitating losses.

Current Policy

Regulation of a large firm depends on how it is legally structured. Some financial institutions—such as banks, bank holding companies (BHCs), and GSEs—are federally regulated and supervised for safety and soundness (called prudential regulation), whereas firms operating solely in capital markets do not face similar regulation. Since 2008, the two GSEs have been in government conservatorship under a new regulator that has closely circumscribed their operations. Insurers are subject to prudential regulation at the state level rather than on a consolidated basis across states and noninsurance subsidiaries.

The Dodd-Frank Act (P.L. 111-203) reformed financial regulation in response to the crisis. It tried to mitigate TBTF through a new **enhanced prudential regulatory (EPR) regime** administered by the Fed for large BHCs and nonbanks designated as systemically important financial institutions (SIFIs) by the Financial Stability Oversight Council (FSOC). It also applied heightened risk management standards to payment, clearing, and settlement systems designated as systemically important financial market utilities (SIFMUs) by FSOC. FSOC is chaired by the Treasury Secretary and largely composed of the financial regulators. Dodd-Frank also created a new FDIC **resolution regime** (called Orderly Liquidation Authority) for financial firms (including BHCs but excluding banks) deemed TBTF at the time of their failures based on the logic that a bailout can be avoided if a firm can be wound down safely. It is modeled on bank resolution and has never been used. The law also added new limits on Fed and FDIC emergency assistance in an effort to **limit bailouts**.

The Dodd-Frank Act made all large U.S. BHCs and intermediate holding companies of foreign banks (IHCs), as well as nonbank SIFIs, subject to EPR. EPR was intended to impose more stringent prudential requirements than those applied to other firms to account for the systemic risk they posed. The Fed implemented new regulatory requirements for BHCs to undergo stress tests, submit capital plans and resolution plans ("living wills"), hold more capital and liquidity, limit counterparty exposure, and comply with risk management requirements. In 2018, P.L. 115-174 (often referred to as S. 2155) raised the asset threshold for BHCs subject to EPR from $50 billion to $250 billion while providing the Fed discretion to apply tailored EPR standards to BHCs with between $100 billion and $250 billion in assets. The Fed implemented this change through a rule that placed BHCs into four categories and applied tiered standards to each category. Only one bank subject to EPR has failed since enactment: SVB was a Category IV bank subject to the least stringent EPR standards. There are currently 26 U.S. BHCs and 10 IHCs subject to EPR.

After enactment of the Dodd-Frank Act, FSOC designated three insurers (AIG, Prudential, and MetLife) and one nonbank lender (GE Capital) as SIFIs (see **Table 1**). Originally perceived as a start, the four designations instead proved to be the high mark. By 2018, all four were de-designated due to business changes, court decisions, and changes in the philosophy of FSOC leadership. There have

not been any designated SIFIs since. (There are currently eight SIFMUs, all of which were designated in 2012.) The Fed never finalized EPR requirements on nonbank SIFIs amid criticism that regulations designed for banks could not be successfully mapped onto nonbank business models.

Table 1. Former Nonbank SIFIs

	Designation Date	De-designation Date
AIG	July 9, 2013	Sept. 29, 2017
GE Capital	July 9, 2013	June 29, 2016
Prudential	Sept. 20, 2013	Oct. 17, 2018
MetLife	Dec. 19, 2014	Mar. 30, 2016 (by court ruling)

Source: CRS, based on FSOC documents.

Issues for Congress

Is regulating TBTF preferable to alternatives? Risk is central to financial activity, so an optimal system is probably not one where large firms never fail but rather one in which a failure does not cause financial instability. Financial crises impose large costs on the economy. However, regulation imposes costs on firms that may be passed on to borrowers in the form of higher borrowing rates and reduced credit availability. Ideally, the benefits of greater financial stability would outweigh those costs.

