The Resolution of Too Big to Fail

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Other Views:

• Paul H. Kupiec, *Is Dodd Frank orderly liquidation authority necessary to fix too-big-to-fail?*, American Enterprise Institute (Oct. 22, 2015), https://www.aei.org/research-products/working-paper/is-dodd-frank-orderly-liquidation-authority-necessary-to-fix-too-big-to-fail/.

• Nicola Cetorelli & James Traina, *Resolving "Too Big to Fail,"* Federal Reserve Bank of New York Staff Reports (June 2018), https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr859.pdf.

• Satish Thosar & Bradley Schwandt, *Has 'Too Big To Fail' Been Solved? A Longitudinal Analysis of Major U.S. Banks*, J. Risk & Financial Management (Feb. 1, 2019), https://www.researchgate.net/publication/330813288_Has_'Too_Big_To_Fail'_Been_Solved_A_Longitudinal_Analysis_of_Major_US_Banks.

• Saule T. Omarova, *The "Too Big to Fail" Problem*, Minn. L. Rev. (June 13, 2019), https://minnesotalawreview.org/article/the-too-big-to-fail-problem/.

• *Ending Too Big to Fail*, Federal Reserve Bank of Minneapolis, https://www.minneapolisfed.org/policy/endingtbtf (last updated January 10, 2018).

No financial firm in the United States should be considered too big to fail (TBTF). That is the universal view of the American banking industry.[1]

Global leaders nominally agree. In 2009, amidst the churn of government actions related to the financial crisis, the global Group of 20 finance ministers and central bank governors directed the Financial Stability Board (FSB) to propose globally coordinated measures to address the matter. In the understanding of the FSB, "The TBTF problem arises when the threatened failure of a SIFI [systemically important financial institution]—given its size, interconnectedness, complexity, cross-border activity or lack of substitutability—puts pressure on public authorities to bail it out using public funds to avoid financial instability and economic damage."[2] In May 2019, the FSB launched an evaluation of ten years of "too-big-to-fail reforms."[3] Among the tasks it has set for itself is assessing whether implementation of the reforms encouraged since the last recession "are reducing the systemic and moral hazard risks associated with systemically important banks."[4] This is a serious inquiry, so it will be important to read the findings. A draft report was scheduled to be issued for public consultation in June 2020, with a final report planned for publication by the end of 2020.

Only so much candor can be expected from representatives of government agencies scoring their own homework, who will also be careful not to paint themselves into a corner out of which they may wish to step in the future. Yet credibility will be at stake in what the FSB reports. Current FSB Chairman Randal Quarles also happens to be the Federal Reserve's Vice Chairman for Supervision, in which position he has been carefully outspoken. If the report reflects his views, it will be worth the study.

This paper provides commentary within the context of the ongoing FSB assessment. It appreciates that rejection of TBTF is currently universal among U.S. policymakers and asks, where is the controversy? The theme of the paper is a recognition that apprehension persists that this policy consensus may be fragile, resting upon an ambivalent chronicle of regulatory rescues of troubled banks. The accumulation of new tools by statute and

1 That view is not universally held around the world, even if pledges of fidelity to ending TBTF are otherwise mouthed. With the possible exception of the United Kingdom, I am not confident of any government other than the United States that in practice rejects the notion of too big to fail. I am not comfortably sure that, in a pinch, the U.K. authorities would actually live up to their professed repudiation of TBTF. There is little historical pattern to demonstrate that they would.

2 Financial Stability Board, *Evaluation of too-big-to-fail reforms: Summary Terms of Reference* (May 23, 2019), https://www.fsb.org/wp-content/uploads/P230519.pdf.

3 Press Release, Financial Stability Board, FSB launches evaluation of too-big-to-fail reforms and invites feedback from stakeholders (May 23, 2019), https://www.fsb.org/wp-content/uploads/R230519.pdf.

4 *Id.*

regulation has made bank rescues unnecessary, but it does not make them impossible. The paper echoes the call for improving the utility of bankruptcy processes to address failed banks, which would justify and facilitate transformation of the recent consensus against rescues into a durable fabric of the regulatory culture.

Along the way, the paper asserts that there are no U.S. banks that are too big to fail, catalogs several of the more significant new regulatory tools, describes perceptions of past policymaker attitudes, and offers several vignettes of landmark regulatory bank rescues of recent decades. Some key lessons to be learned from the record are propounded.

In the meantime, daily events continue to test regulatory resolve. Today, Vice Chairman Quarles and all other U.S. policymakers renounce TBTF. However, during the Great Cessation,[5] policymakers have been willing to take actions approaching a TBTF policy for money market mutual funds. Perhaps there is comfort in that the agency of intervention was the Federal Reserve, explaining carefully that the policy was within its traditional role to use instruments intended to provide financial support to *solvent* firms facing *liquidity* issues, i.e. aiding firms to honor redemptions without having to defund performing assets and flood the market with asset sales.[6]

I. TBTF Is Incompatible with Markets

There are good reasons for credible repudiation of TBTF policies. The concept is incompatible with free markets, where business failure is as much a part of the market process as is success; allowing businesses—including banks—to fail transfers resources from hands of failure to more capable hands as reward for success. Moreover, markets ensure that neither condition is irremediable. Opportunity for new ventures should be just as available tomorrow as should be the chance of failure should current success turn sour.

