

# TOO BIG HAS FAILED

Thomas M. Hoenig  
President and Chief Executive Officer  
Federal Reserve Bank of Kansas City

Omaha, Neb.  
March 6, 2009

The views expressed by the author do not necessarily those of the Federal Reserve System, its governors, officers or representatives.

Two years ago, we started seeing a problem in a specialized area of financial markets that many people had never heard of, known as the subprime mortgage market. At that time, most policymakers thought the problems would be self-contained and have limited impact on the broader economy. Today, we know differently. We are in the midst of a very serious financial crisis, and our economy is under significant stress.

Over the past year, the Federal government and financial policy makers have enacted numerous programs and committed trillions of dollars of public funds to address the crisis. And still the problems remain. We have yet to restore confidence and transparency to the financial markets, leaving lenders and investors wary of making new commitments.

The outcome so far, while disappointing, is perhaps not surprising.

We have been slow to face up to the fundamental problems in our financial system and reluctant to take decisive action with respect to failing institutions. We are slowly beginning to deal with the overhang of problem assets and management weaknesses in some of our largest firms that this crisis is revealing. We have been quick to provide liquidity and public capital, but we have not defined a consistent plan and not addressed basic shortcomings and, in some cases, the insolvent position of these institutions.

We understandably would prefer not to “nationalize” these businesses, but in reacting as we are, we nevertheless are drifting into a situation where institutions are being nationalized piecemeal with no resolution of the crisis.

With conditions deteriorating around us, I will offer my views on how we might yet deal with the current state of affairs. I’ll start with a brief overview of the policy actions we have been pursuing, but I will also provide perspective on the actions we have taken and the outcomes we have experienced in previous financial crises. Finally, I will suggest what

lessons we might take from these previous crises and apply to working our way out of the current crisis.

In suggesting alternative solutions, I acknowledge it is no simple matter to solve. People say “it can’t be done” when speaking of allowing large institutions to fail. But I don’t think that those who managed the Reconstruction Finance Corporation, the Resolution Trust Corporation, the Swedish financial crisis or any other financial crisis were handed a blueprint that carried a guarantee of success. I don’t accept that we have lost our ability to solve a new problem, especially when it looks like a familiar problem.

### **Current Policy Actions and Problems**

Much has been written about how we got into our current situation, most notably the breakdowns in our mortgage finance system, weak or neglected risk management practices, and highly leveraged and interconnected firms and financial markets. Because this has been well-documented, today I will focus on the policy responses we have tried so far and where they appear to be falling short.

A wide range of policy steps has been taken to support financial institutions and improve the flow of credit to businesses and households. In the interest of time, I will go over the list quickly.

As a means of providing liquidity to the financial system and the economy, the Federal Reserve has reduced the targeted federal funds rate in a series of steps from 5.25 percent at mid-year 2007 to the present 0 to 25 basis-point range. In addition, the Federal Reserve has instituted a wide range of new lending programs and, through its emergency lending powers, has extended this lending beyond depository institutions.

The Treasury Department, the Federal Reserve and other regulators have also arranged bailouts and mergers for large struggling or insolvent institutions, including Fannie Mae and Freddie Mac, Bear Stearns, WaMu, Wachovia, AIG, Countrywide, and Merrill Lynch. But other firms, such as Lehman Brothers, have been allowed to fail.

The Treasury has invested public funds, buying preferred stock in more than 400 financial institutions through the TARP program. TARP money has also been used to fund government guarantees of more than \$400 billion of securities held by major financial institutions, such as CitiGroup and Bank of America. In addition, the Federal Reserve and the Treasury Department have committed more than \$170 billion to bail out the troubled insurance company AIG.

Other actions have included increased deposit insurance limits and guarantees for bank debt instruments and money market mutual funds.

The most recent step is the Treasury financial stability plan, which provides for a new round of TARP spending and controls, assistance for struggling homeowners, and a plan for a government/private sector partnership to buy up bad assets held by financial institutions and others.

The sequence of these actions, unfortunately, has added to market uncertainty. Investors are understandably watching to see which institutions will receive public money and survive as wards of the state.

Any financial crisis leaves a stream of losses embedded among the various participants, and these losses must ultimately be borne by someone. To start the resolution process, management responsible for the problems must be replaced and the losses identified and taken. Until these kinds of actions are taken, there is little chance to restore market

confidence and get credit markets flowing. It is not a question of avoiding these losses, but one of how soon we will take them and get on to the process of recovery. Economist Allan Meltzer may have expressed this point best when he said that “capitalism without failure is like religion without sin.”

