

The University of New Hampshire Law Review

Volume 8
Number 2 *Pierce Law Review*

Article 3

February 2010

Bringing to Heel the Elephants in the Economy: The Case for Ending “Too Big To Fail”

Ann Graham
Texas Tech University School of Law

Follow this and additional works at: https://scholars.unh.edu/unh_lr



Part of the [Banking and Finance Law Commons](#), and the [Corporate Finance Commons](#)

Repository Citation

Ann Graham, *Bringing to Heel the Elephants in the Economy: The Case for Ending “Too Big To Fail”*, 8 *Pierce L. Rev.* 117 (2010), available at http://scholars.unh.edu/unh_lr/vol8/iss2/3

This Article is brought to you for free and open access by the University of New Hampshire – Franklin Pierce School of Law at University of New Hampshire Scholars' Repository. It has been accepted for inclusion in The University of New Hampshire Law Review by an authorized editor of University of New Hampshire Scholars' Repository. For more information, please contact sue.zago@law.unh.edu.

Bringing to Heel the Elephants in the Economy: The Case for Ending “Too Big To Fail”

ANN GRAHAM*

TABLE OF CONTENTS

I.	THE CURRENT PROBLEM: A BLANK CHECK FOR ECONOMIC GIANTS	118
	A. <i>Identifying “TBTF”</i>	118
	B. <i>Recognizing the Cost of TBTF</i>	126
II.	THE FIX THAT DID NOT FIX THE TBTF PROBLEM: FDICIA’S RISK-BASED PREMIUMS, LEAST COST TEST, AND PROMPT CORRECTIVE ACTION	129
III.	RECOGNIZING BUBBLES	137
IV.	RECONSIDERING CONSOLIDATION	142
V.	REVISING EXPECTATIONS AND ADDRESSING MORAL HAZARD	151
VI.	LAYING OUT THE GAME PLAN TO END TBTF	154

There are key areas of reform within our regulatory structure that should be addressed in any effort to strengthen the oversight of our financial markets, enhance consumer protection and promote market discipline. Of primary importance is addressing too big to fail. Market participants should understand that large institutions can and will fail and that an effective resolution mechanism will be uniformly applied to institutions in a fair, transparent and consistent manner.¹

– FDIC Chairman Sheila Bair, June 17, 2009

* Professor of Law, Texas Tech University School of Law. I wish to thank my colleagues in the American Association of Law Schools (AALS) Financial Institutions Section for thought-provoking scholarship, challenging discussions, and collegial encouragement. I owe particular gratitude to Art Wilmarth, Patricia McCoy, Heidi Schooner, Kathleen Keest, Elizabeth Renuart, Elizabeth Schiltz, Christopher Peterson, Howell Jackson, and Keith Fisher. Michele Thaetig, my intrepid assistant, has also earned my appreciation and thanks.

1. Press Release, Fed. Deposit Ins. Corp., FDIC Chairman Sheila C. Bair Comments on the Obama Administration’s Regulatory Reform Plan (June 17, 2009), available at <http://www.fdic.gov/news/news/press/2009/pr09091.html>.

“Capitalism without failure is like Christianity without hell. These institutions not only brewed the Kool-Aid but drank it. [Some of the banks and mortgage companies] were like an arsonist who got caught in the house after he set it on fire.”²

– Warren Buffett, May 4, 2008.

I. THE CURRENT PROBLEM: A BLANK CHECK FOR ECONOMIC GIANTS

A. Identifying “TBTF”

Financial institutions labeled “Too Big To Fail” (TBTF) are those whose insolvency could shake the foundations of the U.S. financial system and our economy. The term “too big to fail” became part of our popular vocabulary in the wake of federal bank regulatory intervention to prevent the failure of Continental Illinois National Bank in 1984.³ After the banking and savings-and-loan crisis of the 1980s, the pros and cons of the TBTF policy were extensively debated.⁴ Despite Congressional efforts to limit application of TBTF,⁵ the doctrine has returned with renewed vigor during the current crisis. Responding on an *ad hoc* basis, federal banking regulators have employed a TBTF policy to prevent what Federal Reserve

2. Jason Zweig, *Buffett Advice: Buy Smart . . . and Low*, CNN MONEY, May 6, 2008, <http://money.cnn.com/2008/05/05/news/companies/buffet.pm.wrap/index.htm> (alteration in original) (reporting Warren Buffet’s remarks, made at a press conference following the Berkshire Hathaway annual meeting).

3. See generally 1 DIV. OF RESEARCH & STATISTICS, FED. DEPOSIT INS. CORP., HISTORY OF THE EIGHTIES—LESSONS FOR THE FUTURE ch. 7 (1997), available at <http://www.fdic.gov/bank/historical/history/vol1.html>; DAVID S. HOLLAND, WHEN REGULATION WAS TOO SUCCESSFUL—THE SIXTH DECADE OF DEPOSIT INSURANCE: A HISTORY OF THE TROUBLES OF THE U.S. BANKING INDUSTRY IN THE 1980S AND EARLY 1990S ch. 4 (1998).

4. See, e.g., *Economic Implications of the “Too Big to Fail” Policy: Hearing Before the Subcomm. on Econ. Stabilization of the H. Comm. on Banking, Fin. & Urban Affairs*, 102d Cong. (1991); HOLLAND, *supra* note 3, ch. 4.

5. HOLLAND, *supra* note 3, ch. 4; see also 1 DIV. OF RESEARCH & STATISTICS, *supra* note 3, at 33–35, 57, 68, 82, 91, 96, 99 (providing viewpoints on “too big to fail” from regulators who held office at the time of FDIC’s Continental Illinois intervention).

Chairman Ben Bernanke saw as potential for the "second Great Depression."⁶ Once the floodgates opened, Sunday announcements concerning bailout deals became the new business-as-usual.

Assisted transactions involving TBTF entities have included: Bear Stearns (investment bank: purchased by JP Morgan Chase in a federally brokered transaction, March 16, 2008);⁷ IndyMac (major subprime lender: placed in conservatorship on July 11, 2008, with deposits and assets later sold at a discount to OneWest Bank, FSB, on March 19, 2009);⁸ Fannie Mae and Freddie Mac (Government Sponsored Entities (GSEs): placed in conservatorship by the Federal Housing Finance Agency on September 7, 2008);⁹ American International Group, Inc. (AIG) (insurance conglomerate: received \$85 billion in exchange for government ownership of 79.9% equity stake

6. "Nothing made me more frustrated than having to intervene in a couple cases where wild bets threatened to bring down the financial system. . . . But I was not going to be the Federal Reserve chairman who presided over the second Great Depression." David Goldman, *Bernanke: Economy to Bounce Back Stronger*, CNN MONEY, July 27, 2009, http://money.cnn.com/2009/07/26/news/economy/bernanke_town_hall (internal quotation marks omitted) (quoting Ben Bernanke at a town hall meeting in Kansas City, Missouri on July 26, 2009); see also James J. Cramer, *Thank Bernanke*, NEW YORK MAGAZINE, June 15, 2009, available at <http://nymag.com/news/businessfinance/bottomline/57177/>.

7. KATE KELLY, STREET FIGHTERS: THE LAST 72 HOURS OF BEAR STEARNS, THE TOUGHEST FIRM ON WALL STREET 181–214 (2009); Andrew Ross Sorkin, *In Sweeping Move, Fed Backs Buyout and Wall St. Loans*, N.Y. TIMES, Mar. 17, 2008, at A1; see *Turmoil in U.S. Credit Markets: Examining the Recent Actions of Federal Financial Regulators: Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs*, 110th Cong. (2008) [hereinafter *Turmoil in U.S. Credit Markets*].

8. Press Release, Fed. Deposit Ins. Corp., FDIC Closes Sale of Indymac Federal Bank, Pasadena, California (Mar. 19, 2009), available at <http://www.fdic.gov/news/news/press/2009/pr09042.html>; Press Release, Fed. Deposit Ins. Corp., FDIC Establishes IndyMac Federal Bank, FSB as Successor to IndyMac Bank, F.S.B., Pasadena, California (July 11, 2008), available at <http://www.fdic.gov/news/news/press/2008/pr08056.html>; FDIC, Failed Bank Information, <http://www.fdic.gov/bank/individual/failed/IndyMac.html> (last visited Jan. 28, 2010).

9. See Stephen Labaton & Edmund L. Andrews, *In Rescue to Stabilize Lending, U.S. Takes Over Mortgage Finance Titans*, N.Y. TIMES, Sept. 8, 2008, at A1; Press Release, U.S. Dept. of Treasury, Statement by Henry M. Paulson, Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers (Sept. 7, 2008), available at <http://www.ustreas.gov/press/releases/hp1129.htm>

on September 17, 2008, two days after Lehman Brothers's similar requests for government assistance were denied and Lehman forced into bankruptcy);¹⁰ Wachovia (one-time fourth-largest U.S. bank, heavily involved in subprime lending: purchased by Wells Fargo on Oct. 10, 2008, after initially being approved as an assisted purchase by Citigroup);¹¹ Merrill Lynch (investment bank: acquired by Bank of America in a deal announced on September 15, 2008, and closed at year-end 2008, later yielding litigation over executive bonuses paid to Merrill executives and not disclosed to Bank of America shareholders);¹² and Citigroup (once the world's largest financial institution by market value: received repeated bailouts during Fall 2008 and Spring 2009).¹³ The Bush administration's Troubled Asset Relief Program of \$700 billion and the Obama administration's Economic Stimulus Package of \$825 billion have also provided subsidies accruing more to TBTF entities than to smaller community banks doing business under a more traditional, less risky business model.¹⁴

In contrast to these government-assisted transactions involving TBTF entities, federal banking regulators declined to rescue other seemingly TBTF entities. Lehman Brothers, once one of the five

10. See Matthew Karnitschnig et al., *U.S. to Take Over AIG in \$85B Bailout; Central Banks Inject Cash as Credit Dries Up*, WALL ST. J., Sept. 17, 2008, at A1.

11. See Colin Barr, *Citi Plays the Heavy*, CNN MONEY, Oct. 6, 2008, <http://money.cnn.com/2008/10/03/news/citi.bailout.heavy.fortune/index.htm>; *Feds Give Green Light to Wells Fargo-Wachovia*, NEWSER.COM, Oct. 10, 2008, <http://www.newser.com/story/39663/feds-give-green-light-to-wells-fargo-wachovia.html>; *Following the Bailout Money to Wells Fargo*, WCCO, Feb. 9, 2009, <http://wcco.com/national/Wells.Fargo.money.2.931141.html>.

12. See Liz Rappaport, *Lewis Testifies U.S. Urged Silence on Deal*, WALL ST. J., Apr. 23, 2009, at A1 (reporting Bank of America CEO Ken Lewis's testimony under oath to NY Attorney General that then-Treasury Secretary Henry Paulson repeatedly told him that "the U.S. government was committed to ensuring that no systemically important financial institution would fail").

