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TOO BIG TO FAIL IN U.S. BANKING: QUO VADIS?

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I. Introduction

Too big to fail (TBTF) is a term frequently used in banking to describe how bank regulators may deal with severely financially troubled large banks. At least in the United States, it is also a much misunderstood term. Except for a brief period in the mid-1980's, TBTF did not and does not now mean what it clearly appears to be saying. The term came into common usage in 1984, when the regulators were faced with the economically insolvent Continental Illinois National Bank in Chicago, which was both the seventh largest bank in the country at the time and the largest correspondent bank having interbank deposit and Fed funds relationships with more than 2,200 other banks. Although the poor financial condition and potential insolvency of Continental was widely known both to the Comptroller of the Currency and the other bank regulators from examination reports and to the public from newspaper articles, the insolvency caught the regulators unprepared. They did not have a plan on the shelf ready for immediate use for resolving such a large and important bank. Rather than fail the bank legally, appoint a receiver, sell its assets, protect insured deposits by having them assumed at par by another bank, and permit uninsured depositors and other unsecured creditors to share in any losses, which was the resolution procedure that the FDIC had started to apply to smaller banks shortly before, the federal regulators did not legally fail or close the bank and protected all uninsured depositors and

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other creditors of both the bank and its parent holding company against loss. Both institutions were permitted to continue to operate, but under FDIC control. But, at least initially, the old shareholders were not completely ousted.

The FDIC provided funds to the Continental's parent holding company - - the Continental Illinois Corporation - - by purchasing newly issued preferred stock to be downstreamed to the bank as equity capital. This served to recapitalize the bank and, by having the bank upstream dividends to its parent, permitted the holding company to pay interest on its debt and to stay out of bankruptcy.¹ The FDIC also purchased \$3.5 billion of bad loans from the bank at adjusted book value. The bank was effectively nationalized. The FDIC chose new senior management. The interest of the old shareholders, although not terminated altogether, was greatly reduced. They received a residual claim on the nonperforming loans purchased by the FDIC (FDIC, 1998b). When, after five years, losses from resolving these loans exceeded the amount specified in the financing agreement, the old shareholders' interests were declared worthless and the change in control was complete. The FDIC slowly reprivatized the bank by periodically selling its shares to the public. The last shares were sold and the bank completely reprivatized in 1991.

In 1994, the bank was bought by BankAmerica Corp. The total cost of the rescue operation was estimated by the FDIC to have been some \$1.1 billion on a nonpresent value basis, or about 3 ¼ percent of the bank's assets as of the date of resolution (FDIC, 1998b). The estimated loss is understated by not present valuing recoveries at later dates, but is smaller if computed as a percent of assets one year before resolution before a run reduced Continental's

(Boston College), as well to the audiences at these meetings. The views presented are those of the author and do not necessarily represent those of the Federal Reserve Bank of Chicago or the Federal Reserve System.

¹ In the U.S., chartered banks are legally failed and resolved by their primary federal regulator or state chartering agency and the FDIC under provisions of the FDI Act. In contrast, bank holding companies and nonbank subsidiaries are failed and resolved under the general corporate bankruptcy code like any other nonbank corporation.

asset size by nearly 20 percent. On the whole, the final loss is not greatly different from the loss rate estimated at the time of resolution.

The Continental was resolved in this way in part because the regulators believed that, particularly because of its large size and broad interconnections with other banks, failing the bank and/or its parent bank holding company and imposing losses on its uninsured depositors and creditors would have had serious adverse effects on other banks, financial markets, and the macroeconomy (Committee, 1984; FDIC, 1998b; and Sprague, 1986).² Rightly or wrongly, and the evidence on the existence of serious contagion and systemic risk is open to differing interpretation, the regulators perceived that widespread devastation could result from failing a large bank for a number of reasons, including that bank deposits provide the large share of the country's money supply; banks are the largest lenders to households, businesses, and governments; banks operate much of the payments system; and, particularly in the case of Continental, banks are closely interconnected to each other through interbank deposits and loans, so that losses at any one bank may cascade down the chain to other banks and beyond to financial markets and the macroeconomy and drive otherwise solvent units into insolvency (Kaufman, 1994 and 1996).³ Thus, adverse shocks from bank failures were perceived to be more strongly and widely felt than similar shocks from the failure of nonbank firms of equal size, and the larger the bank the more serious and widespread the damage.

