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SUCCESS DEPENDS ON FAILURE

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As you all know, we are in the middle of a very serious financial crisis, and our economy is under significant stress. There has been much debate about how we should address these challenges, but regardless of the method one supports, all agree that the economy will not recover until the financial system is stabilized and credit flows improve.

The restoration of normal financial market activity depends on how we deal with the problems of our largest financial institutions. It is has been a little more than a year since the first major government rescue occurred with Bear Stearns being acquired by JPMorgan. Since then, numerous programs have been enacted and trillions of dollars of public funds have been committed, much of it directly to our largest institutions. Despite these well-intentioned efforts, the problems remain, and the public's dissatisfaction with how their money is being spent grows.

It is not surprising that the initial measures taken in this crisis were ad hoc. The depth and extent of the problems were not anticipated. However, more than a year has passed and the challenge that still remains is to define a plan that addresses the significant asset problems embedded in our largest institutions. We must provide financial firms, investors and consumers with a clear and fair plan for dealing with firms that many call "too big to fail."

Last month, I gave a speech that outlined a resolution framework and a plan for how we should deal with these large systemically important financial firms. I believe that failure is an option. Those who disagree with my resolution proposal say that it is unworkable. In my remarks today, I will offer more details about how the process would work and explain why I think it is the best solution for getting our financial system and economy on the road to recovery.

Principles for a Resolution Framework

For a free market system to be successful, firms must be allowed to fail based upon a predefined set of rules and principles that market participants can rely on when determining their strategies and making decisions. This is particularly important for problem financial institutions. These key principles should apply if we are talking about a small bank in Tulsa or a large international financial conglomerate in New York City.

The first principle is to properly understand our goals and correctly identify the problems we are attempting to solve. This may sound obvious. However, when we are in the middle of a crisis where more than a half million people are losing their jobs every month, it is tempting to pour money into the institutions thinking that it will correct the problem and get credit flowing once again. Also, rather than letting the market system objectively discipline the firms through failure and stockholder loss, we tend to micromanage the institutions and punish those within reach.

This lack of confidence in the market's remedy is most acute for our largest financial institutions, which have publically disclosed substantial losses. The question that the supervisory authorities must answer is whether the losses are large enough to threaten the solvency of any of these firms. This assessment is the first step in determining actions necessary to restoring public confidence in our financial system.

A second principle is that we must do what is best for the overall economy and not what is best for one group. We need to make sure that when one financial firm fails, the resolution process does not cause significant disruptions to financial markets and the economy or make the

current problems worse. Furthermore, we must do it for the lowest possible cost so that we don't create a long-term fiscal burden on taxpayers.

It is important to recognize that there are not just the direct costs but, more importantly, long-term costs to the economy and financial system. The direct cost of resolving a failed bank, such as the government bearing some of a failed bank's losses, is simple to determine. However, it is much more difficult to know the costs from some of the unintended consequences. For example, market discipline is reduced when a resolution process does not make management, shareholders and creditors bear the costs of their actions.

The third principle is equity of treatment. Regardless of an institution's size, complexity or location, the resolution process must provide consistent treatment of a failing institution's owners, managers, employees and customers. The process must be transparent and clearly stated so that everyone understands what to expect if they gamble with the firm's assets.

When talking about equity of treatment, it is important to recognize that a single process can lead to different outcomes. For example, if any bank is examined and found to be insolvent, it needs to go through the resolution process with the owners losing their investment. However, the eventual outcomes for the institution can be different. A smaller bank's assets and deposits will likely be sold to another bank. In the case of a larger bank, the firm might be temporarily operated as a bridge bank before either being sold or reprivatized. Regardless, it is important that the banks go through the same process or else an incentive will be created for banks to take on excessive risks in an effort to grow large enough to gain favorable treatment.

A final principle is that we must base the resolution process on facts about what works and what does not work. One way to do this is to look at past financial crises. This is not the first

financial crisis, and we can learn a lot about what will and will not be successful by looking back at our own history with financial crises, as well as at the experiences in other countries.

Identifying the Problem

With these principles in mind, how should we go about resolving the current problems at our largest institutions?

