

Policy Analysis

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Bright Lines and Bailouts *To Bail or Not To Bail, That Is the Question*

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Executive Summary

A financial-institution bailout involves government intervention through a transaction or forbearance targeted to a financial institution or group of financial institutions. The action is preemptive as the financial institution does not fail and go out of business, but remains a going concern, benefiting creditors, shareholders, or counterparties. In the absence of a bailout, the financial institution would either be forced to go through receivership or bankruptcy in the prescribed legal form, or have its role in financial intermediation disrupted.

Financial-institution bailout policy in the United States is implemented through three agencies: the Federal Deposit Insurance Corporation, the Federal Reserve, and the Treasury Department. The need for orderly financial dealings, particularly in times of crisis, would dictate a consistent approach by these agencies based on cumulative experience, ensuring that officials devote public resources only where there is a well-defined, transparent, and verifiable policy justification for a bailout. Yet the bailouts over the past year do not reflect a well-defined, transparent, and verifiable policy justification. Even in the cases where a stan-

dard has been articulated, the agencies have not demonstrated that they can successfully implement that standard in practice.

Beyond the inconsistencies and implementation problems, financial-institution bailout policy has been unwieldy, inequitable, extremely costly, disruptive, and lacking in transparency and oversight. The policy response of bailouts and maintenance of the status quo has been precisely the wrong response, as it has led to retaining many of the mega-financial institutions that pose systemic risk, thus planting the seeds for future crises.

This present crisis has demonstrated that undertaking bailouts of troubled institutions, which involves structuring transactions that attempt to transform the institution into a viable one, while simultaneously projecting the reaction of investors and markets, is a process for which government is ill-suited. These bailout powers should be revoked. Financial angst still hangs over the system as the underlying imbalances that led to the crisis have not been reconciled. The ultimate answer is to place troubled institutions into receivership or the relevant form of bankruptcy—including many of the institutions that have already been bailed out.

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Introduction

Is there any reason why the American people should be taxed to guarantee the debts of banks, any more than they should be taxed to guarantee the debts of other institutions, including the merchants, the industries, and the mills of the country?¹

You can't legislate recovery.²

There has been a long history of financial-institution bailouts in the United States dating back to the first treasury secretary, Alexander Hamilton.³ The most recent interventions have added to the many approaches that have been used to address financial-sector stress. Policymakers have held out a rule that poorly managed institutions that are threatened with extinction should exit the financial system. Yet they have always created ad hoc exceptions to this rule as well. The need for orderly financial dealings, particularly in times of crisis, would dictate a consistent approach based on cumulative experience, ensuring that officials devote public resources only where there is a well-defined, transparent, and verifiable policy justification for a bailout.

Yet today's bailouts do not reflect a well-defined, transparent, and verifiable policy justification. As we set forth in the examples throughout this analysis, the chairman of the Board of Governors of the Federal Reserve, the secretary of the treasury, the chairman of the Federal Deposit Insurance Corporation, and their supporting officials have not articulated a clear, bright-line rule to determine whether to bail out a given financial institution. This is not to say that such a bright-line rule could not be found through an examination of the recent bailouts, but merely that leadership of these agencies has not yet publicly provided one. Further, the standard for intervention should not simply be that the failure of an institution will impose losses on a broad array of creditors, shareholders, and counterparties, or that it will present a challenging or difficult receivership

or bankruptcy process to work through. Even if a standard can be articulated, it is another matter to successfully implement that standard in practice. We believe that the lack of a clear standard and the shifting efforts at implementation have exacerbated the current financial turmoil by sending confusing and inconsistent signals to market participants.

The question for analysis is whether it is appropriate to bail out financial institutions, and if so whether a bright-line rule can be developed and implemented that outlines the circumstances in which a bailout is appropriate. As part of our analysis of bailouts of financial institutions, we will first need to define what is meant by the term "bailout" and then fit the most recent string of interventions into the historical context. Once we review the historical examples, we will determine if the use of bailouts has been consistent over time and if the lessons of earlier periods were recognized and incorporated into the current approaches or ignored. Then we will turn to developing an appropriate standard. Through our observations and analysis, we hope to provide guidance as financial turmoil continues under the Obama administration and as these issues are revisited in contemplated legal reforms for the U.S. financial sector.

Definition of Bailout

For purposes of this analysis, we define a bailout of a financial institution as possessing the following elements:

- Government intervention through lending, equity injection, purchase of assets, assisted takeover, loan guarantee, or other tangible benefit, or inaction through regulatory forbearance for a financial institution or group of financial institutions. In the case of a transaction, the repayment of funds extended must be at risk, either because it is not fully collateralized or otherwise fully protected.
- The action taken is preemptive, in that the financial institution benefiting from

intervention does not fail and go out of business through revocation of an operating charter and placement into FDIC receivership (commercial banks) or bankruptcy (noncommercial banks), but remains a going concern, thus benefiting creditors, shareholders, or counterparties of the financial institution.

- In the absence of a bailout, the financial institution would either be forced to go through receivership or bankruptcy in the prescribed legal form, or have its role in financial intermediation disrupted.

Based on this definition, recent examples of financial-institution bailouts would include the Federal Deposit Insurance Corporation's bailout of Continental Illinois in 1984 and Citigroup in 2008; the Federal Reserve's bailout of Bear Stearns and American International Group; and the Treasury's Troubled Asset Relief Program and bailouts of Fannie Mae and Freddie Mac. Under this definition, transactions that would not be considered bailouts would be the FDIC's purchase-and-assumption or payoff transactions, in which a troubled institution does not remain a going concern. Additionally, the exercise of the Federal Reserve's lender-of-last-resort powers would not be considered a bailout as these loans are traditionally fully collateralized.⁴ Interestingly enough, the so-called "savings and loan bailout" of the 1980s and 1990s, which involved the creation of the Resolution Trust Corporation, would not be a financial-institution bailout under this definition, as the transactions were structured to eliminate the institutions as going concerns.

Historical Analysis of Structure of Bailouts, Great Depression to 2007

A historical review of the major financial crises during the past 80 years is vital to an understanding of how the system is currently structured, as the influence of these crises molded the mandated responses to the challenges of contagion, access to credit, resolu-

tion of troubled institutions, and financial instability.

Depression-era Banking Crisis

The Depression and the changes that flowed from it brought us our modern banking system. The number of banks in the United States grew rapidly from 1887 to 1921, increasing from about 5,000 to 30,000—an environment most observers of the sector would describe as overbanked.⁵ Throughout the 1920s, the number of failures began to rise. By 1930, what followed was a series of crises involving bank failures that brought the number of banks rapidly down to 15,000 by 1934. No less a pair of observers than Nobel-prize-winner Milton Friedman and Anna Jacobson Schwartz of the National Bureau of Economic Research described the first crisis in 1930 as:

[a] contagion of fear spread among depositors, starting from the agricultural areas, which had experienced the heaviest impact of bank failures in the twenties. But such contagion knows no geographical limits. The failure of 256 banks with \$180 million of deposits in November 1930 was followed by the failure of 352 with over \$370 million of deposits in December, . . . the most dramatic being the failure on December 11 of the Bank of United States with over \$200 million of deposits. That failure was of especial importance. The Bank of United States was the largest commercial bank, as measured by volume of deposits, ever to have failed to that time in U.S. history.⁶

The term "contagion" refers to a state in the financial industry whereby a seemingly irrational negative cascading effect causes financial institution failures regardless of the institution's actual condition. As Senator Carter Glass explained during the deliberations on deposit insurance in 1933, "when weak banks begin to topple there takes place a disastrous psychology in the whole country that precipitates runs on strong banks that

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break them down.”⁷ In the commercial banking context, this comes about when depositors believe (whether correctly or not), that their bank is in financial trouble based on news of problems at other institutions, and withdraw their funds precipitously, causing widespread panic or a liquidity crisis in several banks.⁸ There is some dispute as to whether contagion is an accurate description of the circumstances at the time of the Depression, but as noted in the comments of Senator Glass, it was largely accepted at the time—and has been by many since then—as the cause of a large number of banking failures.⁹

The Reconstruction Finance Corporation, which was proposed in 1932 by the Hoover administration, was leveraged as a means to bail out institutions in response to the fears of financial contagion during the Depression. One of its primary functions was to serve as an emergency financial institution for the purpose of making loans to and investments in troubled financial institutions. Initially, the RFC focused on making low-interest loans totaling nearly \$1 billion to financial institutions. When that proved largely ineffective, in 1933 the RFC transitioned to making investments in preferred capital stock notes of troubled financial institutions. Ultimately it invested about \$1 billion in over 6,000 banks. These capital injections allowed many of the institutions to meet the capital standards for the newly created FDIC insurance.¹⁰

FDIC Open-Bank Assistance

The Long-Standing Bailout Tool. The FDIC has a number of options under law regarding failing financial institutions. The institution can be addressed on a closed-bank basis, whereby it is put through a specialized process that is analogous to bankruptcy but tailored to banks, and is not bailed out. This can be in the form of an insured deposit payoff, where the institution is closed and placed into a receivership with the FDIC paying depositors the insured portion of their deposits. There is also the purchase-and-assumption (P&A) transaction where the institution is closed and an acquiring institution selected in a competitive bid process purchases

all or a portion of the assets and assumes all or a portion of the liabilities. During 2008, Washington Mutual Bank and IndyMac Bank, FSB, two large insured-thrift institutions, were resolved through closed-bank means respectively by P&A and bridge bank, a form of P&A reserved for larger banks.¹¹ In a P&A, any assets not purchased go into receivership.

Alternatively, the FDIC's open-bank assistance program (OBA) involves a bailout through the provision of financial assistance to insured depository institutions, thus avoiding closure or failure of the bank. OBA was largely modeled after the RFC.¹² It has been the most sustained and heavily relied-upon of the financial-institution bailout programs of the U.S. government. This grant of power currently authorizes the FDIC to make loans to, make deposits in, purchase the assets or securities of, assume the liabilities of, or make contributions to any insured depository institution.¹³ Depending upon how it is structured, OBA would also tend to benefit creditors, shareholders, and counterparties of the institution by avoiding some of the losses imposed in an FDIC receivership.

The OBA power was originally granted to FDIC in 1950, but was limited to instances where the continued operation of the bank receiving assistance was, in the opinion of the Board of Directors of the FDIC, essential to provide adequate banking service in the community.¹⁴ As OBA has evolved, it has primarily been used to resolve insolvent institutions or those likely to fail, as contrasted with the Federal Reserve's lender-of-last-resort authority, which has traditionally been used for illiquid institutions (Table 1).¹⁵

In large part because of the essentiality restriction, only a handful of banks received OBA during its initial three decades in use.¹⁶ The essentiality test was replaced as the basis for determining whether OBA can be granted with the passage of the Garn–St. Germain Act of 1982. In its place was a requirement that severe financial conditions threaten the stability of a number of banks or of banks with significant financial resources.¹⁷ This lower requirement expanded the FDIC's scope for applying OBA.