13. David Enrich & Deborah Solomon, *Citi, U.S. Reach Accord on a Third Bailout*, WALL ST. J., Feb. 28, 2009, at B1.

14. See generally Gretchen Morgenson, *The End of Banking as We Know It*, N.Y. TIMES, Jan. 17, 2009, at BU1 (arguing that the business model of financial behemoths is over).

largest U.S. investment banks,¹⁵ filed for bankruptcy on September 15, 2008¹⁶—the largest Chapter 11 bankruptcy filing in U.S. history¹⁷ and one that “rocked Wall Street.”¹⁸ Washington Mutual, another giant financial institution that failed to get a bailout, was closed by the Office of Thrift Supervision (OTS) on September 25, 2008, with assets subsequently sold by the FDIC as Receiver to JP Morgan Chase.¹⁹ CIT Group, the nation’s largest small business lender, may demonstrate the break point for “not too big to fail” as well as provide more insight into market reaction when troubled institutions do

15. As of January 2008, the top five U.S. investment banks were Bear Stearns, Lehman Brothers, Merrill Lynch, Goldman Sachs, and Morgan Stanley. See Katy Marquardt, *FAQ on Investment Banks*, U.S. NEWS & WORLD REP., Mar. 17, 2008, <http://www.usnews.com/money/business-economy/articles/2008/03/17/faq-on-investment-banks.html>. Bear Stearns was acquired by JP Morgan Chase, Lehman Brothers filed for bankruptcy, Merrill Lynch was acquired by Bank of America, and Goldman Sachs and Morgan Stanley converted to bank holding companies to become eligible for Federal Reserve discount window loans. Posting of Michael J. de la Merced et al. to DealBook, <http://dealbook.blogs.nytimes.com/> (Sept. 21, 2008, 21:35). The approval of the conversion of Goldman Sachs and Morgan Stanley to bank holding companies has been viewed as “the latest signal by the Federal Reserve that it will not let Goldman or Morgan fail.” *Id.*

16. Carrick Mollenkamp et al., *Lehman Files for Bankruptcy, Merrill Sold, AIG Seeks Cash*, WALL ST. J., Sept. 16, 2008, <http://online.wsj.com/article/SB122145492097035549.html>; Posting of Derek Kravitz to Washington Post Investigations, <http://voices.washingtonpost.com/washingtonpostinvestigations/> (Sept. 16, 2008, 15:08 EDT).

17. Yalman Onaran & Christopher Scinta, *Lehman Files Biggest Bankruptcy Case as Suitors Balk*, BLOOMBERG.COM, Sept. 15, 2008, <http://www.bloomberg.com/apps/news?sid=awh5hRyXkvs4&pid=20601087>.

18. *Changes Rock Wall Street*, CNN, Sept. 15, 2008, <http://www.cnn.com/2008/US/09/15/banks.bigchanges/index.html>; Andy Serwer et al., “*We Were Looking at the Abyss*,” FORTUNE, Sept. 28, 2009, at 78, available at http://money.cnn.com/2009/09/08/news/economy/geithner_lehman_bankruptcy.fortune/index.htm.

19. Press Release, Office of Thrift Supervision, Washington Mutual acquired by JPMorgan Chase (Sept. 25, 2008), available at http://www.ots.treas.gov/index.cfm?p=PressReleases&ContentRecord_id=9c306c81-1e0b-8562-eb0c-fed5429a3a56; see also Eric Dash & Andrew Ross Sorkin, *Government Seizes WaMu and Sells Some Assets*, N.Y. TIMES, Sept. 26, 2008, at A1. WaMu was the nation’s largest thrift and its failure represents the largest bank failure in U.S. history. *Id.*

not get a bailout.²⁰ CIT Group received \$2.3 billion in government aid in December 2008, but failed to get more during the summer of 2009.²¹ These transactions illustrate the arbitrary nature of TBTF²² and the market uncertainty about which institutions will be bailed out, as well as the favoritism and windfall profits generated by subsidized acquisitions.²³

Size is not the sole criterion for TBTF.²⁴ The institutions marked for government bailout to prevent failure are described as “too big to liquidate”²⁵ and “too interconnected to fail.”²⁶ The Obama admini-

20. CIT bondholders considered various proposals to keep the firm out of formal bankruptcy proceedings once it became apparent that a government bailout would not be forthcoming. *See, e.g.*, Jeffrey McCracken & Serena Ng, *Bondholders Plan CIT Rescue*, WALL ST. J., July 20, 2009, at A1 (outlining the deal for a \$3 billion high interest rate emergency loan from bondholders); *CIT Debt Restructuring OK'd by Board*, CBS NEWS, Oct. 2, 2009, <http://www.cbsnews.com/stories/2009/10/02/business/main5357941.shtml> (discussing alternative proposals for a debt-equity swap or prepackaged reorganization in the event of bankruptcy).

21. *E.g.*, Editorial, *CIT on the Verge*, N.Y. TIMES, July 23, 2009, at A30.

22. *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 21–23 (Advance Copy, 2009), available at <http://www.cato.org/pubs/pas/pa-637.pdf> (reviewing bank bailouts and public pronouncements). “The justifications for the series of bailouts during the current crisis have been devoid of transparency regarding the precise, institution-specific justification for intervention. There has been no bright-line rule.” *Id.* at 21.

23. *See* Thomas F. Cooley & Thomas Philippon, *The Bailout*, in RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM 323, 323–25 (Viral V. Acharya & Matthew Richardson eds., 2009) [hereinafter RESTORING FINANCIAL STABILITY]. “Our overall assessment is that the U.S. bailout was ill-conceived from the start, both technically and strategically. It gave away taxpayer money, it was confused and inefficient, and in some respects it worsened the crisis.” *Id.* at 323.

24. *See* Huberto M. Ennis & H.S. Malek, *Bank Risk of Failure and the Too-Big-to-Fail Policy*, ECON. Q. (Federal Reserve Bank of Richmond, Richmond, Va.), Spring 2005, at 21, 21–22 (“The too-big-to-fail terminology sometimes can be misleading. While the systemic importance of an organization tends to be closely related to its size, this is not always the case.”).

25. William Poole, President of the Federal Reserve Bank of St. Louis from 1998 to 2008, used this phrase to describe secondary mortgage market giants Fannie Mae and Freddie Mac. William Poole, Op-Ed, *Too Big to Fail, or to Survive*, N.Y. TIMES, July 27, 2008, at WK11.

26. *See Turmoil in the U.S. Credit Markets*, *supra* note 7, at 2–3 (statement of Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys.), available

stration's plan for regulatory reform²⁷ calls these institutions "Tier 1 Financial Holding Companies" or "Tier 1 FHCs," defined as "[a]ny financial firm whose combination of size, leverage, and interconnectedness could pose a threat to financial stability if it failed."²⁸ Internationally, these institutions have been referred to as "large complex financial institutions" or "LCFIs."²⁹

at http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=0a0ec016-ad61-4736-b6e3-7eb61fbc0c69. Chairman Bernanke's testimony about the Bear Stearns bailout gives particular insight into his perspective on TBTF, which raises "difficult questions of public policy." *Id.* at 2.

Normally, the market sorts out which companies survive and which fail, and that is as it should be. However, the issues raised here extended well beyond the fate of one company. Our financial system is extremely complex and interconnected, and Bear Stearns participated extensively in a range of critical markets. The sudden failure of Bear Stearns likely would have led to a chaotic unwinding of positions in those markets and could have severely shaken confidence. The company's failure could also have cast doubt on the financial positions of some of Bear Stearns' thousands of counterparties and perhaps of companies with similar businesses. Given the exceptional pressures on the global economy and financial system, the damage caused by a default by Bear Stearns could have been severe and extremely difficult to contain. Moreover, the adverse impact of a default would not have been confined to the financial system but would have been felt broadly in the real economy through its effects on asset values and credit availability.

To prevent a disorderly failure of Bear Stearns and the unpredictable but likely severe consequences for market functioning and the broader economy, the Federal Reserve, in close consultation with the Treasury Department, agreed to provide funding to Bear Stearns through JPMorgan Chase. Over the following weekend, JPMorgan Chase agreed to purchase Bear Stearns and assumed Bear's financial obligations.

Id. at 2–3; see also Federal Reserve Board, Minutes of the Board of Governors of the Federal Reserve System (Mar. 16, 2008), <http://www.federalreserve.gov/newsevents/press/other/other20080627a2.pdf>; Federal Reserve Board, Minutes of the Board of Governors of the Federal Reserve System (Mar. 14, 2008), <http://www.federalreserve.gov/newsevents/press/other/other20080627a1.pdf>.

27. U.S. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION (2009), http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

28. *Id.* at 10.

29. See Anthony Saunder et al., *Enhanced Regulation of Large, Complex Financial Institutions*, in RESTORING FINANCIAL STABILITY, *supra* note 23, at 139 (defining LCFIs as "financial intermediaries engaged in some combination of com-

As early as 2004, in advance of the current crisis, the Federal Reserve Bank of Chicago hosted an international conference,³⁰ seeking analyses and recommendations for resolving large bank insolvencies, premised on the idea that:

[B]ank failures like illness, death and taxes, are almost a certainty at some time in our future. . . . Past failures have frequently been resolved only at very high cost to society, but they need not be. . . . [T]he cost could be reduced through planning ahead in the good times and having a well-developed, credible, and widely publicized plan ready to put into action by policymakers when the need arises.³¹

These institutions have also been called “too big to save”³² because “[t]he costs of a partial or complete bailout are likely to be very high. The costs comprise not only direct costs for the taxpayers, but also the indirect costs of weakened market discipline and greater moral hazard.”³³

Identifying specific financial institutions that federal regulators currently believe may be too big to fail does not present a mystery. From February 25, 2009, through late April 2009, nineteen banks were required to participate in the Supervisory Capital Assessment Program (SCAP) or “stress testing.”³⁴ On April 24, 2009, the *Wall Street Journal* reported the following list of “banks” undergoing

mercial banking, investment banking, asset management, and insurance, whose failure poses a systematic risk or externality to the financial system as a whole”).

30. Federal Reserve Bank of Chicago, International Banking Conference Series, http://www.chicagofed.org/webpages/events/international_series.cfm (last visited Jan. 30, 2010).

31. SYSTEMIC FINANCIAL CRISES: RESOLVING LARGE BANK INSOLVENCIES, at vii (Douglas D. Evanoff & George G. Kaufman eds., 2005) [hereinafter SYSTEMIC FINANCIAL CRISES].

32. Eva H. G. Hüpkes, “*Too Big to Save*”—*Toward a Functional Approach to Resolving Crises in Global Financial Institutions*, in SYSTEMIC FINANCIAL CRISES, *supra* note 31, at 193.

33. *Id.* at 196.

34. See BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE SUPERVISORY CAPITAL ASSESSMENT PROGRAM: DESIGN AND IMPLEMENTATION (2009), <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20090424a1.pdf> [hereinafter FRB SCAP WHITEPAPER] (providing a whitepaper analysis with a detailed description of SCAP).

stress testing: J.P. Morgan Chase & Company, Citigroup, Bank of America Corporation, Wells Fargo & Company, Goldman Sachs Group, Morgan Stanley, MetLife, PNC Financial Services Group, US Bancorp, Bank of NY Mellon Corporation, SunTrust Banks Inc., State Street Corporation, Capital One Financial Corporation, BB&T Corporation, Regions Financial Corporation, American Express Company, Fifth Third Bancorp, Keycorp, and GMAC LLC.³⁵

Entities selected for SCAP included "[a]ll domestic [bank holding companies] with year-end 2008 assets exceeding \$100 billion."³⁶ These entities, all popularly referred to as "banks," include not only commercial banking operations holding bank charters and accepting federally insured deposits but also insurance companies, mortgage banks, investment banks, and auto financiers. Four federal bank regulatory agencies, the Board of Governors of the Federal Reserve System, the Federal Reserve Banks, FDIC, and OCC required these large financial conglomerates to participate in the SCAP as part of the ongoing supervisory process.³⁷ As the Federal Reserve Report acknowledges, "These 19 firms collectively hold two-thirds of the assets and more than one-half of the loans in the U.S. banking system, and support a very significant portion of the credit intermediation done by the banking sector."³⁸

Now is the time to address the "too big to fail" financial structures. Absent clear direction from Congress that TBTF as a government policy must be rejected, the seeds of the next financial crisis remain.³⁹ To think that financial behemoths have learned their lessons during the current crisis is to believe in fairy tales.⁴⁰

35. Posting of WSJ Staff to Real Time Economics, <http://blogs.wsj.com/economics/> (Apr. 24, 2009, 14:46 EST).

36. FRB SCAP WHITEPAPER, *supra* note 34, at 1.

37. *Id.*

38. *Id.* To paraphrase John Donne, no one of these TBTF institutions is an island. See JOHN DONNE, *Meditation XVII*, in DEVOTIONS UPON EMERGENT OCCASIONS 107 (Ann Arbor Paperbacks 1959) (1624). When one of them fails, the bell tolls for the U.S. and global economies. See *id.*

39. See generally Viral V. Acharya & Rangarajan K. Sundaram, *The Financial Sector Bailout: Sowing the Seeds of the Next Crisis?*, in RESTORING FINANCIAL STABILITY, *supra* note 23, at 327 (arguing that the "overly generous" governmental actions compare unfavorably with U.K. response). "The [U.S. bailout] schemes further shield the unhealthy institutions and their management from mar-

B. *Recognizing the Cost of TBTF*

In July 2009, Neil Barovsky, Special Inspector General for the Troubled Asset Relief Program (TARP), estimated that \$23.7 trillion in taxpayer money could be expended, not only through TARP, but also through dozens of related programs intended to shore up the U.S. financial system and rescue the economy.⁴¹ Costly government actions over the past two years have focused on preventing large bank and nonbank financial institution failures through liquidity infusions, asset purchases, assisted acquisitions, and a host of other

ket discipline, exacerbating moral hazard concerns. The typically sticky nature of regulatory responses during past crises raises the disturbing question: Are these efforts merely sowing the seeds of the next crisis?" *Id.* at 328.