² In part, the parent holding company was protected and not forced into bankruptcy because of legal covenants in some of the debt obligations that prohibited the issuance of additional equity in the bank to anyone other than the holding company. This restriction was perceived by the regulators to have made it more difficult to provide financial assistance to the bank directly (Sprague, 1986). On the other hand, the FDIC argues that had the bank alone had been protected, the holding company had sufficient deposits at the bank to repay its maturing debt and avoid bankruptcy (FDIC, 1998b).

³For example, even long after the failure of the Continental Bank, the FDIC argued that "the failure of one bank would set off a chain reaction, bringing about other failures. Sound banks frequently failed when large number of depositors panicked and demanded to withdraw their deposits, leading to 'runs' on the bank" (FDIC, 1998b, p.212). Likewise, focusing on the payments system, the Federal Reserve believes that "if an institution participating on a private large-dollar payments network were unable or unwilling to settle its net debit position...the institution's creditors on that network might ...then be unable to settle their commitments... Serious repercussions could spread to other participants in the network, to other depository institutions and to the nonfinancial economy generally" (Coleman, 2002, p.68).

The fear is evident in the statement of C.T. Conover, who was the Comptroller of the Currency at the time of the Continental Illinois National Bank resolution in 1984, in his testimony to Congress at the time that

had Continental failed and been treated in a way in which depositors and creditors were not made whole, we could very well have seen a national, if not an international, financial crisis, the dimensions of which were difficult to imagine. None of us wanted to find out (Conover, 1984, p 288).

John LaWare, a former governor of the Federal Reserve System, was more specific about the “dimensions” of this crisis in later testimony before Congress when he was governor. He noted that

it is systemic risk that fails to be controlled and stopped at the inception that is a nightmare condition that is unfair to everybody. The only analogy that I can think of for the failure of a major international institution of great size is a meltdown of a nuclear generating plant like Chernobyl.

The ramifications of that kind of failure are so broad and happen with such lightning speed that you cannot after the fact control them. It runs the risk of bringing down other banks, corporations, disrupting markets, bringing down investment banks along with it....We are talking about the failure that could disrupt the whole system. (LaWare, 1991, p 34).

In addition, at least the Chairman of the House Banking Committee, Congressman St Germain, believed that “had the Continental Illinois been allowed to fail...all those people [would have been] put out of work and all those corporations out of money” (See Appendix and Committee, 1984, p.299). His concern that failed banks physically disappear down a black hole with all hands aboard and that the bank is totaled, so that uninsured depositors lose all their funds, was probably widely shared by the public. Large segments of the public also appear to fear that, even if the bank does not disappear physically, access to depositor accounts is totally or partially frozen for a lengthy period, which greatly increases adverse effects.

The remainder of the paper traces the history of TBTF as it applies to commercial banks and analyzes the changes in its application through time by both the regulators and legislation. The paper does not consider explicit or implicit intervention by bank regulators to protect financial markets from perceived serious shocks originating from nonbank sources such as the commercial paper default by the Penn Central Railroad in 1971, the stock market collapse in 1987, and the Russian default and the Long-Term Capital Management debacle in 1998.