Table 1
Federal Reserve Lender of Last Resort vs. FDIC Open-Bank Assistance

Characteristics of Transactions	Federal Reserve Lender of Last Resort	FDIC Open-Bank Assistance
Financial state of problem institution	Illiquid	Equity insolvent
Duration of assistance	Short-term	Long-term/permanent
Form of assistance	Loan fully collateralized	Loan Capital injection Deposit Asset purchase
Simplicity	Simple, secured lending transaction	Complex with requirements/restrictions over many years
Equity and shareholder impact	None	Significant or complete dilution

Source: Federal Reserve Act, Federal Deposit Insurance Act, authors' analysis.

Table 2
FDIC Open-Bank Assistance Transactions Completed, 1950 to Present

Years	OBA Transactions
1950–1981	8
1982–1992	129
1993–2007	0
2008–2009	2

Source: FDIC, *Managing the Crisis: The FDIC and RTC Experience*, p. 153

If, however, OBA was a costlier option than liquidation, then the essentiality test was still applied.¹⁸ The broadening of the OBA authority, combined with the ensuing banking crisis, resulted in the FDIC dramatically increasing its reliance on OBA (see Table 2).¹⁹

Continental Illinois National Bank and Trust—Too Big to Fail (1984). The best-known OBA transaction was the bailout of Continental Illinois, which was also the FDIC's largest bank resolved prior to 2008. At the time of its resolution, Continental Illinois was the seventh-largest bank in the country with approximately \$40 billion in assets.

During the mid-1970s, Continental's management employed a strategy of rapid growth. From 1976 to 1981, on the asset side, Continen-

tal's commercial and industrial lending grew by 180 percent, a large amount of which was purchased from Penn Square Bank of Oklahoma, which failed in 1982. Over this same period, total assets grew by 110 percent, a level that far outstripped growth at the other largest banks in the country.²⁰ On the funding side, Continental began to rely less on stable core deposits and more on volatile and riskier short-term liabilities, including interbank liabilities and large certificates of deposit. Continental's stock value boomed during this time, from \$13 at the end of 1974 to its peak at \$42 in 1981, a time when most bank stocks did not move very much at all. After Penn Square's failure, Continental began to unravel. Many of the problems in its loan portfolio came to light, and the cost of funding

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its short-term liabilities, which because of their nature repriced quickly, began to rise dramatically. Much of the funding was being provided in the foreign money market. As Continental deteriorated, these sources began to flee, triggering a bank run that ultimately led to the FDIC's OBA package in May 1984. The bank was nationalized, based on the essentiality clause.²¹

As summarized by a former board member of the FDIC, the real reason for the bailout (and others like it) was that "simply put, we were afraid not to."²² The FDIC used OBA because it feared that closing the institution would cause an adverse ripple effect throughout the banking system. The FDIC estimated that 66 banks had more than 100 percent and 113 banks had between 50 percent and 100 percent of their equity capital invested in Continental. A number of those banks would have likely failed if Continental had been closed outright.²³ Unlike under current law, the FDIC did not have the authority to resolve Continental through a bridge bank, as that authority was not granted until the Competitive Equality Banking Act of 1987. All uninsured depositors and non-deposit creditors were covered in the transaction. That bailout of creditors contrasted sharply with the case of many smaller bank failures during that period, in which those outside of the deposit-insurance limit, or debt-holders in priority behind depositors, were not always covered. Top management and the board of directors of Continental were removed. The FDIC infused capital through acquisition of preferred stock in Continental Illinois Corporation. The ultimate cost to the FDIC was approximately \$1.1 billion.²⁴ The resolution of Continental was one of the clearest cases of the bank resolution doctrine known as "too big to fail."

Changes to OBA in the Federal Deposit Insurance Corporation Improvement Act (FDICIA). Heavy reliance on OBA in the 1980s and early 1990s produced a call for an extensive reexamination of the use of this resolution option, which was chosen instead of closing banks outright.²⁵ Although the use of OBA gives the FDIC another resolution option and may minimize disruption to the community, it blurs the concept of a clear exit policy whereby poorly managed insti-

tutions are taken out of the financial system. This is because OBA:²⁶

- was primarily used to resolve larger institutions, so owners and creditors of smaller institutions resented the lack of a level playing field;
- allowed weak institutions to remain open and compete with non-assisted institutions;
- increased moral hazard, because if a bank believes it will be bailed out when it gets into trouble, it will take on more risk than if OBA is not available;
- often benefited shareholders and uninsured creditors of the institution over a closed-bank approach, thus reducing market discipline;
- may be more costly than envisioned if projections are optimistic, losses are recurring, and a closed-bank transaction is ultimately needed, resulting in a long and difficult process for completing the transaction;²⁷ and
- was twinned with significant tax benefits to acquirers at a cost to taxpayers that appeared to exceed any financial benefit received by the government.

Those consequences flow in part from the fact that regulators of financial institutions respond to incentives:

Regulators face perverse incentives to forbear and extend the federal safety net. Forbearance means failing to take timely and appropriate action to reduce the risk an unhealthy institution poses to the deposit insurance fund (e.g., by limiting dividends, restricting excessive risk-taking, or requiring recapitalization). By overextending the safety net, I mean needlessly shielding an insured depository institution from market discipline (whether by treating the institution as too big to fail or using Federal Reserve discount-window loans to keep it open when it is economically insolvent). . . . The 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. . . . Perverse incentives similar to those fostering forbearance encourage regulators to overextend the Federal safety net. By assuming risks better left to private parties the government heightens moral hazard and the potential for future instability. But those costs are long-term and diffuse, and appear in no reckoning of the government's obligations. Extending the safety net confers immediate benefits concentrated in large financial institutions.²⁸

In other words, choosing a bailout is often the easy, quick-fix option for regulators, but the choice causes long-term damage. If pressed in the future to justify their action, they can predictably respond that the situation would have been worse without their intervention.

Given the flaws in OBA, Congress re-examined its use as part of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA),²⁹ and took particular aim at the doctrine of "too big to fail":

The provisions of this legislation that require regulators to take action before a bank becomes insolvent, and then to resolve failed institutions at the least possible cost, would eliminate the "too big to fail" policy that is currently being followed by the FDIC. Since large banks are not necessarily healthier than their smaller counterparts, the Committee believes the FDIC should not use insurance funds to keep them open simply because of their size. . . . The current cost test contains an exception where the FDIC "determines that the continued operation of such insured depository institution is essential to provide adequate depository services in the community." The FDIC has cited this clause as the legal basis for its too-big-to-fail policy. The Committee deliberately deleted this clause and strongly intends that the too-big-to-fail policy is hereby abolished.³⁰

Since FDICIA, the FDIC may undertake OBA if it is the least-cost method or if it meets the systemic-risk exception, which allows OBA only in circumscribed cases.³¹ To invoke the systemic-risk exception requires agreement that applying a least-cost test would have "serious adverse effects on economic conditions or financial stability." The discretion as to when to consider invoking this exception is left to the FDIC. However, if a resolution is not the least-cost approach, the intent of the Congress was to make it very difficult to undertake an OBA transaction except in "those rare instances in which the failure of an institution could threaten the entire financial system."³² The latter determination has to have the agreement of two-thirds of the FDIC Board of Directors, two-thirds of the Board of Governors of the Federal Reserve, and the secretary of the treasury in consultation with the president.³³ Additionally, the secretary of the treasury must document the determination and the Government Accountability Office must review the decision and report to Congress on the basis, purpose, and likely effect of the decision.³⁴

The overall direction of the changes codified under FDICIA was to restrict the use of the federal financial safety net and the discretion of the FDIC. However, there was one exception to that general principle, as under FDICIA there was an amendment to Section 13(3) of the Federal Reserve Act and the power to lend under "unusual and exigent circumstances" to "any individual, partnership or corporation" when it "is unable to secure adequate credit accommodations from other banking institutions."³⁵ This change, which was inserted by Sen. Christopher Dodd (D-CT), was adopted without extensive discussion or debate, but the intention was to allow fully secured, Federal Reserve lending to securities firms in the aftermath of the 1987 stock market crash.³⁶

Other Forms of 1980s Bank Bailouts— Forbearance

Part of the financial-sector turmoil during this period was due to the many structural changes in the economy and how banks operated. For example, there was a transition from a

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heavily regulated environment of limits on interest rates paid on bank deposits (Regulation Q) to a more liberalized environment where banks had to pay more of a market rate for deposits. Additionally, farm-sector problems placed stress on financial institutions. Forbearance was used to get institutions through a difficult period that some argue was caused by circumstances beyond the banks' control. For this reason, management was generally left in place.³⁷ The primary forbearance programs were the net worth certificate program,³⁸ capital forbearance program,³⁹ and income maintenance agreements.⁴⁰

Forbearance ultimately increased the cost of the savings and loan crisis because action on closing institutions was deferred. In some cases, institutions were ultimately resolved at greater costs than if they had been closed initially, before forbearance was granted. Given this fact, many have discredited the use of forbearance.⁴¹

Fannie Mae Bailout during the Early 1980s

During the 1970s, Fannie Mae was able to leverage its low cost of funds, which resulted from its status as a government-sponsored enterprise, to maintain profitability. GSEs are quasi-government entities that are privately owned, but possess certain powers or exemptions that are intended to encourage select economic activity and have the implied backing of the U.S. government.⁴² For example, Fannie Mae and Freddie Mac, the mortgage GSEs, were created to encourage mortgage lending. Consistent with its mission, Fannie Mae borrowed short term in the debt market and used the funds to purchase long-term mortgages. Starting in 1979, short-term borrowing costs rose dramatically and, by 1981, Fannie Mae had a negative market-value net worth of \$10.8 billion.⁴³ In response, the federal government provided limited tax relief and regulatory forbearance in the form of relaxed capital requirements, without making dramatic changes in management.⁴⁴ Freddie Mac, which held relatively fewer of its mortgages in portfolio, did not experience the same financial difficulties as Fannie Mae.

Farm Credit System—Too Populist to Fail (1987)

Another area of credit turmoil during the 1980s was the Farm Credit System, which, like Fannie Mae and Freddie Mac, is a GSE. It faced problems brought on by the farm price bubble that was inflated during the 1970s, in part through the lending programs and encouragement of the Farm Credit System. When the bubble burst, prices dropped by over 50 percent from 1981 to 1986 in many agricultural states such as Iowa, Nebraska, and Minnesota. The Agricultural Credit Act of 1987 created the Farm Credit System Financial Assistance Corporation, which was authorized to issue up to \$4 billion of taxpayer-funded bonds to provide capital assistance to Farm Credit System institutions weakened by losses arising from collapsing farmland prices. Bonds totaling \$1.261 billion were issued with 15-year maturities.⁴⁵ The legislation was justified based on the “continuing depression in agriculture that began in the early 1980s, but whose costs originated in the inflationary period in the late 1960s and 1970s.”⁴⁶

The State of Bailouts and Banking Circa 1991

In the early 1990s, the banking system in the United States was in its worst shape since the 1930s. Some 1,150 commercial and savings banks had failed since year-end 1983, almost double the number of failures since the introduction of the FDIC in 1934 up through 1983. Another 1,500 banks were on the FDIC's problem-bank list. The thrift industry was in even worse shape. More than 900 savings and loans were resolved or had been placed into conservatorship since 1983, which was a larger percentage of a much smaller industry.⁴⁷ Drexel Burnham Lambert, a large investment bank, collapsed in 1990 without a government bailout.⁴⁸ Beyond Continental Illinois, numerous large banks, including Bank of New England and 9 of the 10 largest banks in Texas (including First Republic Bank and MCorp), as well as large savings and loans, including American Savings and Loan and Gibraltar Savings, still rank among the largest financial-institution resolutions in history. What were

thought to be one-off bailouts were needed for GSEs that served the mortgage and agricultural sectors. Building upon the legal infrastructure largely developed during the Depression Era, the lessons learned from this tumultuous period were leveraged during the deliberations leading up to the FDICIA amendments passed in 1991, awaiting the next financial crisis.