Optimal allocation of resources as well as simple notions of fair play rely upon enterprises succeeding or failing based upon their performance. Bad actors, unsuccessful players, and inefficient operators are shown the door by the markets. Resources, on the other hand, are passed on to those more effective at meeting customers' needs, as defined by the actions and choices of customers themselves.

TBTF corrupts market discipline, which has repeatedly shown itself the quickest and firmest regulator of bank activities. Long before bank supervisors assess fines and penalties, a bank's customers and investors smell the scent of financial erosion and respond appropriately by shifting business and funds.

The availability of TBTF rescue policies can mask the realities of business conditions or hold out the hope that someone else can be made to carry undeserved losses. Bad practices are allowed to persist, ineffective actors continue in place, better-run firms face unfair competition from government-favored firms. Overall, assets in the economy become misallocated, and economic welfare diminishes.

II. Where Is the Controversy?

If TBTF is universally rejected in the U.S.—by industry, policymakers, and the general public—where is the controversy? It arises primarily from the question of whether those who say that they reject TBTF really mean it, or *will* really mean it when the chips are down and the cards are played. The most accurate riposte to this is that only time will tell. There is much that is said and much that has been done to make TBTF appear less likely and to seek to reassure the skeptical. Regulatory and legislative steps have been taken both to make TBTF more difficult and to facilitate resolution of failed firms;[7] one might say the latter approach seeks to replace too big to fail with *safe to fail*. As illustrated later in the paper, the U.S. has arguably done more in this line than have other nations home to large financial institutions.[8]

Are there any banks in the United States that, in conditions of insolvency, would be genuinely, practically too big to fail? I am aware of only one bank in United States history that might have been too big to fail: the second Bank of the United States. Chartered by Congress in 1816, that bank did not exactly fail; it just lost its national charter, causing the bank to contract its activities, leading to economic contraction felt throughout the nation. President Andrew Jackson vetoed legislative efforts to renew the charter on the approaching sunset of its twenty-year authority, scheduled for 1836. Franchised with a number of specific powers, congressional backing, and a national reach, the expiration of the national charter and retrenchment of the bank's activities precipitated the panic and deep recession of 1837.[9]

5 Jason Zweig, in a *Wall Street Journal* commentary, credits John Cammack with first offering this term for the sudden recession caused by the precipitate nationwide closing of economic activities in March 2020, responding to the coronavirus. Jason Zweig, *A Simple Investing Playbook for the 'Great Cessation*,' Wall St. J., March 24, 2020, https://www.wsj.com/articles/a-simple-investing-playbook-for-the-great-cessation-11585047600.

6 Board of Governors of the Federal Reserve System, Policy Tools: Money Market Mutual Fund Lending Facility, https://www.federalreserve.gov/monetarypolicy/mmlf.htm.

7 By "resolution," I refer to the process of moving a failed or failing financial firm into liquidation, combination with another firm or firms, or restoring it to operating health.

8 For this discussion, I am trying not to trip over the use of words that can mean different things in different contexts, such as "capital," "liquidity," "failure," and "insolvency." In this paper I invoke these terms as they are employed in bank management and supervision. This brings to mind what Sir Walter Scott wrote in his novel, *Count Robert of Paris*:

> . . . the masters of this idle science make it their business to substitute, in their argumentations, mere words instead of ideas; and as they never agree upon the precise meaning of the former, their disputes can never arrive at a fair or settled conclusion, since they do not agree in the language in which they express them. Their theories, as they call them, are built upon the sand, and the wind and tide shall prevail against them.

Sir Walter Scott, Count Robert of Paris, Vol. 1, 180 (1880). The *idea* that I seek to address is the notion that government agencies will or should rescue insolvent firms from failure. By insolvency, I have in mind the conditions presented by the nation's bankruptcy standards, with their deep history in case law and practice, which govern invocation of and recourse to the bankruptcy resolution process to address insolvency.

9 *See* Andrew T. Hill, *The Second Bank of the United States*, Federal Reserve History, December 5, 2015, https://www.federalreservehistory.org/essays/second_bank_of_the_us.

Two other financial institutions have demonstrated signs of being too big to fail: Fannie Mae and Freddie Mac. Neither of these government sponsored enterprises, however, is a bank. They share with the second Bank of the United States the condition of being chartered by Congress, with attendant market prestige and implicit federal government backing to feed their outsized share in the financial markets. Their insolvency was at the core of the housing bubble and its bursting in 2008, and the financial recession that followed.[10]

III. There Are No TBTF U.S. Banks Today

Of the nation's commercial banking firms, the largest is JPMorgan Chase (JPMC), which as of third quarter 2019 had $2.8 trillion in assets.[11] That is a very large bank (though not the largest in the world). In perspective, it is part of a very large economy.[12] U.S. financial assets in the same period totaled $105.3 trillion.[13] That makes JPMC's share of national financial assets about 2.7%. The share for other banks is proportionately less.

JPMC and other large banks got to be as large as they are because they provide services for which customers are willing to pay; the same is true of banks of all sizes. Should any large U.S. bank become distressed, it has business lines that other firms would be willing to buy for some price (at par or at a discount) or that should be folded because they have little value, i.e. few pay to use them. The idea that there must always be a bigger fish to swallow every other fish is as false in economies as it is in the sea. A large bank, healthy or troubled, can be sold piecemeal.