First, we must determine both the location and size of the losses. Admittedly, it will not be easy. These firms are very large – the four largest bank holding companies each have more than $1 trillion of assets, which accounts for about half of the banking industry's assets. They have offices around the world, and they are involved in many complex businesses. But in order to repair the financial system, we must get the best estimates of the condition and viability of these firms, and we must require them to reflect their losses in their financial statements.

Normally, we think of a business' solvency in terms of the value of its equity capital. When the value of its assets is less than the value of its liabilities, it has negative equity and it has failed. A financial firm, however, can also fail if its liquidity is insufficient to meet its current payment obligations, either because it can't sell its assets for enough to pay off maturing liabilities, or it loses market confidence and cannot borrow enough.

I would note that these are concrete definitions and not subjective conditions. I mention this because it points out that the term "too big to fail" is a misstatement. It does not matter what size the firm is. Although a bank might still be open and operating, if it is insolvent by these definitions, it has failed.

Once we determine a bank's status, we would classify these institutions into three categories, depending on whether they are solvent and what their prospects are for continuing as an ongoing concern.

The first category would be firms whose operations are strong and whose equity remains above minimum requirements. These firms would not require much government support, if any. Some might need to raise additional capital to provide a greater cushion against the losses they may suffer during the current crisis. But these institutions are basically sound and should be able to raise private capital.

The second category would be those institutions whose equity temporarily falls below minimum requirements but are expected to recover in a reasonable period of time as economic conditions improve. These firms have generally sound management, who may have made some mistakes and suffered greater losses than normal due to the economic downturn. It is reasonable to expect these banks to raise additional private capital. However, the government may need to provide some capital in the form of preferred shares and possibly some warrants in return. As an equity holder, the government would have an oversight role regarding the firms' operations and activities.

The final category is for the institutions that are no longer viable either because of liquidity problems or their equity capital is currently negative or it is likely to become negative, based on reasonable expectations of future market and economic conditions. These firms, which would likely soon become equity insolvent without government protections and guarantees, would be declared insolvent by the regulatory authority. Shareholders would be forced to bear the full cost of the positions they have taken and risk losing their investment. Senior management and the board of directors would be replaced because they are responsible for the failed strategy.

A Resolution Process

The question then becomes how to resolve these failed institutions while minimizing the cost and disruption to the economy.

The method most often used when a bank fails is to arrange for a sale of its assets and an assumption of its liabilities by another institution. For these extremely large firms, there are a couple of significant roadblocks preventing this solution. First, the acquiring firm must have the capacity for the acquisition, which means it would have to be in the same size range as the failed institution. And secondly, if such a deal was forged, it would create an even larger firm with greater systemic risks to the economy.

Instead, an extremely large firm that has failed would have to be temporarily operated as a conservatorship or a bridge organization and then reprivatized as quickly as is economically feasible. We cannot simply add more capital without a change in the firm's ownership and management and expect different outcomes in the future.

Experience shows that this approach has worked. The best example was with the failure of Continental Illinois National Bank and its holding company in 1984. Because we are in Oklahoma today, I will note that Continental's problems began with some bad loans it purchased from Oklahoma City's Penn Square Bank. As an officer in our Bank's regulatory function at that time, I was directly involved in the closing of Penn Square. In fact, from 1982 to 1992, 347 banks failed or received FDIC assistance in the Tenth Federal Reserve District states. I was involved in almost every one of these resolutions and all were tragedies. I tell you this to make clear that I do not take this proposal lightly nor do I expect any size bank failure to be easy or

painless. But the process that worked for Continental Illinois is a viable approach to addressing important aspects of today's crisis.

At the time of its failure, Continental Illinois had $40 billion in assets and was the nation's largest commercial and industrial lender. It was the seventh- largest bank in the United States. It had 57 offices in 14 states and 29 foreign countries, a large network of domestic and international correspondent relationships, and a separate function for making residential and commercial real estate loans. It also provided specialized services to a variety of companies.

When Continental failed, its top management and directors were replaced with individuals who had experience operating large, complex organizations. John Swearingen, former chairman of Standard Oil of Indiana, became CEO of the holding company, and William Ogden, a former vice chairman of Chase Manhattan Bank, became CEO.

The FDIC committed to taking a book value of $4.5 billion of bad assets off of Continental's balance sheet and placed them in a separate work-out unit to recover as much of the value of the assets as possible. Among those bad assets, $1 billion was written off as a loss at the time of the transaction.