The Current Financial Crisis—Phase I and the Early Bailouts

There was a noticeable lull in the use of bailouts from the early 1990s until early 2008 thanks to the relative tranquility in the financial-services industry during this period. One notable event during the intervening period was the private-sector-led intervention of hedge fund Long Term Capital Management in 1998, a process to which the Federal Reserve Bank of New York provided input.⁴⁹

Probably the most dramatic difference between the prior crises and the current one has been the short timeframe of the current crisis. Whereas previous financial crises took a decade or more to unfold, the current one has developed over a period of months, and much of it even over a matter of weeks. Additionally, differences in the complexity of underlying collateral values caused greater uncertainty and made more challenging the process of applying bright-line rules between illiquid banks in need of short-term lending and insolvent banks in need of assistance.

Bear Stearns—Too Unusual/Exigent/ Interconnected to Fail (March 2008)

Bear Stearns' difficulties in early 2008 stemmed from its involvement in the subprime-mortgage market. Along with Lehman Brothers, it led the way in subprime-mortgage lending and securitizations of these loans into bonds salable to other end investors. Between 2001 and 2008, a number of Wall Street firms began purchasing billions of dollars of subprime loans. In most cases, these were bought from nonbank mortgage companies, which borrowed money

from firms like Lehman Brothers and Bear Stearns in order to make loans and quickly resell them. Lehman Brothers and Bear Stearns were major players in the subprime market, extending funding in the form of warehouse lines of credit to nonbank lenders, buying the mortgage products, turning them into mortgage-related securities, and then selling these bonds to end investors like insurance companies, pension funds, local governments, and foreign banks.⁵⁰

As explained by Federal Reserve Chairman Ben S. Bernanke, the collapse of Bear Stearns came about because of a "run" by its creditors and customers, analogous to a run by depositors on a commercial bank. The underlying problem was the falling prices of mortgage-related securities, requiring Bear Stearns to mark down the value of those securities and post collateral against credit-default swaps it had issued. Despite the fact that Bear Stearns' borrowings were mostly secured (which should have ensured repayment even if the company itself failed), the illiquidity of markets in mid-March was so severe that creditors lost confidence that they could recoup their loans by selling the collateral. Therefore, they refused to renew their loans and demanded repayment. Bear Stearns' contingency planning had not envisioned a sudden loss of access to secured funding, so it did not have adequate liquidity to meet those demands for repayment. If a sale of the firm could not have been arranged, it would have had to file for bankruptcy. The Federal Reserve, the SEC, and the U.S. Treasury Department all concluded that allowing Bear Stearns to fail so abruptly, at a time when the financial markets were already under considerable stress, would likely have had extremely adverse implications for the financial system and for the broader economy and therefore agreed to bail out Bear Stearns.⁵¹ The bailout consisted of a \$29 billion credit guarantee issued by the Federal Reserve Bank of New York on a non-recourse basis, collateralized by mortgage debt, and a subsequent Federal Reserve-facilitated acquisition of Bear Stearns by the commercial bank JPMorgan Chase. The agreement also calls for JPMorgan Chase to bear the first \$1 billion of any losses associated with Bear Stearns assets.⁵²

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Paulson famously referred to the unlikely use of this power saying: “If you have a bazooka in your pocket and people know it, you probably won’t have to use it.”

Bernanke defended the loans, arguing that a Bear Stearns bankruptcy would have caused a “chaotic unwinding” of investments across the United States.⁵³ Timothy Geithner, then president of the Federal Reserve Bank of New York, supplemented Bernanke’s statement: “In short, we judged that a sudden, disorderly failure would have brought with it unpredictable but severe consequences for the functioning of the broader financial system and the broader economy, with lower equity prices, further downward pressure on home values, and less access to credit for companies and households.”⁵⁴ The minutes of the meeting of the Board of Governors where the decision was made to intervene reveal that “given the fragile condition of the financial markets at the time, the prominent position of Bear Stearns in those markets, and the expected contagion that would result from the immediate failure of Bear Stearns, the best alternative available was to provide temporary emergency financing to Bear Stearns through an arrangement with JPMorgan Chase & Co.”⁵⁵

The legal authority for the Bear Stearns transaction came from the expansion of authority under FDICIA as codified in Section 13(3) of the Federal Reserve Act. That section allows Federal Reserve Banks “in unusual and exigent circumstances,” and when authorized by the Board of Governors of the Federal Reserve System, to discount “for any individual, partnership, or corporation” when it “is unable to secure adequate credit accommodations from other banking institutions.” Prior to its use in the Bear Stearns case, the powers under Section 13(3) had not been used since the Great Depression in 1936, although their use was considered in the case of New York City in 1975, among others. The practical effect of this provision was to shift a portion of the risk of loss from creditors onto the Reserve Banks and indirectly onto the taxpayer. If there is ultimately a loss on the Bear Stearns transaction this would be inconsistent with Senator Dodd’s expressed desire that Section 13(3) loans to securities firms be “fully secured loans.”⁵⁶

Fannie Mae and Freddie Mac—Too Political to Fail (September 2008)

The investment problems of Fannie Mae

in the 1980s flowed from interest-rate risk, but the current investment problems facing the mortgage GSEs flowed from credit risk, as they were hurt by losses in their portfolios of mortgage-related assets. Fannie Mae and Freddie Mac had great stock performance over the decades prior to the subprime crisis and they were labeled “darlings of Wall Street” by some, but they increasingly came under pressure to maintain their high levels of growth in areas beyond their core businesses. As early as the mid 1990s the GSEs began to move into the subprime-mortgage market.⁵⁷ Executives at the GSEs were well aware of the risks that their push into subprime and Alt-A mortgages exposed them to,⁵⁸ but they likely also felt pressure from Congress to push into this market to fulfill affordable-housing goals.

In July 2008, as the condition of the GSEs began to deteriorate, the Housing and Economic Recovery Act of 2008 was signed into law.⁵⁹ This act granted the treasury secretary the power to “purchase any obligations and other securities issued on such terms and conditions as the Secretary may determine and in such amounts as the Secretary may determine.”⁶⁰ Treasury Secretary Henry M. Paulson famously referred to the unlikely use of this power saying: “If you have a bazooka in your pocket and people know it, you probably won’t have to use it.”⁶¹ Before deploying this power, the secretary must first determine that it is “necessary to (i) provide stability to the financial markets; (ii) prevent disruptions in the availability of mortgage finance; and (iii) protect the taxpayer.”⁶² The act also raised the debt ceiling by \$800 billion to \$10.615 trillion.⁶³

By September 2008, as the condition of Fannie Mae and Freddie Mac continued to deteriorate and their stock prices plummeted, the two were placed into conservatorship by the Director of the Federal Housing Finance Agency, the agency responsible for the oversight of Fannie Mae and Freddie Mac.⁶⁴ In a joint announcement with the FHFA Director, Treasury Secretary Paulson appeared to absolve the management of the GSEs when he noted that:

I appreciate the productive cooperation we have received from the boards and the management of both GSEs. I attribute the need for today's action primarily to the inherent conflict and flawed business model embedded in the GSE structure, and to the ongoing housing correction. GSE managements and their Boards are responsible for neither.⁶⁵

Despite that statement, new CEOs supported by new nonexecutive chairmen took over management of the two GSEs. Treasury used its power to purchase obligations and invest up to \$200 billion (\$100 billion for each GSE) in preferred stock, while warrants were issued to Treasury representing an ownership share of 79.9 percent. The preferred stock is particularly important, as pointed out by the FHFA:

The Senior Preferred Stock Purchase Agreements are the cornerstone of the financial support that the U.S. Treasury is providing to Fannie Mae and Freddie Mac. The SPSPAs effectively provide a very long-term federal guarantee to existing and future debt holders. Each SPSA commits the Treasury to purchase up to \$100 billion in senior preferred shares. That commitment protects the credit interests of all holders of the Enterprises' senior and subordinated debt and MBS [mortgage-backed securities].⁶⁶

As of February 2009, there are no plans to place the GSEs under receivership, which would allow for the operations of Fannie Mae and Freddie Mac to be transitioned to fully private entities that would no longer be reliant on any form of government support.⁶⁷

Lehman Brothers—The Bailout That Wasn't (September 2008)

In trying to determine when to bail and when not to bail, it is instructive to look at an example where a troubled institution was not bailed out and failed. In September 2008, Lehman Brothers, the fourth largest investment

bank in the United States, collapsed and filed for Chapter 11 bankruptcy protection. Lehman was also a heavy player in the subprime market, issuing mortgage-related securities and holding on to large positions in subprime and other lower-rated mortgage tranches when securitizing the underlying mortgages.

Federal officials struggled to organize an acquisition or private-sector bailout of Lehman because of fears that a bankruptcy could cause severe problems in the already fragile financial markets. Secretary Paulson maintained that bailing out Lehman Brothers was “never an option,” but assured the public that it could remain confident in the “soundness and resilience” of the financial system. At the same time, Secretary Paulson noted that “we don't take lightly ever putting taxpayers' money on the line to support a financial institution,” though he did not rule out future bailouts of struggling firms.⁶⁸ Julian Jessop, chief international economist at Capital Economics, noted:

The U.S. authorities' unwillingness to underwrite a rescue of Lehman Brothers marks a new phase of the continuing financial crisis. Further casualties look inevitable. Sooner or later the U.S. Treasury and the Fed had to draw the line and the financial sector will eventually be healthier as a result. However, the near-term outlook for the sector and the wider economy remains grim.⁶⁹

Similarly, Gerard Lyons, chief economist at Standard Chartered Bank, said that “the most significant event is the fact that the U.S. authorities signaled that they are not going to step in and protect firms that do not pose a systemic risk.”⁷⁰

In the aftermath of the Lehman Brothers bankruptcy a number of events ensued, many of which are interrelated, beyond the direct impact on Lehman shareholders, creditors, and counterparties:

- The “breaking of the buck” of the Reserve Primary Fund, a money market that

In trying to determine when to bail and when not to bail, it is instructive to look at an example where a troubled institution was not bailed out and failed.