An example of that (albeit imperfect) can be seen in the case of the Dutch bank ABN Amro. In 2007, the bank did not fail, but it was auctioned, with pieces of its business sold to a collection of institutions, including Royal Bank of Scotland, Banco Santander, Fortis, and Bank of America. At the time, ABN Amro was one of the largest banks in Europe. It is true that the ABN Amro transaction almost immediately ran into the foul weather of the global financial recession of 2007-2009, but it demonstrates that large banks can attract a variety of interest for their variety of assets and business lines.[14]

For each troubled bank, more or less care needs to be taken for proper resolution, but I do not know of any whose failure cannot be resolved, whose valuable operations and customers could not be transferred to other hands. Those assets and operations for which there is little or no value can and should be recognized as loss; doing so imposes no further loss on the economy.

Laws and rules for resolving failed banks, as in bankruptcy procedures, are designed to be tailored to the realities of each case. The core purpose of the process is the preservation of value, within each particular context and with appropriate time and care applied. The result in the end should and can be that financial activity for customers and the economy goes on, losses are apportioned by law, and residual value is preserved and allocated with what fairness the statute allows. Can the processes be improved? Certainly they can, as with most legal standards. There has been much very good discussion and research, and proposals have been tabled to improve federal bankruptcy procedures as they affect banks.[15]

Congressional commentary at the time of the consideration of the Dodd-Frank Act frequently asserted a false paradigm: that any failed bank should be capable of resolution overnight, or at least over the weekend. This fed an impatient attitude that any bank whose failure could not be so quickly resolved was just too big. The seemingly instantaneous work of the Federal Deposit Insurance Corporation (FDIC) was regularly pointed to as a prototype. Such a view conjures up a false model, which shortchanges the hard work done by the FDIC and its resolution teams. What appears to happen within 24 hours is the labor of many days in advance and afterwards. The effort is focused on a seamless impact for *customers*, which may not be achieved completely. Insured bank depositors, though, have first priority, successfully served since the establishment of the FDIC; the continuation of their service without interruption is the most visible FDIC accomplishment. The needs and interests of uninsured depositors, bondholders, borrowers, creditors, and others are satisfied less immediately in the case of nearly every failed bank, requiring some time for final resolution.

IV. New Regulatory Tools

Since the 2007-2009 financial recession, U.S. financial supervisors have developed several new tools with which to manage failed bank resolutions, to convert too big to fail into safe to fail. Each tool would take volumes to discuss in detail, as each incorporates hundreds of pages in regulatory language and guidance. Moreover, inasmuch as the tools were developed in haste, and generally with little reference to other tools and regulations, regulatory leadership is currently engaged in a meticulous public review and reform. Efforts are focused on refining and simplifying as well as addressing concerns about how the various regulatory programs interact with each other. There is significant overlap and inconsistency among the regulations, excessive complexity, and mandates to solve the same problem in

10 Explained with great care and detail in Peter J. Wallison, Hidden in Plain Sight (2015). Today, Fannie and Freddie are wards of the state, held in conservatorship by the Federal Housing Finance Agency.

11 Zuhaib Gull & Zain Tariq, *Top 50 US banks & thrifts in Q3'19*, S&P Global Market Intelligence, November 27, 2019, https://www.spglobal.com/marketintelligence/en/news-insights/trending/UjUr4ZCvXWN_rUcLrpHcgw2.

12 U.S. gross domestic product (GDP) for that same quarter was $22.5 trillion. News Release, U.S. Department of Commerce, Bureau of Economic Analysis, Gross Domestic Product, Third quarter 2019 (third estimate); Corporate Profits, Third quarter 2019 (revised estimate) (Dec. 20, 2019), https://www.bea.gov/news/2019/gross-domestic-product-third-quarter-2019-third-estimate-corporate-profits-third-quarter. GDP is not, however, a measure of assets; it is a measure of economic value produced.

13 Quarterly Tables: S.6.q Financial Business, FRED Economic Data, Economic Research, Federal Reserve Bank of St. Louis, https://fred.stlouisfed.org/release/tables?rid=52&eid=812843&od=#.

14 *See* ABN AMRO-Fortis 2007-2010, ABN Amro Newsroom, https://www.abnamro.com/en/images/Documents/010_About_ABN_AMRO/History/ABN_AMRO_geschiedenis_Fortis_2007-2010.pdf.

15 *See, e.g.*, Bankruptcy Not Bailout: A Special Chapter 14 (Kenneth E. Scott & John B. Taylor, eds., 2012).

several ways. Even so, financial supervisors have a weighty toolbox to help manage failed bank resolutions.

The reexamination to make these tools more useful began before the 2016 presidential election. The Trump administration gave it added impetus. Pursuant to Executive Order 13772, signed by President Trump on February 3, 2017, the Treasury Department produced in June 2017 a detailed list of refine-and-reform recommendations.[16] The Treasury Secretary has little authority to write and revise financial services regulations, but he has the lead under the President for developing financial services policy. I can affirm based on my experience serving as Assistant Secretary for Financial Institutions that, free from concerns for bureaucratic turf, Treasury has significant influence in using its good offices to bring together the various financial services agencies to promote a coherent regulatory program. This role was recognized by Congress when it created the Financial Stability Oversight Council with the Treasury Secretary as chairman.[17]

The more prominent new regulatory implements available to financial agencies relating to a failed banking firm include strengthened capital requirements, liquidity standards, stress testing, swaps margin, and resolution planning requirements. Several of these tools have the dual purposes of forestalling bank failure and facilitating resolution nevertheless.