40. *See, e.g.*, Stevenson Jacobs, *Risk-Taking Is Back for Banks 1 Year After Crisis*, S.F. CHRON., Sept. 14, 2009, <http://www.sfgate.com/cgi-bin/article.cgi?f=/n/a/2009/09/13/financial/f080512D22.DTL>.

A year after the financial system nearly collapsed, the nation's biggest banks are bigger and regaining their appetite for risk.

Goldman Sachs, JPMorgan Chase and others—which have received tens of billions of dollars in federal aid—are once more betting big on bonds, commodities and exotic financial products, trading that nearly stopped during the financial crisis.

....

Through mergers and the failure of Lehman Brothers, the mammoth banks whose near-collapse prompted government rescues have gotten even bigger, increasing the risk they pose to the financial system. And they still make bets that, in the aggregate, are worth far more than the capital they have on hand to cover against potential losses.

Id.

41. *Following the Money: Report of the Special Inspector General for the Troubled Asset Relief Program (SIGTARP): Hearing Before the H. Comm. on Oversight & Gov't Reform*, 111th Cong. 2 (2009) [hereinafter *Following the Money*] (statement of Neil Barovsky, Special Inspector Gen. for the Troubled Asset Relief Program), available at http://oversight.house.gov/index.php?option=com_content&task=view&id=2779&Itemid=2; Dawn Kopecki & Catherine Dodge, *U.S. Rescue May Reach \$23.7 Trillion, Barofsky Says*, BLOOMBERG.COM, July 20, 2009, <http://www.bloomberg.com/apps/news?pid=20601087&sid=aY0tX8UysIaM> ("U.S. taxpayers may be on the hook for as much as \$23.7 trillion to bolster the economy and bail out financial companies . . .").

poorly coordinated responses to the “squeaky wheel of the moment,” adopted in a largely *ad hoc* fashion, with little transparency.⁴²

While it may not be possible to assign a dollar cost attributable solely to the TBTF policy, that philosophy has been the central driving force behind each bailout listed above.⁴³ As such, the present and future cost of TBTF is mind-boggling. No one can argue with the assessment that government bailouts have grown to “unprecedented scope, scale, and complexity.”⁴⁴ Recognizing that TBTF is only one component of the business practices and government policies that contributed to and exacerbated the current crisis, scholars and commentators⁴⁵ are focusing analysis on other, more immediate triggering factors: Federal Reserve interest rate policy (keeping interest rates low for so long that excess liquidity in our economy contributed to a real estate bubble); unregulated mortgage originators and poor loan underwriting standards; industry compensation poli-

42. *Oversight Concerns Regarding Treasury Department Conduct of the Troubled Assets Relief Program: Hearing Before the H. Comm. on Fin. Servs.*, 110th Cong. 2 (2008) (statement of Gene L. Dodaro, Acting Comptroller Gen. of the U.S.), available at <http://www.gao.gov/new.items/d09266t.pdf> (“Treasury has provided more than \$155 billion in capital to 87 institutions through [the Capital Purchase Program] as of December 5, 2008. It has also established a Systemically Significant Failing Institution (SSFI) program, through which Treasury may invest in any financial instrument, including debt, equity, or warrants determined to be a troubled asset”); see also U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-09-658, TROUBLED ASSET RELIEF PROGRAM: JUNE 2009 STATUS OF EFFORTS TO ADDRESS TRANSPARENCY AND ACCOUNTABILITY ISSUES (2009), <http://www.gao.gov/new.items/d09658.pdf>.

43. See *supra* notes 7–13 and accompanying text.

44. *Following the Money*, *supra* note 41, at 1 (opening statement of Edolphus Towns, Chairman, H. Comm. on Oversight & Gov’t Reform), available at <http://oversight.house.gov/documents/20090721093704.pdf>.

45. See, e.g., LES LEOPOLD, *THE LOOTING OF AMERICA: HOW WALL STREET’S GAME OF FANTASY FINANCE DESTROYED OUR JOBS, PENSIONS, AND PROSPERITY AND WHAT WE CAN DO ABOUT IT* ch. 6 (2009) (summarizing both “conservative” and “liberal” explanations for the causes of the crisis); HAL S. SCOTT, *THE GLOBAL FINANCIAL CRISIS* (2009) (examining the causes of the crisis). Arguing that collateral debt obligation (CDO) derivatives and credit default swaps are the “weapons of mass destruction” (Warren Buffet’s term) at the heart of a global “fantasy-finance casino,” Leopold calls for a fundamental reevaluation of the structural causes of both the Great Depression and the current crisis. LEOPOLD, *supra*, ch. 1.

cies that encouraged excessive risk-taking; securitization of loans that removed the balance sheet risk of loan default from the originator; complex unregulated derivative securities; and counter-party risk.⁴⁶ All these factors are verifiable contributors to the crisis; however, the overarching premise that the government would step in once a TBTF institution became in danger of failing created the ultimate in moral hazard.⁴⁷ Large institutions not only had no incentive to avoid risky lending and investment practices, they were positively incented to pursue such practices because of an implicit government guarantee against failure.

Putting a dollar figure on the total costs of the recession will be possible only in hindsight. Even with the perspective of time, total cost calculations will vary among reasonable economists. Breaking out costs attributable specifically to the TBTF problem is and will be even more difficult. Nevertheless, TBTF is a significant factor in costs we can observe and quantify now, including specific government cash outlays, damage to the real economy,⁴⁸ loss of output and employment, increase in the national debt and potential for inflation—which could require the Federal Reserve to increase interest rates dramatically, potentially precipitating another recession.⁴⁹

Former President and CEO of the Federal Reserve Bank of Minneapolis Gary H. Stern, who has written extensively on the issue of “Too Big To Fail,” both prior to and in the aftermath of the current

46. LEOPOLD, *supra* note 45, at 73.

47. *See infra* note 50 and accompanying text.

48. *Cf.* Paul H. Kupiec & Carlos D. Ramirez, *Bank Failures and the Cost of Systemic Risk* (FDIC Ctr. for Fin. Research, Working Paper No. 2009-06, 2009), available at http://www.fdic.gov/bank/analytical/cfr/2009/wp2009/CFR_WP_2009_06KupiecRamirez.pdf (investigating “the effect of bank failures on economic growth using data from 1900 to 1930, a period that predates active government stabilization policies and includes periods of banking system distress that are not coincident with recessions”). This study concludes that bank failures engender significant negative externalities that measurably reduce economic growth. *Id.* at 38. Although government policies implemented after the data period here, such as deposit insurance, efficient bank resolution procedures, and prudential bank supervision, may mitigate the impact of bank failures on economic growth, these government policies encourage moral hazard, increase bank risk-taking, and distort resource allocation. *Id.* at 39.

49. *See* RICHARD A. POSNER, *A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION*, at xi (2009).

financial crisis,⁵⁰ concludes that maintaining the *status quo* with regard to TBTF is unacceptable because of the substantial costs TBTF is likely to impose on the U.S. economy.⁵¹ In his words, "We cannot afford such costs."⁵² "Once immediate fires have been doused, policymakers will have to turn to reining in TBTF because, left unchecked, the TBTF embers remaining from our emergency response will likely contribute to future financial conflagrations."⁵³

One of the most disturbing aspects of the current economic disruption and taxpayer burden attributable to TBTF is that Congress has considered this issue before and passed legislation⁵⁴ specifically designed to end this unfair and costly doctrine.

II. THE FIX THAT DID NOT FIX THE TBTF PROBLEM: FDICIA'S RISK-BASED PREMIUMS, LEAST COST TEST, AND PROMPT CORRECTIVE ACTION

In the wake of the banking and thrift crisis of the 1980s,⁵⁵ Congress acted to enhance market discipline through the Federal Deposit Insurance Corporation Improvement Act (FDICIA).⁵⁶ Citing the

50. See generally Fed. Reserve Bank of Minneapolis, Policy Studies: Too Big To Fail, http://www.minneapolisfed.org/publications_papers/studies/tbtf/tbtf.cfm (collected articles from 1988 to present).

51. *Regulating and Resolving Institutions Considered "Too Big to Fail": Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs*, 111th Cong. 6 (2009) [hereinafter *Too Big to Fail Hearing*] (statement of Gary H. Stern, President and CEO, Fed. Reserve Bank of Minneapolis), available at http://www.minneapolisfed.org/news_events/pres/sterntestimony05-06-09.pdf.

52. *Id.*

53. Gary H. Stern, President, Fed. Reserve Bank of Minneapolis, Too Big to Fail: The Way Forward, Address at Winona State University (Nov. 13, 2008), available at http://www.minneapolisfed.org/news_events/pres/stern11-13-08.cfm.

54. See Federal Deposit Insurance Corporation Act of 1991 (FDICIA), Pub. L. No. 102-242, 105 Stat. 2236; discussion *infra* Part II.

55. See generally *United States v. Winstar Corp.*, 518 U.S. 839, 845–48 (1996) (providing a succinct history of the savings-and-loan industry and its regulation through the crisis of the 1980s).

56. FDICIA, 105 Stat. 2236. See also Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Pub. L. No. 101-73, §§ 401(a)(2), 101(6), 103 Stat. 183 (abolishing the Federal Home Loan Bank Board (FHLBB) and creating the Office of Thrift Supervision (OTS), the current federal thrift regu-

severity of that crisis, in which 10 percent of the commercial and savings bank industry and 25 percent of the thrift industry failed between 1980 and 1991, commentators have described FDICIA as “the most important banking legislation since the Banking (Glass-Steagall) Act, which was enacted in 1933 at the depth of the previous most severe banking crisis in U.S. history.”⁵⁷ Just as in the current crisis, the number of failures and, ultimately, the high cost to taxpayers as a result of the savings-and-loan crisis were increased by flaws in the financial institution regulatory structure that “encouraged insured institutions to assume excessive credit and interest rate risks and bank regulators to delay imposing corrective sanctions on troubled institutions and resolving economically insolvent institutions.”⁵⁸

FDICIA’s three most important deposit insurance reforms—(1) capital-based prompt corrective action (PCA), (2) risk-based deposit

lator). Proposals now under consideration would abolish the both the thrift charter and the OTS. *E.g.*, DEPT. OF THE TREASURY, FINANCIAL REGULATORY REFORM, A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION (2009) (presenting the Obama administration’s plan for financial regulatory reform), *available at* http://www.financialstability.gov/docs/regs/FinalReport_web.pdf. FIRREA also terminated the existence of the Federal Savings and Loan Insurance Corporation (FSLIC) and transferred its responsibilities to the FDIC. FIRREA § 205.