No Category I, II, or III bank has experienced safety and soundness problems since EPR was implemented. Nevertheless, the 2023 bank failures indicate that the system is still prone to instability either because regulation is not stringent enough or comprehensive enough or because it has missed its mark—it imposes regulatory burden without effectively reducing risk. Some observers doubt whether regulation could ever make large institutions safe, claiming they are too big (or complex) to successfully regulate or manage. Markets might view EPR as identifying which firms are TBTF and would be bailed out. If so, then EPR could exacerbate moral hazard, which could increase systemic risk if EPR is ineffective. Supervisory failures surrounding the 2023 bank failures suggest one way that regulation could be ineffective. Regulating TBTF could also be ineffective if there is "regulatory capture"—the idea that firms (especially large ones) have outsized influence over their regulators. Two regulators that were abolished in 2008 and 2010 were viewed as ineffective at regulating large firms in part because of regulatory capture.

Two broad alternatives to regulating TBTF firms are "market discipline" and requiring TBTF firms to shrink. The largest banks have continued growing since EPR was implemented. Some critics advocate capping the size of institutions or reducing their scope of activity (referred to as "reinstating Glass-Steagall," in reference to Depression-era legislation that separated banking and securities firms). Although this approach reduces the probability of any firm being TBTF, it could also disincentivize innovation, inconvenience customers, and disrupt the current financial architecture, which could itself cause financial instability and reduce the availability of credit.

Market discipline is the concept that a firm's creditors have an incentive to curb excessive risk taking. But creditors are indifferent to excessive risk taking if they believe that a firm will be bailed out. Even if current policymakers maintain a "no bailouts" policy, they cannot bind future policymakers—a lesson reinforced by emergency assistance in 2023. And market discipline did not prevent excessive risk taking in the runup to the 2008 crisis before the government had committed to bailouts. Thus, policies based on "no bailouts" and market discipline may lack credibility with markets going forward.

Regulating institutions vs. activities. In 2019, FSOC under the Trump Administration issued guidance that shifted priority from institution-based nonbank SIFI regulation to activity-based regulation. Under the Biden Administration, FSOC issued guidance in 2023 to "remove unwarranted hurdles to designation imposed by" the 2019 guidance. H.J.Res. 120 would overturn the 2023 guidance under the Congressional Review Act.

Choosing solely activity-based or institution-based regulation is unlikely to address all sources of systemic risk: Some activities are systemically risky because they are concentrated in a few large institutions, and some pose systemic risk regardless of where they are located. Activity-based and institution-based regulation are not mutually exclusive—regulators can also do both where they have authority. In any case, new activities-based regulation has rarely been pursued since being prioritized in 2019.

Who should be subject to EPR? With mandatory EPR limited to BHCs and foreign IHCs over $250 billion, policymakers have debated who should be subject to EPR. The failure of Signature and First Republic in 2023 highlighted that banks that operate without a BHC structure are not subject to EPR, although their business models are comparable to many similarly sized BHCs, and their failure can also cause instability.

Congress has also debated whether it is preferable to set the mandatory threshold for EPR relatively high or low. Although size does not cause systemic risk, the two are correlated, and size is easy to measure. If the threshold is set high, no systemically unimportant BHC would be captured, but some systemically important BHCs might be exempted. Set low, the opposite might occur. SVB's failure also raised questions about whether the tailoring of EPR required by P.L. 115-174 had undermined its effectiveness.

Policymakers have also debated what to do about the nonbank SIFI process given there are none designated. Yet there are many large nonbank financial firms that play key roles in the financial system. Although bank-like regulations may be unsuitable, these firms pose systemic risk that in principle appropriately tailored regulation could mitigate either through changes to EPR for SIFIs or new authority to their primary regulators. H.R. 3556 would allow Congress to overturn future SIFI designations under expedited procedures and would require FSOC to report to Congress when it makes regulatory recommendations, including EPR recommendations.

Marc Labonte, Specialist in Macroeconomic Policy

Disclaimer