It would be difficult to make a convincing argument that the fallout from a bankruptcy of Bear Stearns would have created more turbulence than Lehman, but that was the apparent conclusion of the Federal Reserve.

invested in Lehman Brothers Holding Inc. debt;⁷¹

- The largest-ever one-day rise in the cost of insurance against bond defaults in the credit-default-swap market;⁷²
- Exacerbation of the cash squeeze at American International Group (see next section);⁷³
- Hedge fund withdrawals at Morgan Stanley and Goldman Sachs;⁷⁴
- A dramatic drop in the level of commercial paper outstanding to levels experienced three years earlier;⁷⁵
- Rates on commercial paper increased upwards of 300 basis points or more for certain nonfinancial firms;⁷⁶ and
- Spreads between LIBOR and T-bill rates ballooned from 100 basis points to over 400 basis points.⁷⁷

It would be difficult to make a convincing argument that the fallout from a bankruptcy of Bear Stearns would have created more turbulence than Lehman, but that was the apparent conclusion of the Federal Reserve when it bailed out Bear Stearns but allowed Lehman Brothers to fail. In congressional testimony, Chairman Bernanke explained the distinction between Lehman and institutions that were bailed out such as Bear Stearns, Fannie Mae, Freddie Mac, and AIG:

Government assistance should be given with the greatest of reluctance and only when the stability of the financial system, and, consequently, the health of the broader economy, is at risk. . . . In the case of Lehman Brothers, a major investment bank, the Federal Reserve and the Treasury declined to commit public funds to support the institution. The failure of Lehman posed risks. But the troubles at Lehman had been well known for some time, and investors clearly recognized—as evidenced, for example, by the high cost of insuring Lehman’s debt in the market for credit default swaps—that the failure of the firm was a significant possibility. Thus,

we judged that investors and counterparties had had time to take precautionary measures.⁷⁸

Bernanke’s congressional testimony says little more than that the decision to let Lehman fail was a judgment call, based on the fact that public investors had known about Lehman’s difficulties for some time. Yet the same can be said of many other institutions. Although many criticize the Lehman decision itself, many more point out that the Lehman case highlights the apparent lack of a decision principle, as the Federal Reserve does not seem to be applying any clear, consistent, or coherent policy supported by detailed reasoning regarding when the bailout of a failing financial firm is appropriate. Market participants had to not only anticipate future government actions, but also price in the costs of the various ongoing government interventions. Moreover, the numbers involved in the Lehman failure are at least as big as those involved in some other cases, as the Lehman bankruptcy will be the largest such filing in U.S. history, covering total assets of more than \$630 billion.⁷⁹ Yet Lehman was allowed to fail, while others were thrown a lifeline. The question is why.

American International Group (AIG)—Too Unusual/Exigent/Interconnected to Fail Part II (September and November 2008)

Former AIG chief executive officer Hank Greenberg aggressively pushed into areas that had little to do with bread-and-butter insurance specialties, like selling life insurance or protecting companies against property losses. AIG experienced a cash squeeze driven in large part by losses in a unit separate from its traditional insurance businesses. That financial-products unit sold the credit-default-swap contracts designed to protect investors against defaults on an array of assets, including mortgage-related securities tied to pools of subprime mortgages. As housing values fell and the subprime-mortgage market crumbled, the value of the contracts dropped sharply, driving \$18 billion in losses over the course of three quarters, forc-

ing AIG to put up billions of dollars in collateral.⁸⁰ Internal models employed by AIG, as well as those of most other financial institutions and ratings agencies, were fatally flawed as to their assumptions regarding the risk of these assets.⁸¹

When credit-rating agencies downgraded AIG debt, these downgrades led to collateral calls of \$14.5 billion.⁸² AIG would have to raise cash by liquidating the underlying collateral securities, many of which were quite illiquid and thus could not be sold quickly, at least not without a huge discount. AIG executives spent the weekend of September 13 and 14 trying to raise cash, either from asset sales, a capital infusion from private-equity firms, or both. They also met with regulators to see if they could transfer capital from some of AIG's subsidiaries to the parent holding company.⁸³

The Federal Reserve Board determined that a disorderly failure of AIG could add to already significant levels of financial market fragility and lead to substantially higher borrowing costs, reduced household wealth, and materially weaker economic performance. The Federal Reserve Bank of New York authorized the creation of a 24-month, credit-liquidity facility which could be drawn upon for up to \$85 billion, with the loan collateralized by all assets of both AIG and its primary unregulated subsidiaries. This is despite the fact that FRBNY does not directly regulate AIG. In exchange, the U.S. government received a 79.9 percent equity interest in AIG along with the right to veto the payment of dividends to common and preferred shareholders.⁸⁴ AIG's chief executive officer was asked to step aside.⁸⁵

The credit facility provided to AIG, as in the case of Bear Stearns, was under the auspices of Section 13(3) of the Federal Reserve Act, even though it was never clear based on the legislative history of FDICIA that insurance firms were intended to be the beneficiaries of such credit.

An additional \$38 billion facility was extended to AIG in October 2008.⁸⁶ The plan came under heavy scrutiny within weeks of the agreement.⁸⁷ In mid-November 2008, the Federal Reserve scrapped the original trans-

action of the combined \$123 billion facility and, working with the Treasury Department, replaced it with a new \$150 billion facility, which included \$40 billion of funds from TARP. The revised structure was intended to improve AIG's ability to sell assets and extend the period for asset sales, but it potentially exposed the government to billions of dollars in future losses. By late February 2009, yet another new structure for the bailout was under consideration.⁸⁸

In contrast to Lehman Brothers, the determination by the Federal Reserve Board was that intervention was necessary in the case of AIG, as again summarized in testimony by Chairman Bernanke:

The Federal Reserve took this action because it judged that, in light of the prevailing market conditions and the size and composition of AIG's obligations, a disorderly failure of AIG would have severely threatened global financial stability and, consequently, the performance of the U.S. economy. To mitigate concerns that this action would exacerbate moral hazard and encourage inappropriate risk-taking in the future, the Federal Reserve ensured that the terms of the credit extended to AIG imposed significant costs and constraints on the firm's owners, managers, and creditors.⁸⁹

The Current Financial Crisis —Phase II and TARP— The “No Bank Left Behind” Act (September–October 2008)

Concerns about the banking system mounted.⁹⁰ Vincent Reinhart, former director of the Division of Monetary Affairs at the Federal Reserve Board, summarized the state of the financial services industry after being whipsawed by the government responses to the crisis:

It was never clear based on the legislative history of FDICIA that insurance firms were intended to be the beneficiaries of such credit.

Perhaps the most ill-advised of the many actions in the lead-up to TARP has been the undermining of the capacity of the financial markets to address these issues without massive government intervention.

Until now, the responses of government officials have been inconsistent and improvisational. Their first impulse was to extend the federal safety net to investment banks. Thus, in March, the Federal Reserve rescued Bear Stearns, breaking a 60-year-old precedent by lending to a nondepository. That set in motion an uneven process of failure and intervention. The private sector lost its incentive to pump capital into troubled firms and gained an incentive to pick among the winners and losers of the government intervention lottery. Lehman Brothers or AIG? Washington Mutual or Wachovia? Rather than forecasting underlying values, financial markets were predicting government intentions. We should not be here, but we are.⁹¹

After addressing the financial crisis on an institution-by-institution basis throughout 2008, Paulson and Bernanke determined that a shift was in order and that it would be better to take a more comprehensive systemwide approach rather than piecemeal action. This shift may also have been due to the heavy drain of resources in earlier bailouts that focused on large financial institutions and the perceived need to address more than this narrow population of institutions. They determined that new powers were needed that would allow for the purchase of toxic assets from institutions.⁹² Paulson lobbied for this new power, noting that “our tool kit is substantial, but insufficient.”⁹³

However, Paulson appears to have had some good initial instincts, reportedly noting at various times throughout the crisis that:

- the perception should be avoided that an institution is too interconnected to fail or too big to fail;⁹⁴ and
- asking lawmakers for the power to purchase hundreds of billions of dollars of assets could incite panic and plunge the country into a recession.⁹⁵

On a number of these issues, Bernanke

reportedly won over Paulson to the side of intervention,⁹⁶ even though structuring transactions and managing private businesses back to health is not a core function of government. Bernanke, a student of the Depression, has been seemingly obsessed with the perceived lack of intervention during the 1930s. He has pulled out every interventionist approach available and even dreamt up a few new ones.

Perhaps the most ill-advised of the many actions in the lead-up to TARP has been the unprecedented and seemingly deliberate undermining of the capacity of the financial markets to address these issues without massive government intervention. Comments in particular by Secretary Paulson, Chairman Bernanke, and President Bush have largely become self-fulfilling prophecies, reaching a zenith with President Bush’s prime-time speech of September 24, 2008, from the White House:

The government’s top economic experts warn that without immediate action by Congress, America could slip into a financial panic and a distressing scenario could unfold. More banks could fail, including some in your community. The stock market would drop even more which would reduce the value of your retirement account. The value of your house could plummet, foreclosures would rise dramatically and if you own a business or a farm you would find it harder and more expensive to get credit. More businesses would close their doors and millions of Americans could lose their jobs. Even if you have good credit history, it would be more difficult for you to get the loans you need to buy a car or send your children to college and ultimately our country could experience a long and painful recession. Fellow citizens, we must not let this happen.⁹⁷

To convince Congress of the need for these new powers, Paulson had to also emphasize the perceived inadequacies of

existing authorities under law, and the dire consequences if these inadequacies were not addressed. He reportedly warned Sen. James Inhofe and others on a conference call that the situation would be far worse than the Great Depression if he was not given the authority to buy the toxic assets.⁹⁸ Sen. Christopher J. Dodd said the looming threats to the U.S. economy outlined by Paulson had galvanized lawmakers, noting that: “I’ve been here 28 years. I’ve never been in a more sobering moment.”⁹⁹ “This is eerily similar to the rush to war in Iraq,” said Rep. Mike McNulty (D-NY), voicing deep skepticism and highlighting the shifting focus of Paulson and Bernanke. “We have been told repeatedly by this administration that the economy is fundamentally sound, and then all of the sudden they say the economy is going to collapse. That is unacceptable.”¹⁰⁰

The scenario outlined by President Bush has largely played out even though the precise powers demanded were given and the hundreds of billions requested were approved. Paulson, Bernanke, and Bush brought on a crisis of confidence in order to secure extraordinary powers they saw as necessary to address the crisis. One of the earliest observers of this phenomenon noted:

[T]he doyens of U.S. fiscal and monetary policy have ignored the most fundamental principle of central banking, which is that the primary responsibility of central bankers is to promote stability and maintain confidence in the capital markets. Our central bankers appear to have suddenly lost confidence both in their own abilities and in the standard tools of fiscal and monetary policy. The original Treasury plan—which called for the transfer of virtually unlimited taxpayer dollars and unlimited spending discretion to Treasury with no judicial or congressional oversight—sent a very bad signal to the markets. Instead of restoring confidence, this approach to the crisis instilled more fear and panic in the markets.¹⁰¹