Capital requirements have been strengthened. There is a complex web of overlapping capital standards,[18] with both a risk-based component that models requirements in line with riskiness of assets, and a risk-blind component that calculates capital by total amount of assets without consideration of risk. The two approaches compensate for the model risk on the one hand and the blindness on the other. The result has been record levels of capital held by banks to absorb losses. Bank capital totaled $1.4 trillion prior to the last recession, and it had risen to $2.1 trillion[19] heading into the recession of the Great Cessation.

Banking firms are now subject to heightened liquidity standards. By regulation they are required to maintain a specific portion of assets that could be quickly converted into cash. Called the Liquidity Coverage Ratio (LCR), the rule imposes a complex formula for calculating how much in high quality liquid assets (HQLA) a bank must maintain to be able to weather extraordinary liquidity demands for up to 30 days. The purpose of the rule is a good one, identified with one of the perennial risks of banking: the difficulty of meeting short-term cash needs while providing borrowers with longer term loans. Shortcomings with the rule became apparent in September 2019, when bankers and regulators alike recognized that the LCR effectively sequesters HQLA, driving banks to keep HQLA unavailable for use in the markets.[20] The LCR strengthens *bank* liquidity, but at the cost of reduced *market* liquidity.

Bank supervisors have long evaluated a bank's ability to cope with potential future economic stress, in particular stress from sharp changes in interest rates. This is known as stress testing. Since 2009, larger banking firms have been subjected to more elaborate economic and financial stress scenarios to test bank performance, especially capital positions. Supervisors like stress testing for being more forward looking than capital regulation, which is largely based upon past and current conditions. Reliant upon guesses about the unknown future, stress tests guide regulators in the assignment of capital buffers for banks, which may facilitate early regulatory intervention in the case of a faltering institution.

The Commodity Futures Trading Commission, which under the Dodd-Frank Act was given authority over swaps derivatives, has promulgated rules requiring posting of financial margin for certain swaps transactions. The posted margin is a bit complicated, and it courts the risks that come from concentrating most swaps transactions within clearing houses. It does reduce the financial exposure of a troubled bank's counterparties, which helps resolve failing institutions.

The Dodd-Frank Act imposed a completely new practice on large banks whereby they are required to share with the Federal Reserve and the FDIC detailed plans for how their institutions could be resolved in case of failure. Termed a "resolution plan" in the statute, it is more commonly called a "living will."[21] The concept is praised by many, but it is not without criticism, since few firms, financial or otherwise, run their businesses as if they were going to fail. Managers run their firms to succeed. Banks and supervisors, however, have been learning from the exercise. For example, rules originally mandated that plans be updated

16 Steven T. Mnuchin & Craig S. Phillips, *A Financial System That Creates Economic Opportunities: Banks and Credit Unions* (Washington: U.S. Department of the Treasury, 2017), https://home.treasury.gov/sites/default/files/2018-07/A-Financial-System-that-Creates-Economic-Opportunities---Nonbank-Financi....pdf.

17 Dodd-Frank Wall Street Reform and Consumer Protection Act § 111, 12 U.S.C. § 5321 (2010).

18 Wharton's Richard J. Herring has counted 39 ways in which large banks are required to measure capital, noting that regulators really only look at 4 of them. Richard J. Herring, *The Evolving Complexity of Capital Regulation*, 53 J. Fin. Servs. Res. 183 (2018), https://doi.org/10.1007/s10693-018-0295-8. See also the January 2018 remarks by Randal K. Quarles, Vice Chairman for Supervision of the Federal Reserve Board, in which he identifies 24 "loss absorbency constraints" (the purpose of bank capital) faced by large banks. Vice Chairman Quarles observed, "While I do not know precisely the socially optimal number . . . I am reasonably certain that 24 is too many." Randal K. Quarles, *Early Observations on Improving the Effectiveness of Post-Crisis Regulation* (Jan. 19, 2018), *available at* https://www.federalreserve.gov/newsevents/speech/quarles20180119a.htm.

19 Federal Deposit Insurance Corporation, Quarterly Banking Profile: Fourth Quarter 2019, https://www.fdic.gov/bank/analytical/qbp/2019dec/qbp.pdf#page=1.

20 *See, e.g.*, Brian Wesbury and Robert Stein, *Repo Madness*, Advisor Perspectives, September 19, 2019, https://www.advisorperspectives.com/commentaries/2019/09/19/repo-madness; Wolf Richter, *Why Banks Didn't Lend to the Repo Market When Rates Blew Out: JPMorgan CEO Dimon*, Wolf Street, October 15, 2019, https://wolfstreet.com/2019/10/15/why-banks-didnt-lend-to-the-repo-market-when-rates-blew-out-jpmorgan-ceo-dimon/; Katanga Johnson & David Henry, *U.S. bankers seize on repo-market stress to push for softer liquidity rules*, Reuters, September 18, 2019, https://www.reuters.com/article/us-usa-fed-repo-banks/u-s-bankers-seize-on-repo-market-stress-to-push-for-softer-liquidity-rules-idUSKBN1W3288.