### **What Might We Learn from Previous Financial Crises?**

Many of the policy actions I just described provide support to the largest financial institutions, those that are frequently referred to as “too big to fail.” A rationale for such actions is that the failure of a large institution would have a systemic impact on the economy. It is emphasized that markets have become more complex, and institutions – both bank and nonbank entities – are now larger and connected more closely through a complicated set of relationships. Often, they point to the negative impact on the economy caused by last year’s failure of Lehman Brothers.

History, however, may show us another experience. When examining previous financial crises, in other countries as well as in the United States, large institutions have been allowed to fail. Banking authorities have been successful in placing new and more responsible managers and directors in charge and then reprivatizing them. There is also evidence suggesting that countries that have tried to avoid taking such steps have been much slower to recover, and the ultimate cost to taxpayers has been larger.

There are several examples that illustrate these points and show what has worked in previous crises and what hasn’t. A comparison that many are starting to draw now is with what happened in Japan and Sweden.

Japan took a very gradual and delayed approach in addressing the problems in its banks. A series of limited steps spread out over a number of years were taken to slowly remove bad assets from the banks, and Japan put off efforts to address an even more fundamental problem – a critical shortage of capital in these banks. As a result, the banks were left in the position of having to focus on past problems with little resources available to help finance any economic recovery.

In contrast, Sweden took decisive steps to identify losses in its major financial institutions and insisted that solvent institutions restore capital and clean up their balance sheets. The Swedish government did provide loans to solvent institutions, but only if they also raised private capital.

Sweden dealt firmly with insolvent institutions, including operating two of the largest banks under governmental oversight with the goal of bringing in private capital within a reasonable amount of time. To deal with the bad assets in these banks, Sweden created well-capitalized asset management corporations or what we might call “bad banks.” This step allowed the problem assets to be dealt with separately and systematically, while other banking operations continued under a transparent and focused framework.

The end result of this approach was to restore confidence in the Swedish banking system in a timely manner and limit the amount of taxpayer losses. Sweden, which experienced a real estate decline more severe than that in the United States, was able to resolve its banking problems at a long term net cost of less than 2 percent of GDP.

We can also learn a great deal from how the United States has dealt with previous crises. There has been a lot written attempting to draw parallels with the Great Depression.

The main way that we dealt with struggling banks at that time was through the Reconstruction Finance Corporation.

Without going into great detail about the RFC, I will note the four principles that Jesse Jones, the head of the RFC, employed in restructuring banks. The first step was to write down a bank's bad assets to realistic economic values. Next, the RFC would judge the character and capacity of bank management and make any needed and appropriate changes. The third step was to inject equity in the form of preferred stock, but this step did not occur until realistic asset values and capable management were in place. The final step was receiving the dividends and eventually recovering the par value of the stock as a bank returned to profitability and full private ownership.

At one point in 1933, the RFC held capital in more than 40 percent of all banks, representing one-third of total bank capital according to some estimates, but because of the four principles of Jesse Jones, this was all carried out without any net cost to the government or to taxpayers.

If we compare the TARP program to the RFC, TARP began without a clear set of principles and has proceeded with what seems to be an ad hoc and less-than-transparent approach in the case of banks judged "too big to fail." In both the RFC and Swedish experiences, triage was first used to set priorities and determine what institutions should be addressed immediately. TARP treated the largest institutions as one. As we move forward from here, therefore, we would be wise to have a systematic set of principles and a detailed plan to guide us.

Another example we need to be aware of relates to the thrift problems of the 1980s. Because the thrift insurance fund was inadequate to avoid the losses embedded in thrift

balance sheets, an attempt was made to cover over the losses with net worth certificates and expanded powers that were supposed to allow thrifts to grow out of their problems. A notable fraction of the thrift industry was insolvent, but continued to operate as so-called “zombie” or “living dead” thrifts. As you may recall, this attempt to postpone closing insolvent thrifts did not end well, but instead added greatly to the eventual losses and led to greater real estate problems.

A final example -- our approach to large bank problems in the 1980s and early 1990s -- shows that we have taken some steps to deal with banking organizations that are considered “too big to fail” or very important on a regional level.