To offset the $1 billion loss to Continental's capital, the FDIC provided $1 billion in capital in exchange for preferred stock, of which $720 million was convertible to common stock upon sale. When converted, the $720 million would amount to a 79.9 percent ownership stake in Continental.

The FDIC also received five-year warrants to purchase the remaining common stock for far below one cent per share ($0.00001). If at the end of five years, the cost of the resolution was more than $800 million, the FDIC would exercise 100 percent of the warrants; if losses were lower, the amount of warrants exercised would be in proportion to the amount of the losses.

To economize on FDIC staff and to provide additional expertise, the loan liquidation unit was staffed by a combination of FDIC personnel, hired specialists and Continental employees under incentive contracts.

Continental Illinois was fully reprivatized by 1991 and eventually purchased by Bank of America in 1994. The FDIC exercised all of the warrants so the shareholders in Continental's holding company effectively lost their entire investment. The FDIC sold all of the preferred shares and shares from exercising the warrants for $1.2 billion, which was a net gain of $200 million. The FDIC also earned $200 million in dividends. The ultimate resolution cost to the FDIC was $1.1 billion, which was 3.28 percent of Continental's assets at the time of resolution.

There has been much talk lately about a new resolution process for systemically important firms that Congress could enact, and I would encourage this be implemented as quickly as possible, but we do not have to wait for new authority. We can act immediately, using essentially the same steps we used for Continental.

Stock could be issued and control assumed by a government entity. A bridge institution could be created within the institution so essential services and operations would continue as normal. Where necessary, the government would provide capital in exchange for preferred shares convertible to common stock upon sale. Existing shareholders would provide the government warrants to purchase all outstanding shares with the amount exercised determined by the government's resolution cost. Senior management and directors would be replaced.

The most difficult part of resolving these large firms without a new resolution process is how to make creditors bear the cost of their positions. Ideally, when a firm fails, all existing obligations would be addressed and dealt with according to the covenants and contractual priorities set up for each type of debt. Insured creditors would have immediate access to their

funds, while other creditors would have immediate access to maturing funds with the potential for haircuts, depending on expected recoveries, any collateral protection and likely market impact. However, this is difficult because it would require negotiating with groups of creditors, unless there's a process that allows regulatory authorities to declare a nonbank financial firm insolvent.

Regardless of how the firm is resolved, short-term liabilities in particular would need to be addressed immediately because of their importance in meeting the creditors' daily payment obligations and operational needs. Quick decisions should also be made on all counterparty arrangements because of the widespread impact that uncertainty would have on the counterparties.

Authorities would also need to assess the market impact – specifically, whether the losses associated with this outcome would lead to a loss of confidence in financial markets and serious funding problems that would threaten the viability of other financial firms. If so, it may be necessary to honor all counterparty arrangements and/or short-term liabilities, as we did with Continental Illinois.

However, this guarantee must be considered as an exception to the normal process. Congress would have to enact an approval process similar to the systemic exception for banks as specified in the 1991 FDIC Improvement Act, requiring approval by two-thirds of the Federal Reserve Board, two-thirds of the FDIC Board and the secretary of the Treasury, in consultation with the president.

As much as I dislike extending government guarantees and thereby reducing market discipline, if we were to implement this exception, I believe we would also need to extend the

same guarantees to all other institutions or we would give failed institutions a competitive advantage.

Another key part of the resolution is that the bad assets need to be taken off the balance sheet of the failed institution at realistic market values and placed in an asset management company, resulting in two entities often referred to as a "good bank" and "bad bank." Alternatively, the FDIC or Treasury as the receiver could take the bad assets and work them out. After writing off the bad assets, the government would provide the "good bank" with enough capital so that it can become a profitable ongoing concern and attractive to private investors for reprivatization. Any recoveries from the bad bank would first go toward paying off the costs of the government, and any proceeds left over would be distributed according to the priority of remaining claimants.

The separation of the bad assets is critical. When a bank has a large share of nonperforming assets, they remain a burden when they are left on the balance sheet, even if they are written down appropriately. For example, they must be funded although they are not producing income. Such a circumstance creates uncertainty about the bank's financial condition and diverts management's attention from the business objectives necessary for recovery. The focus of the "good bank" must be on the future, gaining new customers and expanding operations, while the goal of the "bad bank" must be on getting rid of customers and winding down the operations.