II History of TBTF

TBTF has changed considerably in concept and implementation from both the periods before and immediately after the Continental failure. Before the introduction of deposit insurance in 1934, very big banks did not often become insolvent and fail, even in periods of widespread bank failures and macroeconomic difficulties, such as 1893, 1907, and the early 1930s. For example, between 1921 and 1931, only two of the near 60 banks (3 ½ percent) with loans and investments in excess of \$50 million in 1921 failed and they represented only 0.02 percent of all bank failures in this period. In contrast, 7,000 of the 19,000 banks (37 percent) with loans and investments of under \$0.5 million failed (Federal Reserve Committee, 1933). Likewise, although the annual failure for commercial banks was 6, 11, 8, and 28 percent in 1930, 1931, 1932, and 1933, respectively, the percentage of deposits at failed banks was only 2, 1, 2, and 12 percent of deposits in all banks in these years. Even if more large banks had become insolvent, government regulators had little, if any, authority or resources to assist them. Banks failed either when they were unable to meet depositor claims or when the appropriate regulator believed that their capital was negative and they would default. The banks were forced to suspended operations and were either recapitalized by their old or new owners or liquidated. Assistance to larger banks perceived to be experiencing liquidity, but not solvency, problems was frequently provided by the local clearinghouse of which they were a member, financed by the other member banks. Such

assistance was not provided to banks perceived to be insolvent and full repayment unlikely. Thus, the New York Clearing House did not provide assistance to the medium-sized Knickerbocker Trust in 1907 and the Bank of United States in 1930 and both were liquidated. (Friedman and Schwartz, 1963; Sprague, 1910, O'Brien, 1992, and Trescott, 1992).

But things changed with the introduction of federal deposit insurance, which gave the federal government an implicit financial interest in the solvency of insured banks and a greater role in bank failure intervention. For its first forty-plus years through the 1970's, although there was a de-jure coverage ceiling on insured deposits, the FDIC acted de-facto to protect all depositors, although not shareholders, at nearly all failed banks. It did so primarily by merging the failed banks with solvent banks and effectively assuming some or all of the bad loans or paying the assuming banks for any losses they incurred in the transaction.⁴ Such a procedure (termed purchase and assumption) was used to resolve the Franklin National Bank (New York) in 1974, which was the twentieth largest bank in the country at the time and the first large bank, although still a regional bank but with both an international presence and international ownership, to become insolvent in the post-World War II era. It was failed and sold after an attempt to continue the bank in operation after it became insolvent with funding through large-scale borrowing from the Federal Reserve Bank of New York discount window at below market rates (which eventually accounted for one-half of the bank's total funding), failed to restore it to profitability (Garcia and Plautz, 1988 and Spero, 1980). All depositors were fully protected. The FDIC experienced a moderate loss.

In 1980, the First Pennsylvania Bank (Philadelphia), which was the oldest chartered bank in the U.S. and then the twenty-third largest bank in the country, became insolvent after taking large interest rate bets and losing. Because it was difficult to find an eligible buyer for the bank,

⁴ In 1950, at its request, Congress authorized the FDIC to provide assistance to banks by making loans, purchasing assets, assuming liability, or making contributions to insured banks in danger of default or that lessen the risk to the FDIC (FDIC, 1984).

given the prohibition against interstate banking at the time, and a deposit payoff would drain the FDIC's funds, the FDIC provided open bank assistance. Additional financial support was provided by the Federal Reserve and a consortium of large banks. In contrast to most earlier rescues, the shareholders were left intact, although the FDIC made some management and director changes. When interest rates declined in the next few years, the bank repaid the loans and regained solvency at little net cost to the FDIC, which had included stock warrants in the rescue package and profited from their sale back to the bank in 1983 and 1985. (FDIC, 1998b and Sprague, 1986).

Regulatory rescue operations in which insolvent banks were not legally failed at the time and kept in operation with all depositors, although not necessarily stockholders, protected are referred to as "open bank assistance." If the bank could not be merged because of an absence of eligible and suitable partners, direct assistance to the bank required a determination by the FDIC that the bank was "essential" to the community.⁵ The First Pennsylvania Bank was deemed to be essential because of its large size (FDIC, 1998b and Sprague, 1986). But protection of all deposits effectively eliminated concern and discipline by de-jure uninsured depositors. The FDIC began to view this as a problem.