The most prominent example is Continental Illinois’ failure in 1984. Continental was the seventh-largest bank in the country, the largest domestic commercial and industrial lender, and the bank that popularized the phrase “too big to fail.” Questions about Continental’s soundness led to a run by large foreign depositors in May of 1984.

But looking back, Continental actually was allowed to fail. Although the FDIC put together an open bank assistance plan and injected capital in the form of preferred stock, it also brought in new management at the top level, and shareholders, who were the bank’s owners, lost their entire investment. The FDIC also separated the problem assets from the bank, which left a clean bank to be restructured and eventually sold. To liquidate the bad assets, the FDIC hired specialists to oversee the different categories of loans and entered into a service agreement with Continental that provided incentive compensation for its staff to help with the liquidation process.

A lesson to be drawn from Continental is that even large banks can be dealt with in a manner that imposes market discipline on management and stockholders, while controlling

taxpayer losses. The FDIC's asset disposition model in Continental, which used incentive fees and contracts with outside specialists, also proved to be an effective and workable model. This model was employed again in the failure of Bank of New England in 1991, the failures of nearly all of the large banking organizations in Texas in the 1980s, and also for the Resolution Trust Corporation, which was set up to liquidate failed thrifts.

### **Resolving the Current Crisis**

Turning to the current crisis, there are several lessons we can draw from these past experiences.

- First, the losses in the financial system won't go away – they will only fester and increase while impeding our chances for a recovery.
- Second, we must take a consistent, timely, and specific approach to major institutions and their problems if we are to reduce market uncertainty and bring in private investors and market funding.
- Third, if institutions -- no matter what their size -- have lost market confidence and can't survive on their own, we must be willing to write down their losses, bring in capable management, sell off and reorganize misaligned activities and businesses, and begin the process of restoring them to private ownership.

How can we do this today in an era where we have to deal with systemic issues rising not only from very large banks, but also from many other segments of the marketplace? I would be the first to acknowledge that some things have changed in our financial markets, but financial crises continue to occur for the same reasons as always – over-optimism,

excessive debt and leverage ratios, and misguided incentives and perspectives – and our solutions must continue to address these basic problems.

The process we use for failing banks -- albeit far from perfect in dealing with “too big to fail” banks -- provides some first insight into the principles we should establish in dealing with financial institutions of any type.

Our bank resolution framework focuses on timely action to protect depositors and other claimants, while limiting spillover effects to the economy. Insured depositors at failed banks typically gain full and immediate access to their funds, while uninsured depositors often receive quick, partial payouts based on expected recoveries.

To provide for a continuation of essential banking services, the FDIC may choose from a variety of options, including purchase and assumption transactions, deposit transfers or payouts, bridge banks, conservatorships, and open bank assistance. These options focus on transferring important banking functions over to sound banking organizations with capable management, while putting shareholders at failed banks first in line to absorb losses.

Other important features in resolving failing banks include an established priority for handling claimants, prompt corrective action, and least-cost resolution provisions to protect the deposit insurance fund and, ultimately, taxpayers and to also bring as much market discipline to the process as possible.

I would argue for constructing a defined resolution program for “too big to fail” banks and bank holding companies, and nonbank financial institutions. It is especially necessary in cases where the normal bankruptcy process may be too slow or disruptive to financial market activities and relationships. The program and resolution process should be

implemented on a consistent, transparent and equitable basis whether we are resolving small banks, large banks or other complex financial entities.

How should we structure this resolution process? While a number of details would need to be worked out, let me provide a broad outline of how it might be done.

First, public authorities would be directed to declare any financial institution insolvent whenever its capital level falls too low to support its ongoing operations and the claims against it, or whenever the market loses confidence in the firm and refuses to provide funding and capital. This directive should be clearly stated and consistently adhered to for all financial institutions that are part of the intermediation process or payments system. We must also recognize up front that the FDIC's resources and other financial industry support funds may not always be sufficient for this task and that Treasury money may also be needed.

Next, public authorities should use receivership, conservatorship or "bridge bank" powers to take over the failing institution and continue its operations under new management. Following what we have done with banks, a receiver would then take out all or a portion of the bad assets and either sell the remaining operations to one or more sound financial institutions or arrange for the operations to continue on a bridge basis under new management and professional oversight. In the case of larger institutions with complex operations, such bridge operations would need to continue until a plan can be carried out for cleaning up and restructuring the firm and then reprivatizing it.