As part of the reprivatization process, it is also important to determine the advisability of breaking up or selling off operations and independent subsidiaries where possible, especially given the market discipline problems we have encountered with institutions regarded as "too big to fail." Moreover, assessing the condition and viability of large, complex financial firms is

difficult, and the failure of such a firm may be an indication that it is also too large and complex to manage well. We should avoid setting conditions that only repeat past mistakes in creating too big and too complex an institution.

This system is clearly more equitable than what we have seen so far.

At the start of the TARP I program, $125 billion was provided to the nine largest financial firms without an in-depth, thorough exam of their condition. However, all other banks received TARP funds only if their primary regulator concluded they were strong enough to weather the crisis and continue as an ongoing concern.

The $10 per share that Bear Stearns' stockholders received from the JPMorgan Chase acquisition would not have been possible without the government's guarantee of $29 billion of problem assets. Additionally, the government has committed $173 billion to support AIG's continued operations, with their shareholders standing to reap financial gain if AIG ultimately recovers.

Meanwhile, 46 banks in the United States have failed since the beginning of 2008. All of them were resolved through one of the bank resolution problems I have discussed here today.

How Do We Know the Resolution Process Will Work?

It is understandable that there are concerns about letting these large firms fail, but it should be noted that the program I have just described has a record of success elsewhere.

The economic situation in Sweden in the early 1990s was similar to that in the United States today. Its financial system was dominated by six large banks that accounted for 90 percent of the industry's assets. Sweden took decisive steps to identify losses in its major financial institutions. The viable Swedish banks were soon recapitalized, largely through

private sources, and public authorities quickly took over two large insolvent banks and spun off their bad assets to be managed within a separate entity. Sweden was able to systematically restore confidence in its financial system, and although it took several years to work down and sell off all of the bad assets, there was minimal net cost to the taxpayers.

Some argue that the Swedish situation is not a valid comparison because it dealt with only six banks. In addition, some argue that the Swedish system was much less complex, and that the Swedish government had to work out primarily commercial real estate loans instead of the complex financial assets, structured securities and derivatives that we would have to work out today.

These are valid concerns, but I would point out, first, that although the United States has several thousand banks, only 19 have more than $100 billion of assets, and that after supervisory authorities evaluate their condition, it is likely that few would require further government intervention. Second, as for complexity, I would point out that real estate assets involve considerable complexity, no less so than many financial derivatives.

Another important example is the Reconstruction Finance Corporation (RFC), which was used to deal with banking problems in the United States in the 1930s. The RFC followed a process very similar to what I have described. It began by examining problem banks and writing down the bad assets to realistic economic values, making any needed and appropriate changes in bank management, injecting public equity as needed into these banks, and returning the banks to private ownership. The RFC proved to be highly successful in recapitalizing banks, and like Sweden, there was essentially no net cost to taxpayers. More detailed information on both the Continental Illinois and Swedish models for large bank resolution will be posted today with a text of my remarks on our Bank's website at KansasCityFed.org. Absent a detailed explanation

of why this approach can't be done, it is my hope that it will be useful to provide more details around my view that it can be done.

Let me make two final points.

First, the debate over the resolution of the largest financial firms is often sensationalized because it is framed in terms of nationalizing failed institutions. It is also pointed out that government officials may not be effective managers of private business concerns.

In response, I would note that no firm would be nationalized in this program. Nationalization is the process of the government taking over a going concern with the intent of operating it. Though a bridge institution is the most likely outcome when a large financial firm fails, the goal is for the firm to be reprivatized as quickly as possible. In addition, subject to regulatory agency oversight, the bridge firm would be managed by private sector managers selected for their experience in operating well-run, large, complex organizations.

The second point is related to the complexity issue, which is that it would be hard to find enough people with the required knowledge, experience and skills to fill the open positions. Going back to the Continental Illinois example, we were able to do it then. More generally: The United States is a vast country with a tremendous amount of management resources in a broad-based economic and industrial system. If the United States does not have the talent to run these firms, then we are much worse off than I thought. I refuse to accept that conclusion.