57. PROMPT CORRECTIVE ACTION IN BANKING: 10 YEARS LATER, at ix (George G. Kaufman ed., *Research in Fin. Servs.: Private & Pub. Policy*, Vol. 14, 2002). Other commentators have described the Gramm-Leach-Bliley Act of 1999 (GLBA) in similar terms. *E.g.*, Fed. Reserve Bank of San Francisco, *Gramm-Leach-Bliley Act: A New Frontier in Financial Services*, <http://www.frbsf.org/publications/banking/gramm/index.html>. Whereas FDICIA was intended to impose restrictions on the banking industry and its federal regulators, GLBA was expansive, eliminating the Glass Steagall wall between banking and securities powers for banks. *Id.* The impact of those expanded powers and the mind-set that commercial banking should no longer be kept separate from investment banking contributed to the current crisis just as much as the failure of bank regulators to follow the PCA and least cost resolution strictures of FDICIA. *See* Press Release, Office of the Press Secretary, Remarks by the President on Financial Reform (Jan. 21, 2010), *available at* <http://www.whitehouse.gov/the-press-office/remarks-president-financial-reform>.

58. PROMPT CORRECTIVE ACTION, *supra* note 57, at ix.

insurance premiums, and (3) least cost resolution⁵⁹—represent Congressional response to issues highlighted by the thrift and banking crisis of the 1980s.

First, PCA⁶⁰ was intended to address regulatory forbearance,⁶¹ graphically illustrated by supervisory delay in closing insolvent thrifts. Delayed closings substantially increased the cost to the insurance fund and to taxpayers as these “zombie institutions”⁶² continued to operate their way into increasingly negative net worth before their primary regulator, itself strapped for resources, finally formally closed them.⁶³

59. Richard Scott Carnell, *A Partial Antidote to Perverse Incentives: The FDIC Improvement Act of 1991*, 12 ANN. REV. BANKING L. 317, 325 (1993).

60. 12 U.S.C.A. § 1831o (West 2001 & Supp. 2009). PCA assigns banks to one of five categories, based on leverage ratio and total risk-based capital ratio: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. *Id.* Once a bank drops below the requirements to be “adequately capitalized,” regulators are obligated to follow increasingly stringent enforcement measures as capital declines and, within 90 days after an institution becomes “critically undercapitalized” (having a leverage ratio of less than 2%), the primary regulator must close the institution or explain to Congress the reasons why the institution was not closed. *Id.*

61. I call this the “Scarlett O’Hara Approach to Problem Solving.” 1. Denial: “Fiddle-dee-dee. War, war, war; this war talk’s spoiling all the fun at every party this spring. I get so bored I could scream. Besides . . . there isn’t going to be any war.” and 2. Postponing the inevitable confrontation with a difficult situation: “I’ll think of some way After all . . . tomorrow is another day.” GONE WITH THE WIND (Selznick International Pictures 1939).

62. Economist Edward Kane coined this term during the savings-and-loan crisis of the 1980s to describe an economically insolvent bank that does not file formal bankruptcy because its regulators and central bank keep it open. *See* Bill Bergman, *How the Federal Reserve Contributes to Crises*, MORNINGSTAR ADVISOR, June/July 2009, at 40, 41–42. Kane explains that the term “zombie” emphasizes “the dangers of keeping an institution that was deeply insolvent alive, or at least walking. The notion of the zombie is that it would be put in its grave by its creditors if it weren’t for the black magic of government credit support guarantees and loans.” *Id.* at 42.

63. *See generally* EDWARD J. KANE, *THE S&L INSURANCE MESS: HOW DID IT HAPPEN?* (1989); Lawrence H. White, *Why is the U.S. Banking Industry in Trouble? Business Cycles, Loan Losses, and Deposits*, in *THE CRISIS IN AMERICAN BANKING* (Lawrence H. White ed., 1993).

Second, risk-based insurance premiums⁶⁴ were aimed at a more equitable assessment method of funding federal deposit insurance. Institutions that posed the greatest risk of loss to the insurance fund were to pay the highest premiums. Risk-based insurance premiums (and the other two key FDICIA provisions discussed here) attempted to correct perverse incentives.⁶⁵ One of those perverse incentives, classic moral hazard, results when the costs of engaging in risky activities can be shifted to others—be it the FDIC, taxpayers, or other banks that pay insurance premiums—while the benefits accruing from risky activities are retained.⁶⁶ Higher insurance premiums result in internalization of the costs of risky activities, at least to some degree.⁶⁷

Third, the “least cost resolution” test⁶⁸ was supposed to put an end to “too big to fail”; however, it came with a big exception. In the present crisis, the exception for systemic risk has completely displaced the least cost test. Under the systemic risk exception, the FDIC does not have to choose the least costly resolution for a failing institution:

if, upon written recommendation of the [FDIC] Board of Directors (upon a vote of not less than two-thirds of the members of the [FDIC] Board of Directors) and the Board of Governors of the Federal Reserve System (upon a vote of not

64. 12 U.S.C. § 1817(b)(1) (2006).

65. See Carnell, *supra* note 59, at 317–24 (discussing perverse incentives for owners and managers of financial institutions and for regulators). For regulators, “[t]he benefits of forbearance (and the costs of stringency) are short-term and easily identifiable. The costs of forbearance (and the benefits of stringency) are long-term and less obvious.” *Id.* at 322. During the crisis of the 1980s, regulators and bankers alike succumbed to two perverse incentives which, in my experience as a former regulator, can be characterized as “not on my watch” and “betting the bank.” The first is an effort to defer negative consequences—actual cost and reputational damage. The second occurs when the bank is insolvent or nearly so. Both bank management and regulators, with little left to lose at this point, gamble that the institution, through high risk investments or activities, can earn its way back to health. This approach almost always increases the amount of loss. The correct response to both temptations is: when you are in a hole, stop digging.

66. Carnell, *supra* note 59, at 319.

67. See *generally id.* at 358–62 (discussing risk-based premiums).

68. 12 U.S.C. § 1823(c)(4), *amended by* Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, § 204(d), 123 Stat. 1632, 1650–51.

less than two-thirds of the members of such Board), the Secretary of the Treasury (in consultation with the President) determines that (I) [compliance with the least cost test] would have serious adverse effects on economic conditions or financial stability; and (II) any action or assistance under this [provision] would avoid or mitigate such adverse effects.⁶⁹

More safeguards built into the systemic risk exception to the least cost resolution test include requirements: (1) that the Secretary of the Treasury document the decision⁷⁰ and provide written notice to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Banking, Finance and Urban Affairs (now the House Committee on Financial Services);⁷¹ (2) that the GAO review the decision and prepare a report to Congress;⁷² and (3) that the FDIC recoup any losses to the insurance fund caused by exercise of the systemic risk exception through a special assessment on all insured depository institutions.⁷³ Obviously, Congress intended the systemic risk exception to be invoked rarely and only after thorough analysis and coordinated approval at the highest levels of multiple bank regulatory agencies—with virtually guaranteed second-guessing by Congress.

In 1993, shortly after passage of the FDICIA, informed commentators noted that “[p]roperly implemented, the reforms should align the incentives of institutions’ owners, managers, and regulators more closely with the interests of the deposit insurance funds. But vigorous, good-faith implementation is crucial.”⁷⁴ Another observer concluded that “[a]lthough FDICIA does not ban the too-big-to-fail doc-

69. *Id.* § 1823(c)(4)(G)(i).

70. *Id.* § 1823(c)(4)(G)(iii).

71. *Id.* § 1823(c)(4)(G)(v).

72. *Id.* § 1823(c)(G)(4)(iv).

73. *Id.* § 1823(c)(G)(4)(ii), amended by Helping Families Save Their Homes Act § 204(d).

74. Carnell, *supra* note 59, at 317; see also Lissa Lamkin Broome, *Redistributing Bank Insolvency Risks: Challenges to Limited Liability in the Bank Holding Company Structure*, 26 U.C. DAVIS L. REV. 935 (1993) (presenting another study of methods to reduce moral hazard and increase market discipline written shortly after passage of FIRREA).

trine, it has substantially reduced the likelihood of future large bank bailouts.”⁷⁵ These expectations obviously have not been met.

Given FDICIA’s limitations on “too big to fail,” serious attention must now be directed to determining how federal financial regulatory agencies could override the least cost test to arrange government bailouts for such a large number of financial institutions in 2008–2009.⁷⁶ Several factors were likely at work, including: (1) failure to recognize systemic risk in the economy in time to prevent problems that demanded least-cost-test override;⁷⁷ (2) failure to address economic incentives for financial institution growth and interconnectedness, which intensified over the fifteen years between passage of the FDICIA and the current crisis;⁷⁸ (3) counter-cyclical regulation issues making it more difficult for regulators to put the brakes on risky activities in a time of general economic prosperity;⁷⁹ (4) failure to

75. Larry D. Wall, *Too-Big-To-Fail After FDICIA*, ECON. REV. (Fed. Reserve Bank of Atlanta, Atlanta, Ga.), Jan./Feb. 1993, at 1, 1.

76. See *supra* notes 7–13 and accompanying text.

77. See Stern, *supra* note 53 (quoting GARY H. STERN & RON J. FELDMAN, TOO BIG TO FAIL: THE HAZARDS OF BANK BAILOUTS 112, 114 (2004)).

Policymakers could reduce the uncertainty that they face when a large bank fails by knowing the potential exposures other banks have to the failing institution in advance and practicing their response to such failures. . . . [Supervisors should examine] how the failure of one institution would affect the solvency of [other large banks]. . . . [T]he government would focus on spillovers and cross-institution exposure. . . . Supervisors should develop detailed plans for addressing the failure of a large bank, test those procedures in simulations, and revise the procedures to account for test results. Supervisors should repeat the cycle regularly, given the rapidly changing operations of the largest banks.

Id. (alterations in original); see also Viral V. Acharya et al., *Regulating Systemic Risk*, in RESTORING FINANCIAL STABILITY, *supra* note 23, at 283, 283–303.

78. See generally Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215.

79. See 1 DIV. OF RESEARCH & STATISTICS, *supra* note 3, at 246 (“To impose prudential restraints is meddlesome and it restricts profits. If the banking system is expanding rapidly, if they can show they’re making good money by the new business, for us to try to be too tough with them, to hold them back, is just not going to be acceptable.” (quoting Fed. Reserve Governor Charles Partee)).

develop a "financial disaster recovery plan" in advance,⁸⁰ and (5) political pressure and effective lobbying on behalf of large financial institutions.⁸¹

In 2002, the Western Economic Association convened a conference on "Prompt Corrective Action In Banking: 10 Years Later"⁸² to examine issues of market discipline under the PCA regime. Now, as then, the threshold question is to determine the primary goal of financial institution supervision. From the establishment of federal deposit insurance in 1933 until the banking crisis of the 1980s, regulators understood that the principal objective of banking supervision was to prevent bank failures.⁸³ This was a reasonable Congressional mandate following the devastating impact of bank failures during the early years of the Great Depression. During the banking and saving-and-loan crisis of the 1980s, it became apparent that too much focus on the goal of avoiding bank failures resulted in regulatory forbearance,⁸⁴ or delay in closing insolvent financial institutions, which substantially increased losses to the deposit insurance fund and to taxpayers. A goal of preventing bank failures is likely to conflict with a goal of minimizing cost to the insurance fund.⁸⁵

With passage of the FDICIA in 1991, Congress gave bank regulators the unambiguous goal "to resolve the problems of insured de-

80. The need for a specialized means of resolving large financial institutions was apparent in the 1984 bailout of Continental Illinois. *See id.* at 249 ("In addition to systemic risk, the logistical difficulties and potential expense of liquidating a large bank also contributed to regulatory reluctance to close such a bank . . .").