21 *See* Board of Governors of the Federal Reserve System, *Living Wills (or Resolution Plans)*, July 1, 2020, https://www.federalreserve.gov/supervisionreg/resolution-plans.htm (citing relevant provision in Dodd-Frank and implementing regulations).

annually, but neither regulators nor banks could keep up with the pace. Subsequently, regulators finalized amendments to the rules providing for biennial or triennial plan updates, with more frequent updates in the case of significant changes, such as merger and acquisition activities. Banks have also used the resolution planning to identify and trim off subsidiaries that had outlived their value. Although they are sure to be less than the intended roadmap for resolution that advocates advertise, the resolution plans may provide a useful inventory to assist agencies in supervising orderly resolutions.

V. Single Point of Entry (SPOE)

Drawing upon these and other authorities, the FDIC has developed a supervisory strategy for resolving large, complex banking *firms*. I emphasize firms, because the FDIC has long had authority and deep involvement with the resolution of *banks*. Its experience with resolution of *large* banks has been quite limited. Nearly all large banking firms, moreover, are financial holding companies of which the bank is a subsidiary accompanied by other bank or nonbank subsidiaries. Title II of the Dodd-Frank Act extended to the FDIC authority for resolving such financial firms should bankruptcy proceedings appear to be inadequate.

The FDIC developed a program pursuant to this authority, which it calls the Single Point of Entry strategy.[22] This approach is directed toward the parent holding company of a failing bank rather than to the bank itself. It allows regulators to avoid taking individual resolution actions for various parts of the firm (a multiple point of entry strategy). Under SPOE, resources available to the holding company would be transferred to failing bank subsidiaries and possibly other troubled constituent pieces of the holding company to keep them whole. Allowing these subsidiaries to continue operations would reduce the risk of disruptions to their customers and to the economy.[23]

To facilitate the SPOE strategy, the Federal Reserve promulgated regulations requiring certain large firms to maintain specific levels of total loss absorbing capacity (TLAC). The concept is that TLAC measures the abundance of resources that must be maintained available either to forestall failure or to assist in resolution, including the *conversion* of certain forms of debt instruments into resources available to cushion loss.[24]

While the SPOE strategy has never been tested—and may it ever remain so—it is a particularly promising approach for orderly resolution by the FDIC. It would allow for continued operation of essential functions, preserving function and value (as in bankruptcy) while resolution proceeds.

VI. Perceptions of Policymakers

Much of the foregoing has addressed the question of whether there are any TBTF banks in the U.S., touching both on the size of the institutions—a concern implied by the term *too big* to fail—and the ability to resolve large institutions such that they are *safe* to fail. This latter point, involving the agencies charged with managing bank failure, began with a survey of new resources available to the financial regulators. Yet there is more to be said.

The size of U.S. banks relative to the overall financial system, and the panoply of agency resources now available for resolution, can be marshalled into a powerful argument that there is no need to forebear resolution of any failing banking institution. The persistence of TBTF concern in the U.S. may then be a matter of perception, particularly public perception of regulatory willingness to use the available tools.

Whether there are grounds for such perception is a fair question, since regulatory attitudes toward bank failure in the United States, over many years, have been equivocal. Our bank regulators have not been alone in that posture. I recall attending a meeting with a senior official of the central bank of a European country that is home to large banks. When I raised the question of TBTF in his nation, he replied that bank failure was not part of their program. To be sure, I asked him again and received the same response affirming a TBTF supervisory posture. As I wrote at the outset of this paper, that question put to U.S. policymakers today would produce an unequivocal response: TBTF is not part of our program. What, however, has been the record in the past?

Continental Illinois National Bank and Trust Company is often pointed to as the first example of a failing U.S. large bank where regulators exercised forbearance[25] instead of closing a large bank. In 1984, all three federal bank regulators—the FDIC, the Office of the Comptroller of the Currency (OCC), and the Federal Reserve—approved extraordinary measures, including the protection of uninsured depositors and bondholders from loss, to keep the bank in operation.[26] The OCC was the bank's lead supervisor. In hearings before a subcommittee of the House Banking Committee, the following colloquy took place between Comptroller C.T. Conover and committee Chairman Fernand St Germain:

> Chairman St Germain. . . . can you ever foresee one of the 11 multinational money center banks failing? Can we ever afford to let any one of them fail?

22 Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76,614-76,624 (Dec. 18, 2013), *available at* https://www.fdic.gov/news/board/2013/2013-12-10_notice_dis-b_fr.pdf.

23 For a good, yet concise, discussion of SPOE and MPOE, see Paul L. Lee, *A Paradigm's Progress: The Single Point of Entry in Bank Resolution Planning*, The CLS Blue Sky Blog (Jan. 18, 2017), https://clsbluesky.law.columbia.edu/2017/01/18/a-paradigms-progress-the-single-point-of-entry-in-bank-resolution-planning/.

24 For a discussion of the final TLAC rule see *Federal Reserve's Final Rule on Total Loss Absorbing Capacity and Eligible Long-Term Debt*, Davis Polk (Jan. 11, 2017), https://www.davispolk.com/files/2017-01-11_davis_polk_federal_reserves_final_rule_on_tlac.pdf.