Shareholders would be forced to bear the full risk of the positions they have taken and suffer the resulting losses. The newly restructured institution would continue the essential services and operations of the failing firm.

All existing obligations would be addressed and dealt with according to whatever priority is set up for handling claims. This could go so far as providing 100 percent guarantees to all liabilities, or, alternatively, it could include resolving short-term claims expeditiously and, in the case of uninsured claims, giving access to maturing funds with the potential for haircuts depending on expected recoveries, any collateral protection and likely market impact.

There is legitimate concern for addressing these issues when institutions have significant foreign operations. However, if all liabilities are guaranteed, for example, and the institution is in receivership, such international complexities could be addressed satisfactorily.

One other point in resolving “too big to fail” institutions is that public authorities should take care not to worsen our exposure to such institutions going forward. In fact, for failed institutions that have proven to be too big or too complex to manage well, steps must be taken to break up their operations and sell them off in more manageable pieces. We must also look for other ways to limit the creation and growth of firms that might be considered “too big to fail.”

In this regard, our recent experience with ad hoc solutions to large failing firms has led to even more concentrated financial markets as only the largest institutions are likely to have the available resources for the type of hasty takeovers that have occurred. Another drawback is that these organizations do not have the time for necessary “due diligence” assessments and, as we have seen, may encounter serious acquisition problems. Under a more orderly resolution process, public authorities would have the time to be more selective

and bring in a wider group of bidders, and they would be able to offer all or portions of institutions that have been restored to sound conditions.

### **Concluding Thoughts**

While hardly painless and with much complexity itself, this approach to addressing “too big to fail” strikes me as constructive and as having a proven track record. Moreover, the current path is beset by ad hoc decision making and the potential for much political interference, including efforts to force problem institutions to lend if they accept public funds; operate under other imposed controls; and limit management pay, bonuses and severance.

If an institution’s management has failed the test of the marketplace, these managers should be replaced. They should not be given public funds and then micro-managed, as we are now doing under TARP, with a set of political strings attached.

Many are now beginning to criticize the idea of public authorities taking over large institutions on the grounds that we would be “nationalizing” our financial system. I believe that this is a misnomer, as we are taking a temporary step that is aimed at cleaning up a limited number of failed institutions and returning them to private ownership as soon as possible. This is something that the banking agencies have done many times before with smaller institutions and, in selected cases, with very large institutions. In many ways, it is also similar to what is typically done in a bankruptcy court, but with an emphasis on ensuring a continuity of services. In contrast, what we have been doing so far is every bit a process that results in a protracted nationalization of “too big to fail” institutions.

The issue that we should be most concerned about is what approach will produce consistent and equitable outcomes and will get us back on the path to recovery in the quickest manner and at reasonable cost. While it may take us some time to clean up and reprivatize a large institution in today's environment -- and I do not intend to underestimate the difficulties that would be encountered -- the alternative of leaving an institution to continue its operations with a failed management team in place is certain to be more costly and far less likely to produce a desirable outcome.

In a similar fashion, some are now claiming that public authorities do not have the expertise and capacity to take over and run a "too big to fail" institution. They contend that such takeovers would destroy a firm's inherent value, give talented employees a reason to leave, cause further financial panic and require many years for the restructuring process. We should ask, though, why would anyone assume we are better off leaving an institution under the control of failing managers, dealing with the large volume of "toxic" assets they created and coping with a raft of politically imposed controls that would be placed on their operations?

In contrast, a firm resolution process could be placed under the oversight of independent regulatory agencies whenever possible and ideally would be funded through a combination of Treasury and financial industry funds.

Furthermore, the experience of the banking agencies in dealing with significant failures indicates that financial regulators are capable of bringing in qualified management and specialized expertise to restore failing institutions to sound health. This rebuilding process thus provides a means of restoring value to an institution, while creating the type of stable environment necessary to maintain and attract talented employees. Regulatory

agencies also have a proven track record in handling large volumes of problem assets – a record that helps to ensure that resolutions are handled in a way that best protects public funds.

Finally, I would argue that creating a framework that can handle the failure of institutions of any size will restore an important element of market discipline to our financial system, limit moral hazard concerns, and assure the fairness of treatment from the smallest to the largest organizations that that is the hallmark of our economic system.