To incentivize large depositors to once again monitor and discipline their banks and reduce the costs of failure to itself, the FDIC experimented in 1983-84 with failing banks and not protecting uninsured depositors (FDIC, 1997). However, all the banks resolved in this fashion (termed modified payoff) were reasonably small. The uninsured depositors shared in any loss with the FDIC on a prorata basis. But rather than being forced to wait for their funds to be collected and paid by the receiver from the sale of the bank assets, which could take many years to complete, uninsured depositors were for the first time paid advance dividends by the FDIC at

⁵ In days when interstate and, in some states, even intrastate banking was restricted, it was difficult at times to find acquiring banks.

the time of resolution effectively equal to the estimated prorata recovery amount.⁶ This amount was made available at the bank that assumed the insured deposits at par value. This important innovation minimized the adverse effects from the loss of liquidity to these depositors. Because often the fear of bank failures is based more on the inability to access one's account rather than the credit loss in its value, by liquifying the deposits, advance dividends effectively made resolutions with losses to uninsured depositors both economically and politically more feasible (Kaufman, 2002a and Kaufman and Seelig, 2002).⁷ But the Continental caught the regulators unprepared to deal with such a large institution and caution overrode experimentation.⁸ As Sprague noted, "what were the real reasons for doing the...bailouts? Simply put, we were afraid not to." (Sprague, 1986, p.10).

The decision to protect the Continental Bank after permitting smaller banks to fail and not protecting their uninsured depositors drew sharp criticism from some legislators, particularly on the basis of fairness of treatment from those representing the local areas that had recently suffered small banks failures. In defending the action in testimony before the House Banking Committee, Todd Conover, Comptroller of the Currency at the time, was drawn into stating that the regulators

⁶ In 1982, the FDIC had resolved the medium-sized Penn Square Bank (Oklahoma City) with losses to uninsured depositors but through a deposit payoff, when its large and uncertain off-balance sheet contingent obligations made it difficult for the FDIC to sell the bank quickly. Up to that time, it was by far the largest bank failure resolved with losses to uninsured depositors. These depositors received receivership certificates and were paid only through time as the FDIC, as receiver, liquidated the bank assets (FDIC, 1998b). The final payments were made and the receivership ended in 1996. Uninsured depositors received nearly 90 percent of the par value of their deposits on a non-present value basis.

⁷ Quick payment of depositors at closed banks to reduce the loss in liquidity has an interesting history in the U.S. It was included in the form of a question in a questionnaire mailed to bankers and bank supervisors the National Monetary Commission in 1908, proposed by Senator Carter Glass in 1931 as a superior strategy to federal deposit insurance, attempted by the Federal Reserve Bank of New York in 1932 and, actually implemented by both the New York State Banking Department and the Reconstruction Finance Corporation in 1933 (Kaufman, 2002).

⁸ In addition, at the time,

There also was a belief at the FDIC that, while market discipline for investors and shareholders was desirable, depositor discipline was more of a mixed blessing. In practice, depositor discipline generally affected only unsophisticated depositors. Sophisticated depositors, who really should have provided depositor discipline, generally were already out of failing institutions by the time it was closed. (FDIC, 1998b)

However, because the Continental Bank was basically a single office unit bank, it conducted mostly a wholesale business and most deposits at the date of resolution were uninsured. Although there had been a significant run on the

were unlikely to permit any one of the 11 largest multinational banks to fail, although he tried to argue that “it isn’t whether a bank fails or not. It is how it is handled subsequently to its failure that matters.” (See Appendix and Committee, 1984, pp 299-300).⁹ Although the newswires did not highlight this exchange, the next day (September 20, 1984), the Wall Street Journal headlined a lengthy article on the hearings “U.S. Won’t Let 11 Biggest Banks in Nation Fail—Testimony by Comptroller at House Hearing Is First Policy Acknowledgement” (Carrington, 1984). And so, the term TBTF was born! Using event study methodology, O’Hara and Shaw (1990) found that the market awarded positive excess returns to these 11 banks on September 20.