25 By regulatory forbearance, I refer to regulators refraining from enforcing, at least for a time, certain regulatory standards, including refraining from applying particular requirements that would likely lead to closing an insolvent bank. For example, in the 1980s, the Federal Home Loan Bank Board, which supervised federally chartered savings associations, allowed a number of insolvent institutions to remain in operation because the Federal Savings and Loan Insurance Corporation did not have adequate resources to cover the insured deposits.

26 For a concise history of the Continental Illinois bank troubles, see Renee Hamilton, *Failure of Continental Illinois*, Federal Reserve History (Nov. 22, 2013), https://www.federalreservehistory.org/essays/failure_of_continental_illinois.

Mr. Conover. The answer to that, Mr. Chairman, is that we have got to find a way to. In order to have a viable system.

Chairman St Germain. The fact of the matter is, as a practical matter, neither you nor your successors are ever going to let a big bank the size of Continental Illinois fail.

Mr. Conover. Mr. Chairman, it isn't whether the bank fails or not. It is how it is handled subsequent to its failure that matters. And we have to find a way. I admit that we don't have a way right now. And so, since we don't have a way, your premise appears to be correct at the moment.

Chairman St Germain. That is one of the prime reasons for these hearings. We have quite a few, but one of our principal reasons is we have to make a decision. Do we allow, ever, a large bank to fail?

Mr. Conover. I think it is important that we find a way to do that.[27]

Today, several decades later, have the regulators found "a way to do that"? About five years after the Continental Illinois rescue, reflecting on the actions of the FDIC, William Isaac, who was FDIC Chairman at the time of the Continental problems, said:

> I wonder if we might not be better off today if we had decided to let Continental fail, because many of the large banks that I was concerned might fail have failed anyway. . . . And they are probably costing the FDIC more money by being allowed to continue several more years than they would have had they failed in 1984.[28]

Such reflections by a former regulator, who has since only reinforced his reputation for perspicacious review, suggest that the regulators had sufficient tools, even in the mid-'80s, to close a large bank. Comptroller Conover, in his testimony, opined that they did not, while explaining, however, that the issue was more one of *how to handle* a large failed bank "subsequent to its failure that matters." As discussed above, even the details and work involved with the closure of smaller banks take time and effort well after the weekend protection of insured depositors.

In their December 1990 study of the TBTF doctrine, Cleveland Federal Reserve Bank researchers Walker F. Todd and James B. Thompson concluded, "Politics, not pure economics, is now clearly the driving factor in preserving the doctrine . . . ."[29] All policymakers today—legislative and executive—have renounced the TBTF doctrine. An examination of a sample of bank rescues may demonstrate the challenges to policymakers in applying that renunciation.

VII. The Legacy of Bank Rescues

Since Dodd-Frank, we have seen little evidence contrary to the current U.S. attitude against TBTF, but there have also been few banks facing failure. What has been the longer-term legacy of actual rescues?

Continental Illinois National Bank and Trust Company, was the nation's seventh or eighth largest bank in 1984, and it was the largest rescue at the time. It was not the first bank rescued by regulatory action, but it was the first one justified by the large size of the institution rescued—the first implementation of what came to be called too *big* to fail. As noted above, regulators were clearly uneasy about the actions that they took to rescue the bank, but policymakers found agreement that better tools would be needed to ensure that banks are safe to fail.

In October 1981, the FDIC announced that it was working with Greenwich Savings Bank (located in New York City) to find a buyer for the bank, which was reeling from the effects of the national double-digit interest rate environment. At the same time, the FDIC announced that any sale of the bank would be orderly and protect *all* the bank's depositors (insured as well as uninsured) from loss. The FDIC was concerned not only about Greenwich; the agency was worried about the condition of several New York savings banks and the potential for contagion from the failure of one undermining public confidence in the others. Losses from the failure of those banks might strain FDIC resources and undermine confidence in the FDIC itself as it coped with meeting insurance obligations to depositors. In November, the FDIC announced that it had assisted the merger of Greenwich into Metropolitan Savings Bank. In doing so, the FDIC made use of its authority under Section 13(e) of the Federal Deposit Insurance Act (FDIA), allowing such action on the grounds of averting threatened losses to the insurance fund.[30] Greenwich, with assets of $2.5 billion, was then the FDIC's third largest bank collapse. The estimated cost to the FDIC of the transaction was $465 million.

From 1981 through 1985, the FDIC assisted in the mergers of 17 failing savings banks, with sizes ranging from the $55 million asset Mechanics Savings Bank in Elmira, New York to the $5.3 billion asset Bowery Savings Bank in New York City. Eleven of these savings banks were located in New York, and others were based in Minnesota, New Jersey, Washington, Pennsylvania, and Oregon.[31] In personal conversations with then former FDIC Chairman Isaac, he emphasized to me a point made more than a decade after the resolutions by the authors of the FDIC study:

27 *Inquiry Into Continental Illinois Corp. and Continental Illinois National Bank: Hearings Before the Subcommittee on Financial Institutions Supervision, Regulation, and Insurance of the Committee on Banking, Finance, and Urban Affairs, House of Representatives," Ninety-Eighth Congress, Second Session, September 18, 19 and October 4, 1984*, at 299-300, https://fraser.stlouisfed.org/title/inquiry-continental-illinois-corp-continental-illinois-national-bank-745?start_page=305.