What ultimately passed after the Congress added some fiscal sweeteners to the bill was the Emergency Economic Stabilization Act of 2008,¹⁰² which granted the Treasury secretary authority to purchase troubled assets in an amount up to \$700 billion outstanding at any one time.¹⁰³ The purpose of EESA was to restore liquidity and stability to the financial system which the Treasury interpreted to include stimulating lending.¹⁰⁴ Interestingly, there was little quantitative support for this request. As a Treasury spokeswoman noted: “It’s not based on any particular data point. We just wanted to choose a really large number.”¹⁰⁵ These purchases would be made from financial institutions—including banks, savings associations, credit unions, security brokers and dealers, and insurance companies.¹⁰⁶ However, the long-term viability of the financial institution is one required consideration under the Act:

[I]n determining whether to engage in a direct purchase from an individual financial institution, the long-term viability of the financial institution in determining whether the purchase represents the most efficient use of funds under this Act.¹⁰⁷

During the deliberations for TARP, analogies were made by former government officials between the TARP and the Resolution Trust Corporation.¹⁰⁸ However, these analogies are flawed, as the RTC acquired and disposed of assets from mortgage-related financial institutions that had been closed by their primary regulator, either the Federal Home Loan Bank Board or the Office of Thrift Supervision. As a comparison, on the “buy side” those managing TARP would have to decide which assets to purchase from which institutions and at what prices. These three difficult decisions were a *fait accompli* for the RTC because it handed all of the assets of the failed thrifts other than those sold to acquirers at resolution. On the “sell side,” the TARP approach would be to hold assets until maturity or until the secretary of the Treasury determined that

Paulson, Bernanke, and Bush brought on a crisis of confidence in order to secure extraordinary powers they saw as necessary to address the crisis.

The Treasury and Congress's push to invigorate lending, if successful, would have the effect of reinflating the bubble of credit that was beginning to deflate through an ongoing deleveraging process.

an asset sale was “optimal.”¹⁰⁹ The RTC, by contrast, was directed to maximize the value of assets, minimize the impact of transactions, make efficient use of funds and minimize losses—which generally meant a swift disposition to avoid holding costs.¹¹⁰ The differences in these two approaches made the proposed TARP purchase of assets an entirely unworkable concept in practice.

Even before EESA was enacted, in the deliberations leading to its passage, additional questions arose as to how TARP would work in practice, and these questions endured as the TARP plan was implemented. For example, would the TARP program be limited to publicly traded financial institutions and exclude mutually held, family-owned, and other private banks?¹¹¹ Another question was whether overseas firms and hedge funds could participate.¹¹²

Once EESA was passed, members of Congress questioned the uses to which TARP funds were being put.¹¹³ Banks came under criticism for continuing to pay dividends, as one estimate concluded that the equivalent of about half of injections were paid out in the form of dividends. “The whole purpose of the program is to increase lending and inject capital into Main Street. If the money is used for dividends, it defeats the purpose of the program,” said Sen. Charles Schumer (D-NY), who has called for the government to require a suspension of dividend payments.¹¹⁴ Additionally, questions arose as to whether limits should be placed on banks using the money to acquire other banks.¹¹⁵ Some banks also came under fire for not utilizing TARP money to extend loans. “In their eagerness to get everyone on board, I think they failed to make the program stringent enough,” noted Schumer.¹¹⁶ But it is understandable that banks would be hesitant to extend loans in the midst of market turmoil. Political pressure mounted on banks to lend the TARP money, leading to a promise to use bailout funds for new loans.¹¹⁷ This effort has predictably led to a backlash by banks that are now refusing TARP funding to avoid the attached conditions.¹¹⁸

There are a great many imbalances in the financial markets, which will require wringing out the excesses of mortgage-related debt to bring prices back in line with reality. Rather than allowing the markets to work through these imbalances, the Treasury and Congress's push to invigorate lending, if successful, would have the effect of reinflating the bubble of credit that was beginning to deflate through an ongoing deleveraging process. Thus, as Treasury has interpreted renewed lending as the best means to carry out TARP, this translates into subsidizing financial institutions with government funding in order to encourage increased lending. But that is simply a repetition on a grand scale of the flawed business model underlying Fannie Mae and Freddie Mac. Worse, it constitutes government credit allocation.

Beyond the efforts to attach strings to TARP funds, individual members of Congress have also reportedly made contacts to ensure that local banks get their fair share of TARP funding. Stories abound about contacts that have been made by home-state delegations. Additionally, a provision was inserted into EESA which targeted select banks that had less than \$1 billion of assets, had been well-capitalized as of June 30, served low- and moderate-income areas, and had taken a capital hit in the federal seizure of Fannie Mae and Freddie Mac.¹¹⁹

Within weeks of the passage of EESA, there was an oft-noted change of direction. Initially, problem assets were going to be purchased from financial institutions, and the program was sold to Congress and taxpayers on that basis. Then the focus turned to capital injections into banks—or what was called the Capital Purchase Program. The shift was caused in part by the many challenges faced in getting the originally envisioned asset-purchase program up and running, as Treasury had overpromised what could reasonably be delivered in a short time. These investments were allowed, given the broad definition of “troubled asset” under the law.¹²⁰ This change in strategy to capital injections took place after the United Kingdom took the same approach.¹²¹ It is also reminiscent of the

approach of the RFC in the United States, although that corporation focused on troubled banks—as opposed to TARP, which focuses on viable banks. This strategy was also supported by the Federal Reserve Board and some prominent economists in the early days of the development of TARP.¹²²

Participating banks had to agree to several conditions to receive capital injections, including limits on executive compensation, a requirement of Treasury’s consent before any increase in common dividends during the initial three years; and an open-ended provision regarding future unilateral changes by Treasury.¹²³ The capital injections were undertaken by purchasing senior preferred shares.¹²⁴ What ensued was a feeding frenzy by lobbyists to ensure that their clients received a piece of the taxpayer-subsidized funding.¹²⁵

Once again, Paulson had concerns about capital injections: he felt the government would be forced to pick winners and losers; banks might sit on the capital instead of deploying it; and there was potential for the government to meddle in the institutions’ affairs.¹²⁶ He feared that asking Congress for the power to invest in companies would make private investors unwilling to put money into the banks for fear of being diluted by the government.¹²⁷ However, he went forward despite these concerns, and the first nine purchases of equity occurred on October 28 after a meeting between Paulson, Bernanke, and representatives from nine of the nation’s largest banks.¹²⁸ Strong-arming dilution of ownership through government-mandated capital injections is very troubling. Reportedly, Paulson *required* participation by the nation’s largest banks, regardless of their financial condition, in order to avoid a stigma from being attached to recipients of the government capital injections.¹²⁹

As Treasury turned to the alternative strategy of injecting capital to get banks to lend, it soon became doubtful that weakness in the banks’ capital position was the reason for their unwillingness to lend. For example, the Federal Reserve’s *Senior Loan Officer Opinion Survey* solicits respondents on a quarterly basis regarding their credit standards over the prior

three months.¹³⁰ Although it is clear from the survey that credit standards tightened for the period from August through October 2008, when the capital injections were debated, the stated reasons for the tightening were primarily a combination of the general economic outlook, a reduced tolerance for risk, and industry-specific problems (see Table 3). Deterioration in the bank’s capital position was near the bottom of the respondents’ eight stated reasons for tightening credit during the period (38.4 percent). Large banks cited deterioration in capital position as a reason for tightening of credit at a greater percent than other banks (45.2 percent versus 28.6 percent). Until the impact of the economy, risk tolerance, industry-specific concerns, and other cited reasons have been addressed, there is no reason to believe that credit will or should necessarily be flowing as readily as it did in the recent past. Finally, in mid-2008 the FDIC noted that more than 90 percent of institutions (based on number of institutions and total assets) met or exceeded the highest regulatory capital requirements.¹³¹ If banks are hesitant to lend when so many of them independently have sufficient capital, it is not clear why they would lend government-injected capital. As noted previously, if institutions are forced by the government to lend, then that obviously raises concerns about government credit allocation.

Finally, the TARP approach of industry-focused bailouts, combined with the failure to articulate a clear standard for their use, has opened the door to requests for bailouts from other interests, ranging from automobile makers to real estate developers; to cities, states, and universities; and even the porn industry.¹³²

The Current Financial Crisis —Phase III— The Megabanks

Two researchers from the FDIC have noted an increasing trend in what are called “megabanks,” financial institutions like JPMorgan Chase, Wachovia, Citigroup, and Bank of

Strong-arming dilution of ownership through government-mandated capital injections is very troubling.

Table 3
Reasons Cited by Lending Officers for Tightening of Credit

Reasons for Tightening Credit Standards	Oct. 2008	Jan. 2009
Uncertain economic outlook	98.2%	100.0%
Reduced tolerance for risk	86.8%	85.7%
Industry-specific problems	80.8%	91.8%
Decreased liquidity in secondary market	56.6%	44.9%
Less aggressive competition	49.1%	55.1%
Increase in defaults public debt market	45.3%	42.9%
Deterioration in bank's capital position	38.5%	26.5%
Deterioration in bank's liquidity position	36.5%	12.2%

Source: Board of Governors of the Federal Reserve System, Division of Monetary Affairs, "October 2008 Senior Loan Officer Opinion Survey on Bank Lending Practices," November 3, 2008; Idem, "January 2009 Senior Loan Officer Opinion Survey on Bank Lending Practices," February 2, 2009.

Note: Stated reason is considered very or somewhat important by the respondents. Period is three months, ending October 2008 and January 2009, respectively.

America, which are banking behemoths. Many of these came together as megabanks over the past decades as a result of more than 5,000 mergers and acquisitions from the early 1990s through 2008. They also highlight the fact that this phenomenon has increased systemic risk in the U.S. banking and financial system, and that losses associated with a single megabank failure have the potential to be catastrophic to the Bank Insurance Fund (i.e., capital position of the FDIC).¹³³

Given the capital position of the FDIC, any weakness displayed by the megabanks raises critical concern. As of September 2008, the FDIC's Bank Insurance Fund stood at a mere \$35 billion, down from \$53 billion in March 2008.¹³⁴ The December 2008 year-end financial statements should be published by March 2009, and the FDIC must disclose the impact of the Citigroup OBA, which is discussed in detail in this section. Additionally, a change under EESA effective as of last October will also be reflected in the financial statements, as the Act temporarily increased the deposit insurance coverage from \$100,000 to \$250,000 through the end of 2009. This will likely also adversely impact the standing of the FDIC, as it may lead to larger payouts for any institutions likely to be resolved during 2009.¹³⁵ The

exposure flowing from the Bank of America OBA in January 2009, also addressed in this section, will cause further financial deterioration.