81. *See generally* Anne Flaherty & Jim Kuhnenn, *House Panel to Begin Push on Financial Overhaul*, SEATTLE TIMES, Oct. 14, 2009, http://seattletimes.nwsourc.com/html/politics/2010058761_apusfinancialoverhaul.html (noting that the broad sector of banks, insurance companies, and real estate entities spent close to \$223 million on lobbying in 2009).

82. PROMPT CORRECTIVE ACTION, *supra* note 57, at x.

83. Robert A. Eisenbeis & Larry D. Wall, *The Major Supervisory Initiatives Post-FDICIA: Are They Based on the Goals of PCA? Should They Be?*, in PROMPT CORRECTIVE ACTION, *supra* note 57, at 110.

84. 1 DIV. OF RESEARCH & STATISTICS, *supra* note 3, at 46–51 (discussing the use of forbearance).

85. *See* Eisenbeis & Wall, *supra* note 83, at 109, 111 ("The goals of preventing failure and minimizing deposit insurance losses make fundamentally different demands on bank supervisors and have different implications for loss sharing and incentives to management.")

pository institutions at the least possible long-term cost to the Deposit Insurance Fund⁸⁶—the least cost test discussed above.

PCA, another key component of FDICIA, limits regulator discretion by listing specific enforcement measures to be imposed as a financial institution's capital drops from "adequately capitalized"⁸⁷ to "undercapitalized"⁸⁸ to "significantly undercapitalized"⁸⁹ to "critically undercapitalized."⁹⁰ Within ninety days after a bank's capital level drops to 2 percent of its total assets (critically undercapitalized),⁹¹ regulators are required to appoint a conservator or receiver or to explain the reason for deferring the closing for no more than an additional ninety days.⁹²

Despite these black-and-white statutory standards for taking enforcement actions and for closing troubled financial institutions, we see in the current crisis regulatory failure to recognize problems at the early stages when corrective enforcement measures contemplated by FDICIA might save an institution.⁹³ Both financial institutions and regulators succumbed to a "bubble mentality" in acting as though interest rates would always remain low and residential home prices would always increase.⁹⁴ Then, when the residential real estate bubble burst, bank regulators could not, or would not, follow FDICIA's clear directives to close near-insolvent institutions before they could become a severe drain on the Treasury and on the federal deposit insurance fund.⁹⁵

86. 12 U.S.C. § 1831o(a)(1) (2006).

87. *See* 12 C.F.R. § 325.103 (2009) (defining capital categories of adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized as measured by total risk-based capital ratio, Tier 1 risk-based capital ratio, and leverage ratio).

88. *See* 12 U.S.C. § 1831o(e) (specifying required regulatory actions).

89. *See id.* § 1831o(f) (specifying required regulatory actions).

90. *See id.* § 1831o(h) (specifying required regulatory actions).

91. 12 C.F.R. § 325.103(b)(5).

92. 12 U.S.C. § 1831o(h)(3).

93. *See, e.g., supra* notes 7–13 and accompanying text.

94. *See* J. Bradford DeLong, Houses in the Air, (Aug. 24, 2005), <http://www.project-syndicate.org/commentary/delong39/English>.

95. *See supra* note 7–13 and accompanying text (listing assisted transactions); Gary H. Stern, President, Fed. Reserve Bank of Minneapolis, *Better Late Than Never: Addressing Too-Big-To-Fail*, Address at Brookings Institution (Mar. 31, 2009), available at http://www.minneapolisfed.org/news_events/pres/Stern03-31-

III. RECOGNIZING BUBBLES

If we learn anything from the current crisis, it should be recognition of a phenomenon that has, in a dependably recurrent pattern, seduced and deluded both the wise and the foolish: bubbles happen.⁹⁶

The following five stages⁹⁷ accurately describe the real estate bubble which, in part, triggered the financial melt-down:

1. Displacement refers to a change in economic circumstances which creates new, profitable opportunities, such as the very low interest rates and rising home prices.
2. Euphoria or overtrading occurs when news about profits from rising home prices, especially when purchased with high leverage, draws more buyers to the market and creates a feedback loop driving prices up even more.
3. Mania or bubble is the high point when the prospect of easy gains—in this case through low-doc, no-doc, “liar loans” funding the purchase of a home whose value “will only go up”—attracts first-time investors and “swindlers eager to mulct them of their money.”⁹⁸
4. Distress is the beginning of the end, as knowledgeable investors perceive that “expected profits cannot possibly justify

09.pdf (outlining ways to correct these regulatory failures to use PCA before it is too late). The Minneapolis Federal Reserve Bank proposes to address this problem in three ways: early identification, enhanced PCA, and communication of a bank’s deteriorating capital to creditors. *Id.*

96. See EDWARD CHANCELLOR, *DEVIL TAKE THE HINDMOST: A HISTORY OF FINANCIAL SPECULATION* 21 (1999) (explaining that the bubble metaphor was first applied to speculative excesses at the time of the South Sea Bubble in 1720). Before the South Sea Bubble, there was the Tulip Bubble. *Id.* Like the tulip, a bubble’s “ephemeral beauty [can be] seen as a seductive illusion to the unwary. . . . A bubble grew rapidly, delighting beholders with its reflective brilliance, but disappeared instantaneously. It was sustained only by air or wind . . .” *Id.*

97. NIALL FERGUSON, *THE ASCENT OF MONEY: A FINANCIAL HISTORY OF THE WORLD* 121–22 (2008) (listing the five stages of an asset bubble—ties to the real estate bubble are the author’s addition).

98. *Id.* at 122.

the now-exorbitant price,”⁹⁹ especially when there are shocks such as higher interest rates, re-pricing of adjustable rate loans, higher loan defaults, and the first failures of subprime lenders. More sophisticated investors begin to take profits by selling. Others continue to succumb to the “greater fool theory.”¹⁰⁰

5. Revulsion or discredit is the bursting of the bubble. As prices fall, everyone “stampedes for the exits.”¹⁰¹

In addition to these five stages of a bubble, there are three other common features: asymmetric information, cross-border capital flows, and easy credit¹⁰²—all present in the real estate bubble.

“Irrational exuberance”¹⁰³ describes the psychological basis of a speculative bubble, defined as:

[A] situation in which news of price increases spurs investor enthusiasm, which spreads by psychological contagion from person to person, in the process amplifying stories that might justify the price increases and bringing in a larger and larger class of investors, who, despite doubts about the real value of an investment, are drawn to it partly through envy of others’ successes and partly through a gambler’s excitement.¹⁰⁴

99. *Id.*

100. The “greater fool theory” describes investment actions apparently predicated on the idea that however overpriced an asset may be, the purchaser can turn a quick profit by selling it to an even greater fool. See BETHANY MCLEAN & PETER ELKIND, *THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON* 74 (2003).

101. FERGUSON, *supra* note 97, at 122.

102. *Id.*

103. A popular phrase first used by then Chairman of the Fed. Reserve Alan Greenspan in discussing the 1980s Japanese bubble economy and subsequent collapse. Alan Greenspan, Chairman, Bd. of Governors of the Fed. Reserve Sys., *The Challenge of Central Banking in a Democratic Society*, Remarks at the Annual Dinner and Francis Boyer Lecture of the American Enterprise Institute for Public Policy Research (Dec. 5, 1996), available at <http://www.federalreserve.gov/boarddocs/speeches/1996/19961205.htm>.

104. ROBERT J. SHILLER, *IRRATIONAL EXUBERANCE* 2 (2d ed. 2005).

George Soros has graphed the “boom-bust” model¹⁰⁵ through eight stages essentially tracking the five stages above. His graph illustrates a trend that starts slowly, accelerates gradually, and falls sharply.¹⁰⁶ He also emphasizes the feedback loop in which market participants begin to believe the hype, accelerating the rise in prices.¹⁰⁷ This feedback loop is not new, even in the real estate arena. In the 1980s, real estate moguls “flipped” properties, quickly inflating the apparent value of properties with several sales during the course of a day, each with a higher sales price backed by a new higher appraisal—until the savings and loans associations that funded loans collateralized by falsely-valued real estate crashed in failure.¹⁰⁸

The recorded history of economic bubbles¹⁰⁹ extends from Tulip Mania in the 1630s, to the South Sea Bubble in 1720, the Mississippi Bubble, the Railway Mania of 1845, the Stock Market Crash of 1929, the Bank and S&L Crisis in the 1980s, the Japanese Bubble of the 1980s, the Dot-com Bubble in the late 1990s, and now, to the present fallout of a residential real estate bubble.¹¹⁰ Economists understand bubbles quite thoroughly.¹¹¹ Given human greed we can,

105. GEORGE SOROS, *THE CRASH OF 2008 AND WHAT IT MEANS: THE NEW PARADIGM FOR FINANCIAL MARKETS* 66–70 (2009).

106. *Id.* at 67.

107. *See id.* at 67–73 (calling this phenomenon “reflexive, circular relationships”).

108. *See* David B. Newdorf, *Inside Fraud, Outside Negligence and the Savings and Loan Crisis: When Does Management Wrongdoing Excuse Professional Malpractice?*, 26 *LOY. L.A. L. REV.* 1165, 1182–83 (1993); Michelle D. Monse, *Ethical Issues in Representing Thrifts*, 40 *BUFF. L. REV.* 1, 12 n.40 (1992).

109. *See generally* CHANCELLOR, *supra* note 96 (providing a history of bubbles).

110. *Id.*; *see* Yuliya Demyanyk, *Ten Myths About Subprime Mortgages*, *FED. RES. BANK CLEVELAND ECON. COMMENT.*, July 23, 2009, <http://www.clevelandfed.org/research/commentary/2009/0509.cfm>. “[N]either the origin of this crisis or the way it has played out was unique at all. . . . Argentina in 1980, Chile in 1982, Sweden, Norway, and Finland in 1992, Mexico in 1994, and Thailand, Indonesia, and Korea in 1997 all experienced a pattern similar to the U.S. subprime boom-and-bust cycle.” *Id.*

111. *See, e.g.*, Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 *MINN. L. REV.* 373 (2008), *reprinted in* NANCY B. RAPOPORT ET AL., *ENRON AND OTHER CORPORATE FIASCOS: THE CORPORATE SCANDAL READER* 1129, 1136–37 (2d ed. 2009) (providing hypotheses for the residential real estate bubble, while noting that “[o]ccasional bubbles may well be an inevitable side effect of a market economy”).

with certainty, anticipate future bubbles. The real challenge is to establish in advance some regulatory mechanism to recognize future bubbles as they develop and to minimize the widespread economic pain when they ultimately crash. This responsibility fits with duties of a systemic risk regulator.

The Federal Reserve has been proposed as the new systemic risk regulator.¹¹² Bubbles do contribute to inflation and influence monetary policy, which suggests that the Federal Reserve has the expertise to identify an emerging asset bubble. Unfortunately, recent history shows that former Federal Reserve Chairman Alan Greenspan presided over the low interest rates, easy credit, and failure to restrict predatory lending that were substantial contributing factors in the creation of the real estate bubble.¹¹³ To counter the groupthink, euphoria, and mania which can infect regulators and market participants alike, it would be wise to separate the responsibility for setting monetary policy from the responsibility for monitoring the results, past and probable.¹¹⁴ The basic rules of auditing require both separation of duties and independent review.