28 Quoted in Walker F. Todd & James B. Thomson, *An Insider's View of the Political Economy of the Too Big to Fail Doctrine*, Working Paper 90-17, Federal Reserve Bank of Cleveland, at 1 (Dec. 1990), https://fraser.stlouisfed.org/title/working-paper-federal-reserve-bank-cleveland-4494/insider-s-view-political-economy-big-fail-doctrine-494544/fulltext.

29 *Id.* at 6. I would comment, however, that "pure economics" is integrally involved in politics. At Johns Hopkins University, where I received my university economics training, the department was called the Department of Political Economy. Economics involves the study of such things as the allocation of a nation's resources and production, inherently political questions.

30 For more information on Greenwich and the FDIC's action, see Federal Deposit Insurance Corporation, History of the Eighties—Lessons for the Future 211-34 (1997) (Chapter 6, "The Mutual Savings Bank Crisis"), *available at* https://www.fdic.gov/bank/historical/history/211_234.pdf.

31 *Id.* at 226.

the actions of the FDIC in managing the early 1980s savings bank crisis made sure that "this crisis was not compounded by a sense of public panic."[32]

Unity Bank and Trust Company was a minority-owned de novo institution located in the Roxbury-Dorchester area of Boston; it had $9.3 million in assets and was founded in 1968. In July 1971, the FDIC provided financial assistance to Unity Bank in the form of a $1.5 million five-year loan. As described by the FDIC in its 1971 annual report, the loan was "part of an assistance program under which additional financial aid, including approximately $500 thousand, was provided by a group of Massachusetts banks."[33] The FDIC provided the assistance pursuant to Section 13(c) of the FDIA, which authorized the FDIC "to provide financial assistance to an insured operating bank in danger of closing whenever, in the opinion of the Board of Directors, the continued operation of such a bank is essential to providing adequate banking service in the community."[34]

In April 1980, the three federal banking regulators (the FDIC, the OCC, and the Federal Reserve) approved open bank assistance for First Pennsylvania Bank, N.A. (First Penn). The bank, with $8 billion in assets, was the largest bank headquartered in Philadelphia, and the 23rd largest bank in the United States. The support consisted of five-year loans totaling $500 million: $325 million from the FDIC and $175 million from a group of banks. Added support came from a $1 billion line of credit via the Federal Reserve's discount window.[35] First Penn provided to the FDIC and the banks 20 million warrants for purchase of stock in the holding company at $3 per share. In November 1983, First Penn paid off its loans to the FDIC and repurchased half of the warrants held by the agency. In May 1985, the bank bought back the rest of the warrants held by the FDIC. The net cost to the FDIC for the assistance package was zero.[36] Irvine Sprague, then with the FDIC, offers an eye-witness vignette from the interagency discussion:

> I recall at one session, Fred Schultz, the Fed deputy chairman, argued in an ever rising voice, that there were no alternatives—we had to save the bank. He said, "Quit wasting time talking about anything else!" Paul Homan of the Comptroller's office was equally intense as he argued for any solution but a failure.[37]

The Troubled Asset Relief Program (TARP), which Congress enacted at the pleading of Treasury Secretary Henry Paulson after first voting it down, funded direct Treasury investment in the stock of some 707 financial firms. This was not the purpose of the program as explained to Congress. The original idea, abruptly changed by Secretary Paulson once the bill became law, was to use some $700 billion to purchase troubled loans held by banks, clearing the way for banks to make new loans to boost the economy. Paulson quickly realized that pricing the troubled loans would be a political minefield, inviting endless criticism that Treasury paid too little or too much—whatever it did—for the assets. Never before had so much money been appropriated with so little congressional guidance. Paulson decided to use the funds instead to buy direct investments in the capital of banks. The TARP assistance to banks, over the life of the program, totaled $245 billion, with a net positive return to Treasury of $24 billion (above repayment of principle, a positive 9.8% return on investment overall).[38]

While Treasury provided the funds, bank regulators screened the banks to be qualified for TARP investments. The initial investments were targeted for a group of nine large institutions (three of which did not begin 2008 as banking firms) whose leaders were invited to a special meeting at the Treasury with the Secretary and bank regulators. Not all of the invited institutions wanted or needed the investments, but all were persuaded to accept. Nearly five years later, former Senator Chris Dodd and former Congressman Barney Frank (former Chairmen of the Senate Banking and House Financial Services Committees) penned an op-ed piece in which they confirmed what was well known. "Secretary Paulson essentially had to compel several of the largest banks to accept Troubled Asset Relief Program money even though some did not need it or want it, lest the institutions that did require help be stigmatized."[39] That is, Treasury invested in healthy banks as well as troubled banks in order to camouflage which was which. I personally heard similar stories from numerous bankers, leaders of banks of all sizes.

In sum, 707 banks of all sizes and conditions received government capital boosts from TARP. With TARP, size did not govern, and good health did not disqualify. However popularly portrayed, the program was not a demonstration of a policy of TBTF, but rather an example of nervous policymakers trying to do something to appear to be working to ward off economic decline and minimize bank failures.[40]

32 *Id*. at 231. For an insightful and well documented study of the 2008 financial crisis, which *did* become a panic, see William M. Isaac, Senseless Panic (2010).