The FDIC attempted to restore market discipline after the Continental failure by progressively narrowing the stakeholders it protected in large bank failures. In 1986, it did not protect the creditors of a bank holding company --The First Oklahoma Corporation - - when its lead subsidiary bank - - The First National Bank of Oklahoma City - - became insolvent, so that the holding company, although not the bank, failed and filed for bankruptcy. Holding company creditors were not protected and shareholders were wiped out. The bank was sold at a loss to the FDIC to a newly chartered Oklahoma subsidiary of First Interstate Bankcorp (California). In 1988, the FDIC failed banks owned by the FirstRepublic Corporation (Dallas). However, it protected all depositors and creditors of these banks when it sold the banks, including the lead bank - - The First Republic National Bank - -, to a newly chartered FDIC operated bridge bank, which was, in turn, sold shortly afterwards to the NCNB Corporation, the parent holding company of the then Nations Bank in North Carolina. (FDIC, 1998b and Seidman, 1993).¹⁰

bank in the year before its resolution, the failure of all uninsured depositors to flee, in part, reflected a series of nonbinding assurances provided by federal regulators other than the FDIC to protect these depositors.

⁹ The complete transcript of the exchange between Conover and the Committee is shown in the Appendix.

¹⁰ The FDIC also permitted the banks’ parent holding company - - FirstRepublic Bank Corporation (Dallas) - - to file for bankruptcy by extending loans directly to the subsidiary banks rather than to the holding company (FDIC, 1998b).The significance of this was noted by William Seidman, who was Chairman of the FDIC at the time, as follows:

Unlike Continental Illinois, we gave our guarantee and our money directly to two of the banks owned by the company (the Dallas and Houston banks), but not to the holding company itself and its bond - and stockholders. This difference was of great significance. It removed the

In 1989, the FDIC permitted some uninsured depositors, nondeposit creditors, and off-balance sheet counterparties, although not uninsured nonaffiliated depositors, to experience losses when many but not all of the subsidiary banks of MCorp (Dallas) were failed (FDIC, 1998b). The FDIC effectively treated the separately chartered bank subsidiaries of MCorp as a branch system and charged the solvent banks for losses on their interbank deposits at the insolvent banks. Thus, by 1990, TBTF no longer meant what it did in 1984, but basically only that a bank was “too big to impose losses on most uninsured depositors” (Kaufman 1990). Indeed, the term TBTF in terms of not permitting a bank holding company to legally fail applied basically only to the Continental and a few other holding companies from 1984 through 1986 and to banks for only two more years through 1988.

However, while the definition of “fail” was narrowed, the definition of “big” to protect uninsured depositors was broadened and progressively reduced to eventually include even the \$2 billion of National Bank Washington (D.C.), which was only about the 250th largest bank in the country and apparently more “too political to fail” than TBTF. In addition to protecting all depositors at its domestic offices, the FDIC also protected all deposits at the bank’s off-shore office in the Bahamas.¹¹

safety net from the billions of dollars of holding company debt. It reduced our insurance losses, disciplined the creditors of the holding company for their bad investment, and stabilized the banking system. (Siedman, 1993, p. 150).

¹¹ This rescue drew unusual attention that hastened the end of TBTF for two reasons. One, a conflict between the FDIC and the Fed about protecting the offshore deposits. According to William Seidman, Chairman of the FDIC at the time, the FDIC was forced to protect the foreign deposits by the Federal Reserve, which claimed that not doing so would trigger a run against foreign deposits at offshore offices of other U.S. banks and threaten domestic financial stability (Bacon, 1990). Two, a minority owned and oriented bank - - the Freedom National Bank in Harlem, New York, organized by baseball star Jackie Robinson in 1964 - - failed shortly afterwards, but uninsured depositors, many of whom were minority charities and churches, were not protected. Although the Freedom Bank was considerably smaller than the National Bank of Washington, a number of New York City congressman vocally questioned the fairness of the policy, (Bacon, 1990).