Wachovia Corporation—We Have Bailout . . . Never Mind (September 2008)

Like many of the investment banks, mortgage GSEs, and AIG, Wachovia suffered massive losses from its mortgage-related investments, including a \$100 billion portfolio of option-ARMs inherited from its acquisition of Golden West Financial Corporation in California in 2006. Simultaneously, Wachovia pushed aggressively into commercial real estate. A new chief executive officer, Robert Steel, was brought in to restructure Wachovia, but by September 2008 the bank was on the brink of failure.¹³⁶

As noted previously, there was a lull in the FDIC's use of the OBA option from 1993 onward. A proposed acquisition of Wachovia Corporation by Citigroup would have broken this lull, as it was proposed in the form of an OBA transaction. Under the amendments to FDICIA, the secretary of the Treasury, in consultation with the president on the recommendation of the Federal Reserve and FDIC, must make an emergency determination that OBA is

The TARP approach of industry-focused bailouts, combined with the failure to articulate a clear standard for their use, has opened the door to requests for bailouts from other interests.

necessary to avoid serious adverse effects on economic conditions and financial stability. However, the FDIC has not been forthcoming on the details of how it arrived at this determination in the case of Wachovia.¹³⁷ FDIC Chairman Sheila Bair’s public explanation notes only that the “decision was made under extraordinary circumstances with significant consultation among the regulators and Treasury,” and that “this action was necessary to maintain confidence in the banking industry given current financial market conditions.”¹³⁸ The FDIC estimated that this transaction would involve zero cost to the BIF.¹³⁹ Under the OBA provisions that were added as part of FDICIA for any “emergency determination,” the secretary of the Treasury has to document the determination, and the GAO must review its basis, purpose, and likely effect. The GAO has not yet undertaken a review of the Wachovia OBA determination.¹⁴⁰ Ultimately, the OBA transaction was abandoned after Wachovia and Wells Fargo came to a separate agreement without FDIC OBA.¹⁴¹

Citigroup—Too Global to Fail (November 2008)

Citigroup was hurt not only by tens of billions of dollars in write-downs of mortgage-related securities, but also by a lack of cohesion in implementing its business model as a global financial conglomerate. The company failed to turn a profit during 2008 and announced plans to slash tens of thousands of jobs. The failure of Citigroup’s proposed acquisition of Wachovia triggered further uncertainty about Citigroup’s place in the future financial landscape. Its share value plummeted nearly 60 percent during one week in late 2008.¹⁴²

Citigroup was among the nine largest U.S. banks that agreed to sell preferred shares to the Treasury in exchange for a combined \$125 billion in TARP funds, and it received \$25 billion in October 2008. Then, as its troubles mounted, the government unveiled a plan in November 2008 to bail out Citigroup using OBA, with \$20 billion in preferred stock injected by the Treasury Department using TARP funds.

As part of the plan, Treasury, the Federal Reserve, and the FDIC agreed to guarantee against the possibility of losses on up to \$306 billion of Citigroup’s risky loans and securities backed by commercial and residential mortgages. Under the agreement’s loss-sharing arrangement:

- Citigroup assumes all of the first \$29 billion in losses on the risky pool of assets.
- Beyond that amount, the government will absorb 90 percent of the remaining losses with:
 - TARP funding of \$5 billion.¹⁴³
 - FDIC funding from the BIF of \$10 billion.
- Citigroup will absorb 10 percent of the remaining losses.
- The Federal Reserve finances the remaining assets with a non-recourse loan to Citigroup, subject to 10 percent loss sharing with Citigroup.¹⁴⁴

Because the transaction was structured in this way, with TARP in a first-loss position, the TARP was used to indirectly “bail out” the FDIC BIF to the extent of up to \$5 billion. This was not a specified use for TARP funding that was deliberated prior to the passage of the EESA. The FDIC did not disclose an estimated cost to the transaction as it did when announcing the Wachovia transaction, and as it has historically done so when announcing failures or open-bank assistance transactions (see Appendix 1). Another piece of information that was missing from the earlier Wachovia press release was the following statement: “On the whole, the commercial banking system in the United States remains well capitalized.”

As a condition of the bailout, Citigroup is barred from paying quarterly dividends to shareholders of more than one cent a share for three years unless the company obtains consent from the Treasury, FDIC, and Federal Reserve.¹⁴⁵ The agreement also places restrictions on executive compensation, including bonuses. Some of the existing management

Because the transaction was structured in this way, with TARP in a first-loss position, the TARP was used to indirectly “bail out” the FDIC’s Bank Insurance Fund to the extent of up to \$5 billion.

The Citigroup bailout casts substantial doubt on the quality of the analysis and decisionmaking processes used by the regulatory agencies as the financial crisis continued to unfold.

team—including Vikram Pandit, who had only joined the company a year earlier—was left in place,¹⁴⁶ although former Treasury secretary Robert Rubin subsequently retired as the senior counselor of Citigroup and announced that he would not stand for reelection to the board of directors.¹⁴⁷

With operations stretching around the globe in more than 100 countries, Citigroup was considered such a large, interconnected player in the financial system that its possible collapse would have caused further damage to already fragile financial and economic conditions. In a terse and uninformative joint statement, the FDIC, Treasury, and Federal Reserve explained the reasons for the intervention:

With these transactions, the U.S. government is taking the actions necessary to strengthen the financial system and protect U.S. taxpayers and the U.S. economy.

We will continue to use all of our resources to preserve the strength of our banking institutions and promote the process of repair and recovery and to manage risks. The following principles guide our efforts:

- We will work to support a healthy resumption of credit flows to households and businesses.
- We will exercise prudent stewardship of taxpayer resources.
- We will carefully circumscribe the involvement of government in the financial sector.
- We will bolster the efforts of financial institutions to attract private capital.¹⁴⁸

The Citigroup bailout casts substantial doubt on the quality of the analysis and decisionmaking processes used by the regulatory agencies as the financial crisis continued to unfold. This is reflected mainly in the inexplicably dramatic turnaround in the position of Citigroup and the agencies' reaction to it: within weeks, Citigroup went from a poten-

tial acquirer for Wachovia—which logically would mean it was financially stable enough to be approved as an acquirer—to needing tens of billions of dollars in government assistance.¹⁴⁹ This implies that either the level of problems at Citigroup was not known to regulators in October when the initial TARP funding was extended, or it was known and the regulators had already decided that Citigroup was too big to fail and was going to be bailed out so it wouldn't fail.

The Citigroup case has drawn a great deal of attention from politicians who, apparently emboldened by the government's OBA intervention, are providing their input on a wide range of operational decisions for Citigroup. Such interventions constitute de facto nationalization. These decisions, such as the purchase of a corporate jet and the sponsorship for the New York Mets baseball team, would more appropriately be left to Citigroup management and point to a troublesome trend in the unintended consequences of OBA. The specter of nationalization will be even more pronounced if preferred shares are converted into common equity shares as announced in late February 2009, leading to further uncertainty about Citigroup's future.¹⁵⁰

Bank of America—Citigroup Cut and Paste (January 2009)

Bank of America's troubles primarily flowed from its purchase in September of Merrill Lynch, and as time passed more details were revealed that showed dramatic deterioration in Merrill's portfolio. At one point, Bank of America considered backing out of its commitment to purchase Merrill, as they considered the changed circumstances a material-adverse change that would allow them to cancel the deal. However, Paulson and Bernanke reportedly applied pressure on Bank of America to stay with the transaction in order to avoid further destabilizing the market, and offered it a deal similar to the one provided to Citigroup.¹⁵¹

As with the Citigroup transaction, Treasury, the Federal Reserve, and the FDIC agreed to guarantee against the possibility of losses on up to \$118 billion of risky loans and securities

backed by commercial and residential mortgages. Under a loss-sharing arrangement under the agreement:

- Bank of America assumes all of the first \$10 billion in losses on the risky pool of assets.
- Beyond that amount, the Government will absorb 90 percent of the remaining losses with
 - TARP funding an unknown share up to \$10 billion in total with FDIC, and¹⁵²
 - FDIC will fund an unspecified share from the BIF of up to \$10 billion with TARP.
- Bank of America will absorb 10 percent of the remaining losses.
- The Federal Reserve finances the remaining assets with a nonrecourse loan to Bank of America, subject to 10 percent loss sharing with Bank of America.¹⁵³

As with Citigroup, by structuring the transaction with TARP in a first-loss position, the TARP was used to indirectly “bail out” the FDIC BIF to the extent of up to \$10 billion. As in the case of Citigroup, the FDIC did not disclose an estimated cost for the transaction (see Appendix 2). As an additional historical note, Bank of America purchased Continental Illinois after it was sold off by the FDIC in the 1990s.

As a condition of the bailout, Bank of America is barred from paying quarterly dividends to shareholders of more than one cent a share for three years unless the company obtains consent from the Treasury, FDIC, and Federal Reserve. The agreement also places restrictions on executive compensation, including bonuses.¹⁵⁴

Making Sense of the History—Why the Bailout Option Was Chosen

The bailout option was chosen for a wide variety of policy justifications as detailed in the

following summary table (Table 4). Unfortunately, there has never been a clear, bright-line rule that has been consistently followed over the decades as to how or when a financial institution should be bailed out. The standards and forms used have been varied and vague, and have depended upon the underlying policy justification for intervention.

There was a familiar pattern with each of the cited bailouts, whether it was during the Depression, the 1980s, or the current economic crisis. Initially, the financial institution took on risks through aggressive growth strategies that achieved what seemed to be above-average or extraordinary gains. Eventually, markets and values began to turn, and ultimately a corrective financial spiral was triggered that put the financial institution on the brink of failure. Too often, delays in recognizing losses and regulatory forbearance compounded the losses. There was also a pattern to the legislative response. In each case following the financial crisis new legislative changes were implemented that were supposed to address the problem. During the 1930s, deposit insurance, Section 13(3), and the RFC addressed contagion, undercapitalization, and a credit crunch. Bridge bank authority during the 1980s and the systemic risk exception during the 1990s addressed the notion of “too big to fail.” During the current crisis, TARP once again addressed a credit crunch. Yet many of these problems still endure into 2009.

Setting a Bright-Line Rule—The 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. The norm for each has been a series of vague conclusory statements containing select buzzwords (stability, disruption, contagion, fragile/fragility, protect taxpayers) (see Table 5). The true consistent basis for intervention is clear from the statements regarding Bear Stearns and AIG, but is unstated in the others: “prominent posi-

There was a familiar pattern with each of the cited bailouts, whether it was during the Depression, the 1980s, or the current economic crisis.