33 Annual Report of the Federal Deposit Insurance Corporation 1971 6 (1972), *available at* https://www.fdic.gov/about/strategic/report/archives/fdic-ar-1971.pdf. For more background on this bank and the FDIC's rescue efforts, see Irvine H. Sprague, Bailout: An Insider's Account of Bank Failures and Rescues 35-52 (1986).

34 Annual Report, *supra* note 33, at 5.

35 Federal Deposit Insurance Corporation, *Managing the Crisis: The FDIC and RTC Experience—Chronological Overview*, Chapter 3: 1980 (1998), https://www.fdic.gov/bank/historical/managing/chronological/1980.html.

36 Federal Deposit Insurance Corporation, *Managing the Crisis: The FDIC and RTC Experience*, Vol. One: History, 158-59, *available at* https://www.fdic.gov/bank/historical/managing/documents/history-consolidated.pdf.

37 *See* Sprague, *supra* note 33, at 88-89.

38 U.S. Department of the Treasury, Troubled Asset Relief Program, Monthly Report to Congress—March 2020, https://www.treasury.gov/initiatives/financial-stability/reports/Documents/2020.03%20March%20Monthly%20Report%20to%20Congress.pdf.

39 Chris Dodd and Barney Frank, *Pulling the plug on failed banks*, Politico, July 28, 2013, https://www.politico.com/story/2013/07/dodd-frank-too-big-to-fail-criticism-094839.

40 William Isaac, comparing TARP with his own regulatory experience managing banking crisis, calls TARP "an ill-conceived program hastily slapped together by a panicked government." Isaac, *supra* note 32, at xvi.

VIII. Some Key Lessons

There is much to be learned from the legacy of our financial resolution experience. Recognizing these lessons will aid policymakers in developing and administering resolution policy.

- The record shows that size does not correlate well with bank rescues. Banks of all sizes have been considered eligible for regulatory mercy in place of market justice.
- You do not even need to be a bank to receive financial help from regulators. A wide variety of firms, depositors, and investors have received regulatory-guided funds.
- You also do not have to *need* assistance to be given assistance. TARP was replete with such examples (a problem not exclusive to financial regulation).
- We have also seen that worried policymakers can be susceptible to reaching for any tools available to them. They may also find creative ways around apparent limitations.
- If we wish to increase the realm for market discipline of troubled banks, we should recognize that the policy issue is not with the banks themselves, but with policymakers who may be apprehensive or otherwise reluctant to let financial firms fail. Such reluctance, which is government policy in other parts of the world, has been foresworn by current U.S. policymakers. That attitude of policymakers can be supported—in hopes that it will be sustained in times of tension—by regularly reviewing and refining the tools available to resolve failing institutions, to make the tools more usable and effective and resolution more predictable.
- We should disabuse ourselves of the idea that bank resolution (beyond protection of insured depositors) happens overnight or over the weekend. What appears to be forbearance may be the normal process of resolution applied in an orderly fashion to limit market disruption and preserve customer confidence. An important element of good resolution policy, as with bankruptcy management, is to preserve value where possible.

IX. Now What?

Following the experience of bank rescues in the 1980s, Congress made changes in the law to restrict regulatory forbearance. The FDIC was limited to failed bank resolutions that imposed the "least cost" on the insurance fund, making open bank assistance much more difficult. Simple leverage capital standards were made secondary to risk-based capital measures. A "prompt corrective action" regime was imposed on regulatory agencies to encourage earlier intervention and reduce FDIC resolution costs.

Similarly, after TARP and related policies of 2008-2009, the Dodd-Frank Act put into law elaborate programs intended to reduce the likelihood of bank failure and reduce the cost of resolution, particularly for larger firms. Several of these are discussed above in Section IV.

The question can be raised, has Dodd-Frank made TBTF impossible, and, if so, is the job done? With respect to bank resolutions, Dodd-Frank follows two themes. On one hand, it retains the primacy of formal bankruptcy for resolution. Yet on the other hand, the backup orderly resolution structure is too easy to invoke when there is consensus among federal financial policymakers that bankruptcy would be inadequate. Because policymakers have been prone to engage in groupthink in times of financial stress, the primacy of bankruptcy may too readily be overridden. It needs to be reinforced: the regulatory resolution authority's role must be seen as *secondary* and not preferred.

The new tools and statutory policies make TBTF unnecessary, but they do not make it impossible. Fundamental elements of bank supervision are judgment and flexibility. As long as they remain indispensable to bank supervision, there will also remain the possibility that judgment will use that flexibility to rescue rather than resolve a failing bank. The actual resolution cases cited above suggest that this may not always be inappropriate. Arguable defenses could be made, for example, of the First Penn case and for at least some of the savings bank actions.

Whatever proclivity may remain for stressed regulators to reach for the panic button in times of stress must be effectively cabined. Given the work that Congress has done by statute in this regard, the most important remaining work may be done in the realm of regulatory culture.

The legal structure of Title II of the Dodd-Frank Act rests upon an understanding that bankruptcy has precedence, but the emphasis appears to be on how to avoid it. Changing that statutory attitude will likely require further legislation. Fortunately, much groundwork has been laid to design improvements to the function of bankruptcy procedures for bank resolution such that little credibility would attach to arguments for recourse to Title II of Dodd-Frank. Those improvements need to find their way into law and practice. To quote Comptroller Conover, "I think it is important that we find a way to do that."