The current financial crisis highlights a critical short-coming to be addressed if we are to avoid future financial crises: under-

112. Martin N. Bailey et al., *A Systemic Regulator for Financial Markets 5* (Council on Foreign Relations, Squam Lake Working Group on Financial Regulation, 2009), available at <http://www.cfr.org/publication/19256/> (arguing that central banks are best positioned to be systemic regulators); U.S. DEP'T OF THE TREASURY, *supra* note 27, 51–54 (the Obama administration's plan for financial reform).

113. See Symposium, *Did the Fed Cause the Housing Bubble?*, WALL ST. J., Mar. 27, 2009, at A13 (presenting a series of articles from differing viewpoints, including: David Henderson, *Don't Blame Greenspan*; Gerald P. O'Driscoll, Jr., *What Savings Glut?*; Todd J. Zwyicki, *Low Rates Led to ARMs*; David Malpass, *The Fed Provided the Fuel*; Judy Shelton, *Loose Money and the Derivative Bubble*; and Vincent Reinhart, *To Change Policy, Change the Law*).

114. Cf. Paul A. Volker in *Conversation with Gary H. Stern*, REGION (Fed. Reserve Bank of Minneapolis, Minneapolis, Minn.), Sept. 2009, at 19, 20, available at <http://www.minneapolisfed.org/pubs/region/09-09/conversation.pdf> (“[Y]es, you need an overall systemic overseer—not with the regulatory or supervisory authority over particular institutions, rather somebody looking over things, beyond individual institutions, for the weaknesses in the system, looking at things that are developing that are problematical, various tendencies, some other toxic assets perhaps in some other form.”).

appreciation of systemic risk. Bubbles are only one manifestation of systemic risk. Until now, our financial regulatory structure has focused on the safety and soundness of individual financial institutions and markets. 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.

As the European Union has already recognized, macro-financial factors, the inter-connectedness of markets and institutions, and financial globalization play important roles in determining the size, nature, and contagious spread of systemic risk.¹¹⁵ New risks will emerge; the key to dealing with them in the future is how well we plan for them now. The European Central Bank is specifically studying how changes in interest rate policymaking, including improved credit and money supply data, may facilitate earlier action to identify financial market distortions and lessen the impact of future bubbles.¹¹⁶ With establishment of a new European Systemic Risk Board (ESRB) responsible for macro-prudential oversight, the EU will empower an independent multi-member board to focus specifically on identifying risk to the stability of the EU financial system as a whole.¹¹⁷ The U.S. should consider this model and tailor it to our own regulatory structure.

115. Lucas Papademos, Vice President, European Cent. Bank, Financial Stability and Macro-Prudential Supervision: Objectives, Instruments and the Role of the ECB, Address at the Center for Financial Studies Conference: The ECB and Its Watchers XI (Sept. 4, 2009), *available at* <http://www.bis.org/review/r090908c.pdf>.

116. Ralph Atkins, *ECB Plans Revamp on Interest Rates to Tackle Bubbles*, FIN. TIMES (London), Sept. 8, 2009, at 6, *available at* <http://www.ft.com/cms/s/0/dde525aa-9bc3-11de-b214-00144feabdc0.html>.

117. *See* Papademos, *supra* note 115.

Following the publication of the Report of the de Larosière Group in February 2009 and the Commission Communication in May, the Ecofin Council agreed in June 2009 that a new independent body responsible for the conduct of macro-prudential oversight in the EU should be established, namely the European Systemic Risk Board (ESRB). The creation of the ESRB was supported by the European Council on 18 and 19 June 2009. In the wake of these decisions, the Commission is preparing legal texts with concrete provisions concerning the establishment and function-

IV. RECONSIDERING CONSOLIDATION

Having identified TBTF as a policy Congress should reconsider, we must ask a critical question. How did the U.S. financial services industry come to be dominated by such a small number of large, interconnected entities?¹¹⁸ Retracing the origins of consolidation can highlight economic incentives, legislative constructs, and regulatory policies that contributed to the present state of the financial services industry and to the current state of the national and global economy in crisis. Knowing how and why aggressive consolidation occurred may indicate what economic incentives to alter, what regulatory policies to revise, what false claims to repudiate, and, finally, what legislation to propose in order to avoid a similar financial collapse in the future.

A Federal Reserve Board Staff Study examining “Bank Mergers and Banking Structure in the United States, 1980-1998,”¹¹⁹ prepared in August 2000, finds:

Since 1980, the U.S. banking industry has experienced a sustained and unprecedented level of merger activity that has substantially affected banking structure. From 1980 through 1998, there were approximately 8,000 mergers, involving about \$2.4 trillion in acquired assets. Not only has the number of mergers been large, but from 1990 to 1999 several

ing of the ESRB, which will be transmitted to the European Parliament and the Council in late September.

Id.

118. See Timothy F. Geithner, *Changes in the Structure of the U.S. Financial System and Implications for Systemic Risk*, in SYSTEMIC FINANCIAL CRISES, *supra* note 31, at 29, for early recognition that consolidation or “[t]he greater systemic importance of a smaller number of large bank-centered financial institutions” is one of key components of changing market structure that contributes to increased systemic risk. *Id.* at 30–31. In 2005, Timothy Geithner was President and CEO of the Federal Reserve Bank of New York; he subsequently became Secretary of the Treasury in January 2009.

119. STEPHEN A. RHOADES, BD. OF GOVERNORS OF THE FED. RESERVE SYS., STAFF STUDY 174, BANK MERGERS AND BANKING STRUCTURE IN THE UNITED STATES, 1980–98 (2000), available at <http://www.federalreserve.gov/pubs/staffstudies/2000-present/ss174.pdf>.

mergers occurred that, at the time of occurrence, were the largest bank mergers in U.S. history.¹²⁰

A later Federal Reserve Board Staff Study examining "Bank Merger Activity in the United States, 1994–2003,"¹²¹ quantifies the impact of industry consolidation:

[D]uring the 1980–2003 period the number of banking organizations decreased from about 16,000 to about 8,000, and mergers of healthy institutions were by far the most important cause of that consolidation. During that period, the share of industry assets held by the ten largest commercial banking organizations (ranked by assets) rose from 22 percent to 46 percent, and the share of industry deposits held by the ten largest (ranked by deposits) rose from 19 percent to 41 percent.¹²²

As the 2000 merger study recognized, consolidation could fundamentally restructure an industry, affecting economic performance in the areas of price, product and service quality, and production efficiency.¹²³ Today, that prediction has become reality. The U.S. financial services industry has become sharply divided into global mega-banks and smaller community banks.¹²⁴ Once an industry has been restructured, the new structure will persist because of "first-mover advantages, information asymmetries, switching costs, and other market imperfections"¹²⁵—unless crisis-response legislation changes the legal landscape, as demonstrated by the banking reform legislation of the 1930s.

120. *Id.* at 1.

121. STEVEN J. PILLOFF, BD. OF GOVERNORS OF THE FED. RESERVE SYS., STAFF STUDY 176, BANK MERGER ACTIVITY IN THE UNITED STATES, 1994–2003, at 1 (2004), available at <http://www.federalreserve.gov/pubs/staffstudies/2000-present/ss176.pdf>.

122. *Id.* at 1 (analysis based on Fed. Fin. Insts. Examination Council (FFIEC) Consolidated Reports of Income and Condition data).

123. RHOADES, *supra* note 119, at 1.

124. See, e.g., Robert DeYoung & William C. Hunter, *Deregulation, the Internet, and the Competitive Viability of Large Banks and Community Banks* (FRB Chicago Working Paper No. 2001-11, 2001), available at http://ssrn.com/sol3/papers.cfm?abstract_id=290284.

125. RHOADES, *supra* note 119, at 1.

Factors that have encouraged rapid consolidation¹²⁶ include: (1) legislative changes during the 1980s that deregulated deposit restrictions;¹²⁷ (2) legislation during the 1990s that encouraged geographic expansion by easing branching limitations;¹²⁸ (3) regulator-facilitated acquisitions of troubled financial institutions as a result of the banking and S&L crisis;¹²⁹ (4) legislation breaking down the 1930s-era wall between banking, securities, and insurance;¹³⁰ and (5) international and domestic regulatory regimes for financial institution capital requirements that relied on institution-generated risk models, resulting in lower capital requirements for large institutions.¹³¹

In addition to a legal framework that favored consolidation, economic incentives added impetus to the trend. While experts differ about whether the largest financial conglomerates actually reap

126. For a comprehensive analysis of bank consolidation from 1979 to 1994, see Allen N. Berger et al., *The Transformation of the U.S. Banking Industry: What a Long, Strange Trip It's Been*, BROOKINGS PAPERS ON ECON. ACTIVITY, No. 2 1995, at 55, available at <http://faculty.chicagobooth.edu/anil.kashyap/research/transformation.pdf> (attributing aggressive consolidation to: (1) regulatory changes, including deposit deregulation and geographic expansion through relaxation of branching restrictions; and (2) technology and innovation, including information processing and loan securitization). As part of an FDIC study, *The Future of Banking in America*, FDIC economists updated industry consolidation analysis to cover the period 1984 to 2003. George Hanc, *Summary and Conclusions*, FDIC BANKING REV., Nov. 2004, at 1, available at <http://www.fdic.gov/bank/analytical/banking/2004nov/article1/br16n1art1.pdf>; see also Kenneth D. Jones & Tim Critchfield, *Consolidation in the U.S. Banking Industry: Is the "Long, Strange Trip" About to End?*, FDIC BANKING REV., Jan. 2006, at 31, 31–32, available at <http://www.fdic.gov/bank/analytical/banking/2006jan/article2/article2.pdf> (identifying continued consolidation with some indication of stabilization, a conclusion that predated the current financial crisis).

127. See Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132.

128. See Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-328, 108 Stat. 2338.

129. See generally 1 DIV. OF RESEARCH & STATISTICS, *supra* note 3 (discussing the banking crisis of the 1980s and early 1990s).

130. See Gramm-Leach-Bliley Financial Modernization Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999).

131. See generally Fed. Reserve Bd., Basel II Capital Accord, Basel I Initiatives, and Other Basel-Related Matters, <http://www.federalreserve.gov/GeneralInfo/basel2/> (last visited Jan. 20, 2010).

economies of scale, enhance diversification, and provide lower cost services to consumers or whether they increase systemic risk,¹³² it is inarguable that becoming one of the protected TBTF entities results in substantially lower cost of funds.¹³³ Smaller banks are charged a higher interest rate when they borrow funds because they lack the TBTF implicit federal government guarantee and are therefore deemed to be riskier for lenders.¹³⁴ Current research indicates that the cost-of-funds differential between smaller banks and those with over \$100 billion in assets increased from 0.29 to 0.78 percentage points from the fourth quarter of 2008 to the end of the second quarter of 2009, after it had become apparent that federal banking regulators were committed to TBTF as a standard under which institutions could expect to be bailed out.¹³⁵ When controlled for economic uncertainty, this represents an annual subsidy to the TBTF banks of \$6.3 billion.¹³⁶ Based on FDIC data, one can conclude that this subsidy is a major reason for the increased profitability of these TBTF banks, effectively representing a redistribution from taxpayers to TBTF banks.¹³⁷ By its nature, TBTF is unfair to small banks and to well-managed banks which pay the insurance premiums that fund bailouts.¹³⁸

132. Compare Geoffrey P. Miller, *Legal Restrictions on Bank Consolidation: An Economic Analysis*, 77 IOWA L. REV. 1083 (1992) (arguing that consolidation would benefit consumers and reduce risk), with Arthur E. Wilmarth, Jr., *Too Big to Fail, Too Few to Serve? The Potential Risks of Nationwide Banks*, 77 IOWA L. REV. 957 (1992) (arguing that consolidation could have adverse effects on consumers and the safety of the banking industry).