III. FDICIA and the Systemic Risk Exemption

The high costs of the large number of bank and, in particular, the S&L failures of the 1980s and early 1990s, the great overuse and widely perceived serious misuse of TBTF in the 1980s, and the perceived inequitable treatment of uninsured depositors at failed banks differing in size or political influence led Congress over the objection of many regulators to reform the structure of deposit insurance, including procedures for resolving insolvencies, in the FDIC Improvement Act (FDICIA) of 1991. The Act introduced regulatory prompt corrective action (PCA) and least cost resolution (LCR) that supplemented regulatory discretion with progressively harsher mandatory sanctions if these sanctions were ineffective and a bank's financial condition continued to deteriorate and more timely resolution when a bank's equity declines to less than a minimum of 2 percent of its on-balance sheet assets at least cost to the FDIC. The purpose of these provisions was "to resolve the problems of insured depository institutions at the least possible long-term loss to the deposit insurance fund" (FDICIA, 1991, p.19). In contrast to before FDICIA, the computation procedure for estimating least cost was spelled out.¹² To help achieve LCR, the Act explicitly prohibited the FDIC from protecting uninsured depositors and other nondepositor bank stakeholders, unless doing so represents the least costly resolution. They must share in the loss with the FDIC in accordance with legal priorities.

But an exemption was provided if the perceived economic costs of not protecting some or all uninsured claimants exceeded the financial gains of complying with LCR. The FDIC could partially or fully protect any noninsured stakeholder and violate LCR if not doing so "would have serious adverse effects on economic conditions or financial stability; and.... [doing so] would avoid or mitigate such adverse effects." In 1993, the FDIC was specifically prohibited from

¹² Before FDICIA, the FDIC frequently used highly creative and publicly undocumented methods for estimating the loss in uninsured depositor payoff resolutions. This cost was almost always found to be far greater than for bank assistance and justified the use of purchase and assumption in which all deposits were assumed by another bank par.

assisting shareholders in the RTC Completion Act. Thus, TBTF became the “systemic risk exemption” (SRE) and encompasses only the possibility of protecting partially or fully some or all nonshareholder stakeholders of insolvent banks.

The new SRE was also made significantly more difficult to invoke than the old TBTF. It requires a retained documented determination by the Secretary of the Treasury in consultation with the President in response to a written recommendation by two-thirds of both the Board of Directors of the FDIC and the Board of Governors of the Federal Reserve System that such action is necessary because in their judgement the above adverse preconditions specified exist and that not taking action that may violate LCR would validate these effects. The Secretary must provide written notice of the determination to the Senate and House Banking Committees. If, after these hurdles, SRE is invoked, other provisions kick in. The Comptroller General of the General Accounting Office must review the basis for the determination, the purpose of any actions taken, and the likely effects on the behavior of the banks and uninsured depositors and the findings reported to Congress. By increasing transparency and accountability, such ex-post congressional and public reviews should serve to reinforce the greater ex-ante hurdles in increasing the hesitancy of the regulators to request SRE and the Treasury to grant it (Mishkin, 1997). In addition, moreover, any loss to the FDIC resulting from protecting uninsured depositors and other creditors must be repaid “expeditiously” by a special assessment on all insured banks scaled to their total assets. This provision should make such action less popular with competing large banks and intensify opposition to its invocation.