Table 4
Bailout Programs and Underlying Policy Justifications

Institution or Program	Structure	Policy Justification/Standard
Reconstruction Finance Corporation	Loans/preferred stock	Contagion, undercapitalization, and to encourage lending
Continental Illinois Bank forbearance	Open-bank assistance Regulatory forbearance	Too big to fail Changes in macroeconomic environment
Fannie Mae (1981)	Tax relief and regulatory forbearance	Changes in macroeconomic environment
Farm Credit System	Government-backed debt	Sustain farm economy
Bear Stearns	Loan	Unusual and exigent circumstances/ too interconnected to fail
Fannie Mae and Freddie Mac (2008)	Preferred stock	Maintain stability, prevent disruption in mortgage market, and protect taxpayers
American International Group	Loan Ownership stake	Unusual and exigent circumstances/too interconnected to fail
Wachovia	Open-bank assistance	Systemic risk
Troubled Asset Relief Program	Asset purchase Preferred stock	Encourage lending
Citigroup	Open-bank assistance	Systemic risk
Bank of America	Open-bank assistance	Systemic risk

Table 5
Stated Justifications for Individual Institution Bailouts

Descriptions	Bailout (date)
<p>“prevent a disorderly failure of Bear Stearns and the unpredictable but likely severe consequences for market functioning and the broader economy”</p> <p>“likely would have led to a chaotic unwinding of positions in those markets and could have severely shaken confidence”</p> <p>“a sudden, disorderly failure of Bear would have brought with it unpredictable but severe consequences for the functioning of the broader financial system and the broader economy”</p> <p>“fragile condition of the financial markets at the time”</p> <p>“prominent position of Bear Stearns in those markets”</p> <p>“expected contagion that would result from the immediate failure”</p>	<p>Bear Stearns (March 2008)</p>
<p>“providing stability to financial markets”</p> <p>“supporting the availability of mortgage finance”</p> <p>“protecting taxpayers”</p>	<p>Fannie Mae/Freddie Mac (September 2008)</p>
<p>“add to already significant levels of financial market fragility”</p> <p>“in light of the prevailing market conditions”</p>	<p>AIG (September 2008)</p>

Table 5 Continued

Descriptions	Bailout (date)
<p>“the size and composition of AIG’s obligations” “severely threatened global financial stability”</p>	
<p>“severe financial conditions exist which threaten the stability of a significant number of insured depository institutions or of insured depository institutions possessing significant financial resources” “would create systemic risk to the credit markets” “necessary to avoid serious adverse effects on economic conditions and financial stability” “necessary to maintain confidence in the banking industry given current financial market conditions”</p>	<p>Wachovia (September 2008)</p>
<p>“committed to supporting financial market stability” “strengthen the financial system and protect U.S. taxpayers and the U.S. economy”</p>	<p>Citigroup (November 2008)</p>
<p>“commitment to support financial market stability” “strengthen the financial system and protect U.S. taxpayers and the U.S. economy”</p>	<p>Bank of America (January 2009)</p>

Sources: Bear Stearns-Ben S. Bernanke (testimony before the Senate Committee on Banking, Housing, and Urban Affairs, April 3, 2008); “Key Bear Deal Players Speak Out,” CNNMoney.com, April 3, 2008, http://money.cnn.com/galleries/2008/news/0804/gallery.bear_stearns_hearing/5.html.

Board of Governors of the Federal Reserve System, “Minutes of the Board of Governors of the Federal Reserve System,” March 14, 2008.

Fannie Mae/Freddie Mac-U.S. Department of the Treasury, “Statement by Secretary Henry M. Paulson Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers,” September 7, 2008.

AIG- Board of Governors of the Federal Reserve, Press Release, September 16, 2008. Ben S. Bernanke, “U.S. Financial Markets” (testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, September 23, 2008).

Wachovia: Federal Deposit Insurance Corporation, “Minutes of the Meeting of the Board of Directors of the Federal Deposit Insurance Corporation,” September 9, 2008, p. 9, 10. Federal Deposit Insurance Corporation, “Citigroup Inc. to Acquire Banking Operations of Wachovia,” September 29, 2008.

Citigroup: Treasury, Federal Reserve, and FDIC (joint statement on Citigroup, November 23, 2008), and attachment on Summary of Terms.

Bank of America: Treasury, Federal Reserve, and FDIC (joint statement on Bank of America, January 16, 2009), and attachment on Summary of Terms.

tion” and “size and composition.” These are euphemisms for the discredited “too big to fail” doctrine, yet for all intents and purposes it is the same policy. When pressed by outside parties or the media for further details, the agencies cling to laws such as the Freedom of Information Act and Government in the Sunshine Act, which ironically were meant to force government agencies to disclose information more fully.¹⁵⁵

Individual Institution Bailouts

So, the question remains: what should be the standard for when the government may consider intervention to bail out a financial institution? The answer depends on a difficult balancing. The following discourse in the aftermath of the Bear Stearns bailout

indicates the challenge in resolving the competing, and sometimes conflicting, desires of retaining market discipline, but also avoiding market failure:

Now that the Fed has stepped in, it’s possible that things will go back to normal. But let’s hope they don’t get too normal: one of the biggest problems in the market in the past decade has been that lenders, clients, and even ordinary small investors have put far too much faith in the magical abilities of Wall Street firms, and have failed to give their promises and performance proper scrutiny. Markets require trust to work well, but when trust is blind they are almost guaranteed to go haywire. We

When regulators send the signal that complexity or size means an institution is more likely to be bailed out then the result will be to encourage the structuring of complex and large institutions.

don't want the paralytic level of skepticism that has reigned in the marketplace in recent months to continue, but we don't want a return to the way things were, either. It's a good thing that Bear Stearns was saved. But it's also a good thing that it nearly died.¹⁵⁶

If a large institution fails, and if that translates into losses for creditors, shareholders, or counterparties of that institution, that in and of itself is not a market failure that should be addressed. Quite the opposite is true. It is the proper role of markets to transmit information regarding the quality of investments. Anna Schwartz probably put the issue of credit losses best in perspective:

It's very easy when you're a market participant to claim that you shouldn't shut down a firm that's in really bad straits because everybody else who has lent to it will be injured. Well, if they lent to a firm that they knew was pretty rocky, that's their responsibility. And if they have to be denied repayment of their loans, well, they wished it on themselves. The [government] doesn't have to save them, just as it didn't save the stockholders and the employees of Bear Stearns. Why should they be worried about the creditors? Creditors are no more worthy of being rescued than ordinary people, who are really innocent of what's been going on.¹⁵⁷

So, the bright-line rule should not simply be laid down when an institution's failure would cause a cascading impact that is broad-based and would cause other failures. But that is the standard that was used when an individual institution failed during the current crisis, with vague statements made about how it would cause disruptions or compromise fragility, stability, or confidence. If the major justification is that the institution is large, then we are back to the "too big to fail" doctrine that was so roundly criticized in the development of FDICIA. When regulators

send the signal that complexity or size means an institution is more likely to be bailed out, then the result of the current bailouts will be, as has happened in the past, to encourage the structuring of complex and large institutions.

The current bailouts were hastily crafted, not well thought out, and as a result constantly changed direction in scope and focus. Policy-making seemed to proceed as if uninformed by the history of the 1980s financial crisis, a history that educates us that the proper approach is to close down troubled institutions. The constant changes in direction bring to mind President Franklin D. Roosevelt's "bold, persistent experimentation." As described in a recent book on the Depression, the concern with that approach is "not merely the new policies that were implemented but also the threat of additional, unknown policies. Fear froze the economy, but that uncertainty itself might have a cost was something the young experimenters simply did not consider."¹⁵⁸

For example, as the crisis unfolded in 2007, the key policymakers first appeared unsure about the causes and urgency of the crisis in a process characterized by regularly timed overstatements and subsequent reversals. Secretary Paulson and Chairman Bernanke led the process of the bailouts. Tracing back the history of the subprime problems, as the initial difficulties in the market began to be revealed, the record shows that both were initially skeptical that the problems in the subprime market presented a serious potential shock to financial stability. In response to a question on the meltdown in the subprime mortgage market, Paulson noted definitively that "I don't think it poses any threat to the overall economy."¹⁵⁹ Similarly, in a speech on the subprime-mortgage market, Bernanke was confident in his proclamation that "[i]mportantly, we see no serious broader spillover to banks or thrift institutions from the problems in the subprime market; the troubled lenders, for the most part, have not been institutions with federally insured deposits. . . . All that said, given the fundamental factors in place that should support the demand for housing, we believe the effect of the troubles in the subprime sector

on the broader housing market will likely be limited, and we do not expect significant spillovers from the subprime market to the rest of the economy or to the financial system.”¹⁶⁰ FDIC Chairman Sheila C. Bair has also been surprised by the extent of the large institution failures.¹⁶¹

A valiant attempt was made to develop a bright-line rule of contagion, which was used by the Federal Reserve to describe the potential fallout from the failure of Bear Stearns. Bernanke set out such a rule of thumb, and based on his testimony he concluded that Bear Stearns had met this test and Lehman Brothers did not. However, as of yet, the Federal Reserve has not released details on the precise contagion that would have resulted from a Bear Stearns bankruptcy.¹⁶² The rationalization given by the Federal Reserve for not intervening when Lehman failed, which largely focused on how far in advance affected parties knew about the troubles of the institution, is not a satisfying standard. An argument can be made that, to varying degrees, in each of the cases of large, troubled institutions there were indicators of the problems in advance. Such a standard introduces all matter of problems of measurement of market knowledge and would actually give an incentive for troubled financial institutions to avoid publicly revealing the details of difficulties.

More recently, the FDIC has had to grapple with implementation of the systemic risk exception codified under FDICIA. Efforts to publicly pronounce a bright-line rule and to support each decision with institution-specific reasoning ended around mid-September 2008. As 2008 wore on, the International Monetary Fund’s member nations committed to preventing the failure of systemically important institutions and the approach of “constructive ambiguity” was pursued. Under this approach no clear public announcement is made to set forth a rule or to offer institution-specific reasons why an institution is bailed out.¹⁶³ This approach appears to have begun with the FDIC’s OBA transaction for Wachovia and was also displayed in the most recent OBA transactions for Citigroup and Bank of America,

which were joint efforts of the FDIC, Treasury, and Federal Reserve. The latter two pronouncements are so sanitized of institution-specific detail that over half of the verbiage for the joint press releases announcing the transactions are identical (compare Appendixes 1 and 2). Thus we have no answers to questions such as why the decision was made to bail out Wachovia, Citigroup, and Bank of America, while Washington Mutual and IndyMac were not. This result is consistent with what two FDIC researchers and a co-author refer to as “optimal bailout policy,” which mimics in practice what the FDIC appears to be following: (1) a guaranteed bailout for big institutions (too big to fail); (2) a randomized bailout for medium-sized institutions (constructive ambiguity); and (3) no bailout for small institutions.¹⁶⁴ Based on the recent OBA transactions, Wachovia, Citigroup, and Bank of America appear to fall into the first category of “too big to fail.” IndyMac and Washington Mutual were on the losing end of the randomized bailout for medium-sized institutions.

TARP and the Viability Test

The TARP approach was an attempt at yet another standard for bailouts, whereby the institution must be “viable” consistent with the objective of targeting healthy institutions that would be in a position to lend. This is a truly unprecedented characteristic of the TARP in expending resources to benefit institutions that are not threatened by imminent failure. It wasn’t employed during the Depression or during the 1980s. As recently as January 2009 Assistant Treasury Secretary Neel Kashkari, who is leading the group within Treasury overseeing the TARP expenditures, emphasized in response to a question on TARP that it was “a healthy bank program” and that “banks must be deemed viable without government assistance to be eligible for the program.”¹⁶⁵

Although this was a stated consideration, as codified in EESA, to focus on viable institutions, it was eviscerated in the case of Citigroup, Inc., and Bank of America. For example, Citigroup received \$25 billion of TARP funding in late October, but it deteriorated so quickly

Although there was a stated consideration to focus on viable institutions, it was eviscerated in the case of Citigroup and Bank of America.

thereafter that it was resolved through OBA in late November with an additional \$20 billion of TARP funding. Bank of America received \$15 billion and Merrill Lynch received \$10 billion of TARP funding in late October, and they were also resolved through OBA in January, with \$20 billion in additional TARP funding.