133. DEAN BAKER & TRAVIS MCARTHUR, CTR. FOR ECON. & POLICY RESEARCH, THE VALUE OF THE "TOO BIG TO FAIL" BIG BANK SUBSIDY 2 (2009), available at <http://www.cepr.net/documents/publications/too-big-to-fail-2009-09.pdf>; see also Gretchen Morgenson, *Fair Game: The Cost of Saving Those Whales*, N.Y. TIMES, Oct. 3, 2009, at BU1.

134. BAKER & MCARTHUR, *supra* note 133, at 2.

135. *Id.*

136. *Id.*

137. *Id.* at 4.

138. See Stephen Labaton, *Banks to Rescue Depleted F.D.I.C.*, N.Y. TIMES, Sept. 30, 2009, at A1 (reporting that the deposit insurance fund would be "in the red" by the end of the week and discussing the FDIC's requirement that banks prepay \$45 billion in insurance premiums to replenish the fund).

Economists understand that the very existence of federal deposit insurance undermines market discipline¹³⁹ and distorts the financial services market.¹⁴⁰ Although the appropriate dollar amount of deposit insurance coverage (temporarily increased from \$100,000 to \$250,000 per deposit account to preserve depositor and general market confidence in the banking system during the current crisis)¹⁴¹ and the undesirable consequences of having any level of federal deposit insurance can be debated,¹⁴² it seems clear on balance that the U.S. deposit insurance system was a key factor in restoring confidence and stability in our banking system after the wave of banking failures in the 1930s.¹⁴³ Deposit insurance played an important role in maintaining a long period of few bank failures from the 1930s to the 1980s.¹⁴⁴ The significance of this discussion regarding deposit in-

139. *But see* Jean Pierre Sabourin, *The Deposit Insurer's Role in Maintaining Financial Stability*, in SYSTEMIC FINANCIAL CRISES, *supra* note 31, at 59, 61–62 (noting that a deposit insurer can play an important role in mitigating systemic risk by taking action *ex ante* to assure that large banks are “too-good-to-fail”). Sabourin writes from the perspective of President and CEO of the Canada Deposit Insurance Corporation. Because the global aspects of the financial crisis and subsequent corrective measures must be taken into account in proposing effective solutions, his breakdown of deposit insurers around the world into three distinct categories—“payboxes,” “least cost systems,” and “risk-minimizers”—is an intriguing approach. *Id.* at 60.

140. *See* VASSO P. IOANNIDOU & JAN DE DREU, THE IMPACT OF EXPLICIT DEPOSIT INSURANCE ON MARKET DISCIPLINE (Tilburg Univ., No. 2006-5, 2006), *available at* <http://arno.uvt.nl/show.cgi?fid=53872>; VASSO P. IOANNIDOU & MARÍA FABIANA PENAS, *Deposit Insurance and Bank Risk-Taking: Evidence from Internal Loan Ratings*, (FDIC Ctr. for Fin. Research, Working Paper No. 2008-07, 2008), *available at* http://www.fdic.gov/bank/analytical/cfr/2008/wp2008/CFR_WP_2008_07_vasso.pdf.

141. Fed. Deposit Ins. Corp., Financial Institution Letter 22-2009, Extension of Temporary Increase in Standard Maximum Deposit Insurance Amount (May 22, 2009), *available at* <http://www.fdic.gov/news/news/financial/2009/fil09022.pdf>.

142. *See* IOANNIDOU & DE DREU, *supra* note 140.

143. *See generally* MILTON FRIEDMAN & ANNA JACOBSON SCHWARTZ, A MONETARY HISTORY OF THE UNITED STATES, 1867–1960, at 434–42 (1963).

144. *See generally* FED. DEPOSIT INS. CORP., THE FIRST FIFTY YEARS: A HISTORY OF THE FDIC 1933–1983 (1984), *available at* <http://www.fdic.gov/bank/analytical/firstfifty/>.

surance is the possibility that increased concentration of deposits in the hands of a few megabanks has created an "uninsurable risk."¹⁴⁵

The U.S. deposit insurance system was not designed for the highly concentrated banking industry we have today.¹⁴⁶ One of the basic principles of insurance requires that "individual loss exposures be independent and spread over a large number of homogeneous units so that no single loss is catastrophic to the insurer."¹⁴⁷ Thus, the current insolvency of the federal deposit insurance fund, with high assessments draining the profits of well-managed, solvent institutions,¹⁴⁸ was entirely foreseeable. Furthermore, unless Congress addresses TBTF, this "uninsurable risk" problem will continue to threaten the federal deposit insurance system in the future, even after the bailouts in progress have been paid for out of public coffers.

TBTF bailouts not only protect the "wrong" economic actors, they also create moral hazard incentives to engage in risky behavior based on the expectation of future TBTF bailouts.¹⁴⁹ Banks may actively pursue internal growth and mergers because they are motivated to become too big to fail.¹⁵⁰ In fact, the biggest banks, which have been the biggest beneficiaries of TBTF to date, fully expect to be selected for more government-assisted mergers, resulting in still greater industry consolidation.¹⁵¹

145. Kenneth D. Jones & Chau Nguyen, *Increased Concentration in Banking: Megabanks and Their Implications for Deposit Insurance*, 14 FIN. MARKETS, INSTITUTIONS & INSTRUMENTS 1, 2 (2005).

146. *Id.*

147. *Id.*

148. See Labaton, *supra* note 138 (noting that the special assessments to replenish the deposit insurance fund will eliminate the industry's earnings for 2009).

149. Cheryl D. Block, *Overt and Covert Bailouts: Developing a Public Bailout Policy*, 67 IND. L.J. 951, 957–58 (1992).

150. Elizabeth F. Brown, *E Pluribus Unum—Out of Many, One: Why the United States Needs a Single Financial Services Agency*, 14 U. MIAMI BUS. L. REV. 1, 44 (2005); see also Viral V. Acharya et al., *A Bird's Eye View—The Financial Crisis of 2007–2009: Causes and Remedies*, in RESTORING FINANCIAL STABILITY, *supra* note 23, at 1, 7 (noting that the TBTF designation is "incredibly costly because it induces, somewhat paradoxically, a moral hazard in the form of a race to become systemic").

151. *Jamie Dimon: More Bank Consolidation*, CNN MONEY, May 4, 2009, http://money.cnn.com/2009/05/04/news/companies/Jamie_Dimon.reut/index.htm

Reasons for focused congressional attention to the problem posed by megabanks that have swelled through consolidation include: (1) a disproportionate amount of losses accruing as a result of the global economic crisis occurred on the balance sheets of a relative handful of large banking conglomerates;¹⁵² (2) TBTF institutions have received the lion's share of federal government bailout assistance;¹⁵³ (3) large financial institutions can be viewed as "the primary private-sector catalysts for the destructive credit boom that led to the subprime financial crisis";¹⁵⁴ and (4) far from being punished for their role in the crisis, the largest banks have become larger still through government bailout money and government-facilitated acquisitions.¹⁵⁵ President of the Federal Reserve Bank of Dallas Richard Fisher put it this way: "In using acquisitions to resolve the crisis, we may have unwittingly perpetuated one of its root causes—the too-big-to-fail doctrine."¹⁵⁶

(quoting Dimon, JP Morgan Chase CEO, "[t]here are still too many banks in the United States").

152. Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 CONN. L. REV. 963, 968, 1044–1045 (2009) ("Seventeen large universal banks accounted for more than half of the \$1.1 trillion of losses reported by the world's banks and insurance companies.").

153. See David Cho, *Banks "Too Big to Fail" Have Grown Even Bigger*, WASH. POST, Aug. 28, 2009, at A01.

154. Wilmarth, *supra* note 152, at 1046.

155. See Cho, *supra* note 153.

156. Richard W. Fisher, President, Fed. Reserve Bank of Dallas, *Two Areas of Present Concern: The Economic Outlook and the Pathology of Too-Big-to-Fail* (with Reference to Errol Flynn, Johnny Mercer, Gary Stern and Voltaire), Remarks before the Senior Delegates' Roundtable of the Fixed Income Forum (July 23, 2009), available at <http://dallasfed.org/news/speeches/fisher/2009/fs090723.cfm>. The four largest commercial banking organizations—Bank of America, JP Morgan Chase, Wells Fargo, and Citigroup—received substantial government assistance during the crisis—"all, at least implicitly, in the name of the too-big-to-fail doctrine"—and "[a]s a group, the total asset base of the four has grown 30 percent since June 2007." *Id.* A significant part of that growth results from acquisitions. *Id.*

Bank of America's assets grew 51 percent from June 2007 to March 2009, assisted in no small part by its acquisitions of Countrywide Financial and Merrill. Wells Fargo's asset base grew 138 percent, thanks

After admitting that the financial markets and the national economy have been ill-served by the size and interrelatedness of financial institutions, bank regulators and politicians will face difficult strategy questions. More research is needed to design feasible means of curbing the size and connectedness of financial institutions. To be effective, the management of size and systemic impact will require committed attention and real corrective measures. Superficial acknowledgment that TBTF is a problem will prove as insufficient as the belated acknowledgement that predatory lending was a problem.

Federal Reserve statements now recognize the need for more effective regulation of large institutions.¹⁵⁷ While higher capital, improved risk-management practices, more robust liquidity management, better compensation structures, and fair dealings with consumers¹⁵⁸ are laudable, these improvements do nothing to address TBTF. Strengthened examination and enforcement, even at the system-wide level, and "macroprudential" oversight,¹⁵⁹ again do nothing to fix TBTF. Cutting back the size and interrelatedness of existing con-

mainly to its acquisition of Wachovia. J.P. Morgan Chase acquired both Bear Stearns and Washington Mutual and grew 43 percent.

Id.

157. See Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., *Financial Regulation and Supervision After the Crisis: The Role of the Federal Reserve*, Address at the Federal Reserve Bank of Boston 54th Economic Conference (Oct. 23, 2009), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20091023a.htm>.

[T]he Federal Reserve is participating in a range of joint efforts to ensure that large, systemically critical financial institutions hold more and higher-quality capital, improve their risk-management practices, have more robust liquidity management, employ compensation structures that provide appropriate performance and risk-taking incentives, and deal fairly with consumers. On the supervisory front, we are taking steps to strengthen oversight and enforcement, particularly at the firmwide level, and we are augmenting our traditional microprudential, or firm-specific, methods of oversight with a more macroprudential, or systemwide, approach that should help us better anticipate and mitigate broader threats to financial stability.

Id.

158. *Id.*

159. *Id.*

glomerates will not be easy¹⁶⁰—practically or politically—although it has been done, and done in response to financial crises. Breaking up financial oligopolies cannot have been an easy task for Theodore Roosevelt at the turn of the twentieth century,¹⁶¹ or for Franklin Delano Roosevelt in the 1930s.¹⁶² “Almost all significant laws and regulations are done in this country in times of crisis.”¹⁶³

160. See, e.g., Gary H. Stern & Ron Feldman, *Addressing TBTF by Shrinking Financial Institutions: An Initial Assessment*, REGION (Fed. Reserve Bank of Minneapolis, Minneapolis, Minn.), June 2009, at 8, 10–11, available at http://www.minneapolisfed.org/publications_papers/studies/tbtf/addressing_tbtf_by_shrinking_revised05-20-09.pdf.

161. See generally LEWIS L. GOULD, *THE PRESIDENCY OF THEODORE ROOSEVELT*, 24, 27–32, 49–53, 64, 142–143, 212–218, 223, 279–281 (1991); EDMUND MORRIS, *THEODORE REX* 88–94, 194–196, 206–209, 426–448 (2001).