Indeed, concurrent changes in the deposit insurance structure that made insurance basically privately funded, although still government managed, further reduced the likelihood of SRE and the cost to the public if and when it is invoked (Kaufman, 2002b and Kaufman and Wallison, 2001). Unlike earlier, FDICIA requires the FDIC to increase premiums whenever losses from failures not stemming from protecting uninsured depositors drive the FDIC’s reserve

to insured deposits ratio below 1.25 percent to recover the shortfall within one year or impose very high premiums. Thus, the government's liability for losses is sharply reduced to effectively only after the aggregate capital of the banking system as a whole is or almost is wiped out and the banks cannot pay the premiums. The cost of paying for all FDIC losses should further incentivize the healthy premium paying banks to prevent the FDIC from riding to the rescue of uninsured depositors at large banks.

Regulators now may also be more reluctant to support invoking the SRE than earlier both because of greater experience with and knowledge about resolving large institutions and because of the better understood adverse effects of moral hazard behavior by the banks. For example, Federal Reserve Chairman Alan Greenspan has recently stated that:

the issue is an organization that is very large is not too big to fail, it may be too big to allow to implode quickly. But certainly, none are too big to orderly liquidate... What you want to avoid is the quick reaction. And that we can do. But not to protect shareholders. And presumably, not to protect non-guaranteed deposits from loss (Greenspan, 2000, p.14)... The potential for greater market discipline at large institutions is substantial (Greenspan, 2001, p.7).

Moreover, as noted by Greenspan, "the least-cost resolution exemption does not require that all uninsured creditors be made whole, but rather that they be made no worse off than they would have been if the bank were liquidated," (Greenspan, 2001, p. 7). Thus, regulators also have the flexibility to keep uninsured depositors at risk, but to limit their exposure to loss to less than the full amount of the loss and thus presumably limit any spillover collateral damage. That is, the uninsured depositors could be subject to partial loss sharing with the FDIC rather than full loss sharing. In addition, to the extent losses are charged first to unsecured creditors and depositors at foreign branches, the uninsured depositors at domestic offices are also likely to be protected wholly or partially. To the uninsured domestic depositors, these subordinated funds serve as capital.

It is interesting to note that the inclusion of provisions in FDICIA requiring least cost resolution and increasing the difficulty of obtaining permission to protect uninsured depositors in TBTF resolutions, which reflected Congress' dissatisfaction with the FDIC's frequent practice of protecting all depositors at high cost, was not the first time that Congress expressed dissatisfaction with this practice and attempted to limit it. In 1950, in response to the FDIC's practice in the 1940's of protecting all depositors through assisted mergers with solvent banks, Congress amended the FDI Act. It restricted the FDIC's ability to protect all depositors only to resolutions in which an assisted merger is less costly than a deposit payoff or when a merger with a suitable partner is not possible but the bank is declared to be "essential" to the community. In his book, Sprague quotes Senator Paul Douglas of Illinois as suggesting at the time that the FDIC's practice was creating "a moral obligation upon the Government to protect all deposits and not merely insured deposits" (Sprague, p.25). Nevertheless, Sprague noted that "despite the fact that Congress made it clear in the 1950 Act that the FDIC was not created to insure all deposits in all banks, in the years since...the regulators have devised solutions that protect even the uninsured in the predominance of cases" (Sprague, p.32).

IV. Conclusion

TBTF has changed greatly in both definition and application since protection of, at least, some claimants of large banks became possible with the introduction of deposit insurance in the 1930s. The concept was broadest in the resolution of the Continental Illinois Bank in 1984, when all claimants of the bank and all creditor claimants of its parent holding company were protected fully against loss and the bank was continued in operation. But, even then, the shareholders of the holding company were effectively wiped out and senior management of both the bank and bank holding company was changed by the FDIC. Since then, the number and type of claimants protected have progressively been significantly narrowed, even before the enactment of FDICIA in 1991. Nevertheless, the high cost and perceived unfairness of TBTF resulted in opposition to its