162. See generally Glass-Steagall Act, ch. 89, 48 Stat. 162 (1933); L. Randall Wray, *Lessons from the Subprime Meltdown*, CHALLENGE, Mar.–Apr. 2008, at 40, reprinted in RAPOPORT ET AL., *supra* note 111, at 1157, 1193 (adopting the argument proposed by Robert Shiller that “the housing downturn of 1925–33, during which housing prices fell by 30%, provided an opportunity for a revolutionary policy response that restructured the housing sector in a manner that made it robust for two generations”); Editorial, *Keep Consumers Safe by Bringing Back Glass-Steagall Act*, SEATTLE TIMES, Nov. 2, 2009, at A11, available at http://seattletimes.nwsourc.com/html/editorials/2010171846_edit02wamu3.html.

Nearly a century ago, the government broke up Standard Oil into the companies that became Exxon, Mobil, Sohio and Chevron. It worked fine. It didn't retard the American economy at all. Former Fed Chairman Paul Volcker has proposed doing the same to J.P. Morgan Chase and Bank of America. It should be done.

There is an obvious way to begin. Bring back the Glass-Steagall Act. That was the original law passed in the Roosevelt administration that created deposit insurance. To limit the risk to the Treasury, it forbade a bank holding company from owning other financial companies. [The Gramm-Leach-Bliley Act of 1999 repealed the Glass-Steagall wall between banking and commerce].

Id.

163. Carrie Johnson, *Businesses Prepare to Mount a Concerted Attack on Regulation*, WASH. POST, Mar. 12, 2007, at A02 (quoting David Chavern, U.S. Chamber of Commerce executive, in expressing industry concern that now is the time to “pick up [their] game” to avoid more stringent regulation in response to the current crisis).

V. REVISING EXPECTATIONS AND ADDRESSING MORAL HAZARD

The first step in ending TBTF should be a clear, emphatic, and unequivocal statement from Congress, the FDIC, the Treasury Secretary, the Federal Reserve, and the President that there will be no more rescue of financial institutions or other related entities based on TBTF. Although this may be viewed as "closing the barn door after the horses are out," the economy actually stands at an appropriate time for a firm forward-looking policy pronouncement. As Federal Reserve Chairman Ben Bernanke has publicly stated: "With the financial turmoil abating, now is the time for policymakers to take action to reduce the probability and severity of any future crises."¹⁶⁴

The imperative now is to counter expectations that the very largest financial institutions are insulated from the consequences of their own mistakes and mismanagement. "The role of expectations can hardly be overstated in the theory of moral hazard."¹⁶⁵ Government intervention may be justified in true emergency situations; however, it is the expectation of continued government bailouts that creates the most serious cases of moral hazard and distorted resource allocation.

Once a public pronouncement has been made that TBTF will no longer be the controlling factor in government policy towards financial crisis, viable plans, market structures, and economic incentives must be in place, not only to prevent a relapse of this insidious doctrine, but also to engender belief going forward that bad management decisions¹⁶⁶ resulting in insolvency will be punished in the marketplace, not rewarded by government.¹⁶⁷ In September 2000, former

164. Bernanke, *supra* note 157.

165. Jörg Guido Hülsmann, *The Political Economy of Moral Hazard*, 2006 *POLITICKÁ EKONOMIE* 35, 39 (Czech Rep.), available at <http://www.vse.cz/polek/abstrakt.php3?IDcl=544> (providing a concise discussion of moral hazard).

166. See James Surowiecki, *Too Dumb to Fail*, *NEW YORKER*, Mar. 31, 2008, at 46, available at http://www.newyorker.com/talk/financial/2008/03/31/080331ta_talk_surowiecki (discussing the Bear Stearns rescue: "You might, then, see the Fed's willingness to help investment banks as evidence of their indispensability. But what it really underscores is how badly Wall Street has managed its business in recent years.").

167. See Paul A. Samuelson, *The Financial Gods That Failed*, *N.Y. TIMES*, Aug. 21, 2007, <http://www.nytimes.com/2007/08/21/opinion/21iht-edsamuelson.1>.

President and CEO of the Federal Reserve Bank of Minneapolis Gary Stern analyzed the problem of “credibility” in convincing market participants who have witnessed TBTF bailouts that TBTF will not be employed in the future.¹⁶⁸ He identifies four strategies that merit consideration.

First, Congress could pass legislation prohibiting bailouts, an option that “essentially requires regulators to ignore incentives to bail out creditors,” and is likely to be unsuccessful because policymakers have persuasive reasons to evade such a prohibition.¹⁶⁹ Since flatly prohibiting TBTF bailouts is not a good answer, this article recommends reducing the “too big” institutions themselves.

Second, Congress could establish procedures that penalize regulators for providing bailouts.¹⁷⁰ Congress, through FDICIA, has already attempted to raise the cost to regulators of employing the systemic risk exception to the “least cost resolution” mandate by requiring public votes and Congressional accountability.¹⁷¹ In the throes of financial crisis, however, such costs are ineffective deterrents when weighed against incentives for the regulators to employ TBTF.¹⁷²

Third, measures such as requiring additional capital for large financial institutions,¹⁷³ or employing subordinated debt¹⁷⁴ as a means

7195844.html (“The late Milton Friedman must be rotating in his grave. He had counseled firmly: Never, never bail out foolish people who have made grave, self-harming mistakes.”).

168. Gary H. Stern, *Thoughts on Designing Credible Policies After Financial Modernization: Addressing Too Big to Fail and Moral Hazard*, REGION (Fed. Reserve Bank of Minneapolis, Minneapolis, Minn.), Sept. 2000, available at http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=3503.

169. *Id.*

170. *Id.*

171. See discussion *supra* Part II.

172. See generally Thorsten Beck, *Deposit Insurance, Bank Resolution, and Lender of Last Resort—Putting the Pieces Together*, in INTERNATIONAL FINANCIAL INSTABILITY: GLOBAL BANKING AND NATIONAL REGULATION 299, 303–04 (Douglas D. Evanoff et al. eds., World Scientific Studies in Int’l Econ., Vol. 2, 2007) (describing the motivation for regulators to postpone bank interventions as “not on my watch,” a phrase that can also describe incentives to employ a TBTF bailout when the pressured atmosphere of the moment suggests that triggering a systemic meltdown could be the alternative).

173. See, e.g., U.S. DEP’T OF THE TREASURY, *supra* note 27, at 24.

of instilling market discipline and providing market signals regarding the financial solvency and stability of large financial institutions, have been proposed and analyzed. These recommendations can be valuable tools in a reform package, but they do not cut to the heart of the TBTF problem. The current crisis spotlights the failure of a regulatory model that “promotes deregulation, reduced supervision and oversight, privatization, and consolidation of market power.”¹⁷⁵ Requiring increased capital and subordinated debt does not fundamentally change that model. When they are adhered to, increased capital requirements may enhance the financial stability of large financial institutions; however, such a regulatory mandate cannot create capital for a troubled institution, nor can it necessarily prevent failures. Recognizing that failures can and will occur, Congress should act to reduce the size and interconnectedness of financial institutions.¹⁷⁶ Only if we change the structures which created the current crisis can we change the outcome.¹⁷⁷

Fourth, the President and Congress could focus on policymakers themselves, appointing regulators who have the philosophical inclination and the backbone to resist bailouts.¹⁷⁸ A maxim of corporate culture change literature makes it clear that “[t]he best system or

174. See, e.g., Robert R. Bliss, *Market Discipline and Subordinated Debt: A Review of Some Salient Issues*, ECON. PERSP. (Fed. Reserve Bank of Chi., Chi. Ill.), First Quarter 2001, at 24; Douglas D. Evanoff & Larry D. Wall, *Subordinated Debt and Prompt Corrective Regulatory Action* (Fed. Reserve Bank of Chi., WP 2003-03, 2003).

175. Wray, *supra* note 162, at 1196.

176. *But see Too Big to Fail Hearing*, *supra* note 51 (statement of Gary H. Stern, President & CEO, Fed. Reserve Bank of Minneapolis).

177. See Schwarcz, *supra* note 111, at 1129–30 (describing a similar problem with initial steps to address the financial crisis that focused exclusively on interest rate adjustments by central banks). “In medical terms, it was as if a doctor were attempting to cure a patient by focusing on curing symptoms, not the underlying disease.” *Id.* at 1130. In this article’s analysis, inadequate capital is a symptom. Financial conglomerates that have been allowed to grow so large and so interconnected that they continue to threaten the global economy are the disease.

178. STERN & FELDMAN, *supra* note 77, at 4 (“Appointment of leaders who are loath to, or at least quite cautious about, providing TBTF bailouts is also a conceptually simple but potentially helpful step.”).

model in the world isn't going to do your organization a bit of good unless you have a top-down commitment to making it work."¹⁷⁹

VI. LAYING OUT THE GAME PLAN TO END TBTF

The foregoing analysis focuses on the need for Congressional action to end TBTF. This government policy has sheltered large financial conglomerates from the consequences of their own disastrous decisions, at the expense of U.S. taxpayers and the U.S. economy. With vision and resolve, Congress can end TBTF and protect our financial system from key mistakes of the past. This article makes the case for ending TBTF bailouts by reducing the size and interconnectedness of large financial conglomerates. Future research should explore mechanisms to:

1. Initiate size caps that limit continued expansion of financial conglomerates through internal growth and acquisitions.
2. End government-assisted acquisitions that allow the largest institutions to grow even larger—at public expense.
3. Reinstate true firewalls between banking and commerce.¹⁸⁰

179. BEST PRACTICES IN LEADERSHIP DEVELOPMENT AND ORGANIZATION CHANGE: HOW THE BEST COMPANIES ENSURE MEANINGFUL CHANGE AND SUSTAINABLE LEADERSHIP 46 (Louis Carter et al. eds., 2005).

180. Former Chairman of the Federal Reserve Board Paul Volcker supports returning banks to their core deposit-taking and lending functions by prohibiting insured depository institutions from engaging in certain risky activities. Dan Grebler, *Volcker Urges Curbs on Big Banks' Risky Trades*, REUTERS, Feb. 2, 2010, available at <http://www.reuters.com/article/idUSTRE6112T320100202>. The "Volcker Rule" places new limits on banks' ability to do proprietary trading, or buying and selling of investments for their own accounts unrelated to customers. *Id.* The "Volcker Rule" is supported by the Obama administration and five former Treasury Secretaries: Michael Blumenthal, Nicholas Brady, Paul O'Neill, George Shultz and John Snow. Philip Barbara, *Ex Treasury Secretaries Back Volcker Rule*, REUTERS, Feb. 21, 2010, available at http://www.reuters.com/article/idUSTRE61L0BB20100222?loomia_ow=t0:s0:a49:g43:r1:c0.400000:b30845286:z0. These activities restrictions would effectively limit the size and systemic risk of financial conglomerates. *Id.*; see also *Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Compa-*

4. Return to meaningful antitrust enforcement.
5. Immediately initiate reform measures such as increased capital for large institutions, subordinated debt requirements that enhance market discipline, enhanced systemic risk monitoring and regulation, and better advance planning for liquidating large complex financial institutions.
6. As a longer term measure, commission a carefully researched report on how to most effectively divide the existing conglomerates into manageable component parts that will no longer be "Too Big To Fail."

Ending TBTF will be no easy task. Yet, the costs of doing nothing to address the problem have proven devastating. The U.S. financial system stands at a watershed.

*nies: Hearing Before the S. Comm. on Banking, Housing, & Urban Affairs, 111th Cong. (2010) (statement of Paul A. Volcker, Chairman, President's Economic Recovery Advisory Board), available at http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=54b42cc0-7ecd-4c0d-88c0-65f7d2002061&Witness_ID=091f5a89-dec4-4905-9fa1-678bfbec823a. The main purpose of the "Volcker Rule" is to deal with the problem of TBTF. *Id.* at 1.*