continued use. FDICIA transformed TBF into SRE and greatly raised the barriers to its use. Partially as a result, since 1992, uninsured deposits have been protected only in a few resolutions of very small banks, where the uninsured deposits were apparently sold to an assuming bank at a sufficient premium to satisfy the LCR test, that is, to reduce the estimated cost to the FDIC below that of paying the uninsured depositors the present value of the prorata estimated recovery value.¹³ Although the total number of resolutions has been small and no very large banks have failed, uninsured depositors have not been protected in any of the largest commercial banks that were resolved and in which the FDIC incurred losses. SRE was never invoked. Thus, the system remains to be tested for the resolution of a large complex bank. But, the combination of the substantial barriers imposed by FDICIA to invoking SRE, the ability of the FDIC to avoid freezing uninsured deposits at failed banks and provide near-instant liquidity to the depositors, the higher direct cost to surviving banks from paying for any FDIC losses, and the apparent greater reluctance of some regulators to invoke SRE than in the past may significantly reduce the probability of its future use.¹⁴

¹³ Uninsured depositors may have been fully protected in some failures in which the FDIC eventually reported a meaningful loss because the FDIC had originally overestimated the recovery value (underestimated the loss rate) and accepted a bid from the assuming bank that offered a premium that was larger than the estimated loss rate at the time but smaller, in retrospect, than the loss rate actually realized and reported.

¹⁴ Whether SRE will be invoked by the government and whether large noninsured depositors will assume it may not be invoked and therefore monitor their banks more carefully also depends in part on the public perception of the probability of its use. Some analysts remain highly skeptical that, when push comes to shove, it will not be invoked and leave uninsured depositors and creditors unprotected. For example, in reviewing the Senate hearings on the confirmation of Donald Kohn as a member of the Board of Governors, a central bank electronic newsletter wrote

Kohn...recommended that banks should be allowed to go bust if they fail the market test. "No depository institution should be insulated from market forces by being considered too big to fail." Perhaps fortunately, nobody in the markets actually believes that doctrine, but political correctness never did have much to do with the real world, did it? (Mander, 2002)

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Appendix

COMPTROLLER CONOVER AND THE BIRTH OF TBTF

CHAIRMAN ST GERMAIN. Mr. Conover, where does Continental Illinois' rank in size among the banks of the United States of America? Is it 11th, 10th, 9th, 8th?

MR. CONOVER. It seems to be moving.

CHAIRMAN ST GERMAIN. Where was it?

MR. CONOVER. It was eighth, approximately.

CHAIRMAN ST GERMAIN. Number eight?

MR. CONOVER. Yes

MR. WYLIE. You have 11 multinationals?

MR. CONOVER. Right.

CHAIRMAN ST GERMAIN. All right

Ever see the fellow who is painting himself into that corner? He doesn't realize there is no door back there. And there is less floor for him to walk over. I got news for you. You are painting yourself in a corner because my question now is: Can you foresee, in view of all the reverberations internationally that you described, had Continental Illinois been allowed to fail, and all those people put out of work and all those corporations out of money and all those other banks that would have failed, in view of that, you can ever foresee one of the 11 multinational money center banks failing? Can we ever afford to let any one of them fail?

MR. CONOVER. The answer to that, Mr. Chairman, is that we have got to find a way to. In order --- ---

CHAIRMAN ST GERMAIN. You are not answering.

MR. CONOVER. In order to have a viable system.

CHAIRMAN ST GERMAIN. Mr. Conover, you said you don't have in your hip pocket the solution for the small banks, and you are never going to have it.

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

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

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

MR. BARNARD.

MR. CONOVER. I think it is important that we find a way to do that.

MR. BARNARD. Thank you.

MR. MCKINNEY. Would Mr. Barnard yield for a moment so I could follow through on the chairman's statement?

MR. BARNARD. I want to follow through too, if you don't mind.

MR. MCKINNEY. With all due respect, I think seriously, we have a new kind of bank. And today there is another type created. We found it in the thrift institutions, and now we have given approval for a \$1 billion brokerage deal to Financial Corporation of America.

MR. CHAIRMAN, let us not bandy words. We have a new kind of bank. It is called too big to fail. TBTF, and it is a wonderful bank.