Policy Prescriptions and Necessary Changes

Financial-institution bailout policy, as it has been carried out during this crisis, has been unwieldy, inequitable, extremely costly, disruptive, inconsistent, and lacking in transparency and oversight. The current allocation of separate bailout powers leaves us with a three-headed hydra possessing vast powers that are implemented through the Treasury Department, Federal Reserve and FDIC. In the wake of Continental Illinois, Congress tried to slay the dreaded “too big to fail” policy when it passed FDICIA. However, “too big to fail” has come roaring back during the current financial crisis. Government policy, in large part, has contributed to the financial crisis by allowing Fannie Mae, Freddie Mac, and megabanks to pose obvious systemic risk and by extending the safety net to investment banks. The policy response of bailouts and maintenance of the status quo has been precisely the wrong response, as it has led to retaining many of the mega-institutions by providing bailouts primarily to large institutions, thus planting the seeds for future crises as they continue to pose systemic risk. By not letting these mega-institutions fail, the government incentivizes them to take on excessive risks in the future, in a classic case of moral hazard. This crisis has demonstrated that undertaking bailouts, which involves structuring transactions that attempt to transform a troubled institution into a viable one, while simultaneously projecting the reaction of investors and markets, is a process for which government is ill-suited. The underlying imbalances that led to the crisis have not been reconciled.

Secretary Paulson has said that he has

learned two primary policy lessons from the past year of bailouts: (1) the Treasury Department, the Federal Reserve, and FDIC should have a limitless range of tools that allow them to undertake all matter of interventions to address financial instability; and (2) there is no playbook for responding to turmoil we have never faced.¹⁶⁶ This intended advice to the incoming Obama administration, given during late 2008, was wrong on both counts. Government policy regarding financial stability should have as its goal the smooth functioning of financial institutions in their role as intermediaries. This would include avoiding actions that exacerbate systemic risk, cause disruptions, or extend periods of disruptions in the market. It should not have as its goal the avoidance of financial institution failures through opaque transactions that limit the process of price discovery. Imbalances leading to financial-sector instability can cause short-term difficulties, but bailouts merely put off making the necessary adjustments to bring these imbalances back in line. At the beginning of 2008, there was an existing legal infrastructure in place, based on decades of experience with financial stress, to address nearly all of the challenges that ultimately arose during the course of the year.¹⁶⁷ There has been little evidence presented of any inherent flaws in the FDIC liquidation or federal bankruptcy process that would justify bypassing these established processes.

In the initial months after the election, the incoming Obama administration smartly kept a safe distance from TARP issues.¹⁶⁸ In recent weeks since the inauguration, the administration has begun to shape more definitively a policy approach to the issue of bailouts. President Obama, who campaigned on the themes of openness and transparency, must first address the challenges the three agencies have had with providing clear and supported justifications for their interventions. Unfortunately, Secretary Timothy F. Geithner’s much-anticipated summary of the administration’s game plan was incredibly light on details.¹⁶⁹ As to bailout policy, the summary noted the establishment of a public-private investment fund, an idea that seems to be an improvement over

Financial-institution bailout policy, as it has been carried out during this crisis, has been unwieldy, inequitable, extremely costly, disruptive, inconsistent, and lacking in transparency and oversight.

the government-centric focus of the previous administration. However, there was little change at all to the unsuccessful TARP program other than to mandate further additional conditions on capital assistance.¹⁷⁰ Future policy is predictable: if conditions improve, the administration will take credit; if conditions worsen, they will simply blame the Bush administration and ask for more powers and more funding. Unfortunately, there is little talk about what really needs to be done: place the troubled institutions in FDIC receivership or the relevant form of bankruptcy, including many of the institutions that have already been bailed out.

FDIC Open-Bank Assistance

The Congress granted the FDIC OBA powers nearly 60 years ago to assure that regulators had options to address communities whose access to banking services were threatened by bank failure. As OBA has evolved, it has become an expensive example of publicly provided corporate welfare for megabank creditors, shareholders, and counterparties, with little evidence presented that it has protected the financial system from systemic risk or that it has been a source of stability during the current crisis.

As a result of a dearth of information from the FDIC, it is challenging to come up with policy recommendations to address the current crisis. The FDIC, which in the past has been a reliably transparent agency, is now secretive and is not consistently disclosing support for its actions, even when pressed with formalized requests. By contrast, the Continental Illinois bailout in 1984 was based on solid statistics released within a few months of the resolution. While it is possible to debate the merits of the Continental Illinois bailout, it can at least be explained by reference to objectively verifiable facts, from which it can be concluded that an adverse effect would likely have occurred in the absence of such action.

An infrastructure for OBA requires either giving the FDIC complete discretion or circumscribing the use of OBA. Over the years it has been in use, it is clear that giving the FDIC broad

discretion in implementing OBA predictably leads to massive bailouts in times of crisis, given the perverse incentives to forbear and extend the federal safety net.¹⁷¹ Congressional efforts to establish the precise circumstances under which to grant OBA in FDICIA have given us industry consolidation and even larger institutions that meet the “systemic risk” test. The search for a reliable bright-line rule that works in practice has come up empty. The FDICIA-mandated reviews of all OBA transactions by the GAO, which will report on the basis, purpose, and likely effect of the determination that OBA was necessary, may take up to a year after the transactions to be completed. The GAO reviews will likely provide good insights, but they will arrive too late to make a difference.

Traditional processes for liquidating large institutions continue to work. These processes were followed in the case of Washington Mutual Bank and Indymac Bank. They also may be followed with Fannie Mae and Freddie Mac, although not administered by FDIC. In the current environment the FDIC may argue that this option is not possible given its weakened financial position and resource constraints. Our recommendation is to discuss more transparently any resource constraints and rely exclusively on P&A transactions, including invoking bridge bank or conservatorship authority, rather than the current reliance on OBA.

Federal Reserve Section 13(3) and Financial Stability

The powers of the Federal Reserve should be limited to those that clearly facilitate achievement of its statutory objective:

maintain long-run growth of the monetary and credit aggregates commensurate with the economy’s long-run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.¹⁷²

The traditional role of the Federal Reserve in times of financial instability has been to lend on

As Open-Bank Assistance has evolved, it has become an expensive example of publicly provided corporate welfare for megabank creditors, shareholders, and counterparties.

The current crisis makes clear the difficulties of granting broad-based authority and the pitfalls of having so much power concentrated in the hands of the Federal Reserve.

good collateral to illiquid commercial banks, a role that supports this objective. Now broader lending authorities have been bestowed upon the Federal Reserve to address the overall stability of the financial system, including lending to financial institutions beyond the commercial banking sector. In 1991, with almost no debate, Congress expanded Section 13(3) and clarified the Federal Reserve's power to extend credit to securities dealers. This was done even though this newly granted power was completely at odds with the lessons from the financial crisis of the 1980s—that the federal safety net should be minimized in order to conserve public resources. The changes to Section 13(3) were a dangerous grant of broad authority, with almost no limits, on the power of intervention and take the focus of the Federal Reserve away from its specified objective.

The current crisis makes clear the difficulties of granting such broad-based authority and the challenges involved in implementation, as well as the pitfalls of having so much power concentrated in the hands of the Federal Reserve. The turmoil after the Lehman Brothers failure is not so much an argument for intervention in that case, but rather an indicator of the impossibility of implementing a clear bright-line rule for bailouts. Efforts to distinguish a bright line between Bear Stearns and Lehman Brothers, and the lack of a consistent policy coupled with the multiple efforts to address the crisis, contributed to the angst visited upon market participants during 2008 and 2009. Even with the economic analysis resources at its disposal, the Federal Reserve has been unable to reliably predict contagion or judge an appropriate timing or level of intervention. Like the FDIC, the Federal Reserve has also been opaque with regard to the precise institution-specific reasons for intervention, which is seemingly at odds with Chairman Bernanke's historical emphasis on transparency regarding central bank policy.¹⁷³

The broadening of the power to lend, combined with the difficulty of valuing many of the mortgage-related assets held by financial institutions during the current cri-

sis, has led to likely losses on extensions to Bear Stearns and AIG. This is inconsistent with the intent of the changes to Section 13(3), which allows lending so long as it is fully secured. The Federal Reserve should have its powers to lend returned to its former role as lender of last resort on good collateral for the purpose of maintaining liquidity, although this is a more challenging role in the current environment. The federal bankruptcy process should be the source of resolving troubled institutions, as it was for Lehman Brothers.

Treasury Department's TARP, Fannie Mae and Freddie Mac

The supporters of TARP had good intentions in their efforts to restore the banks to their role as financial intermediaries at former levels. However, underlying their argument was the simplistic notion that if banks are hesitant to lend because of market conditions, all that needs to be done is to pass a law to rectify the situation. The process of talking down the economy in order to secure these unprecedented and untested powers to provide hundreds of billions of dollars to predominantly viable financial institutions has done enormous damage to market confidence and stability. What ensued was Washington at its worst: hastily crafted legislation, pork-barrel politics, fear-mongering, unintended consequences, and a feeding frenzy for lobbyists and members of Congress alike. It is encouraging that in Treasury Secretary Geithner's confirmation testimony he placed a priority on the need to "unwind the extraordinary interventions taken to stabilize the financial sector,"¹⁷⁴ but it is difficult to reconcile with the talk of further bailouts coming from the Obama administration.

As in the case of TARP, the policy justifications behind the creation of Fannie Mae and Freddie Mac were well-intended. But the results were these behemoths that were "too big to fail" that posed an enormous systemic risk to the financial system. The next step is to move the pair from conservatorship to receivership to reduce the systemic risk going

forward and wind down the government sponsorship which Secretary Paulson rightly called a “flawed business model.”¹⁷⁵

Appendix 1: Citigroup Press Release (November 23, 2008) Joint Statement by Treasury, Federal Reserve and the FDIC on Citigroup

Washington, DC—The U.S. government is committed to supporting financial market stability, which is a prerequisite to restoring vigorous economic growth. In support of this commitment, the U.S. government on Sunday entered into an agreement with Citigroup to provide a package of guarantees, liquidity access and capital.

As part of the agreement, Treasury and the Federal Deposit Insurance Corporation will provide protection against the possibility of unusually large losses on an asset pool of approximately \$306 billion of loans and securities backed by residential and commercial real estate and other such assets, which will remain on Citigroup’s balance sheet. As a fee for this arrangement, Citigroup will issue preferred shares to the Treasury and FDIC. In addition, and if necessary, the Federal Reserve stands ready to backstop residual risk in the asset pool through a non-recourse loan.

In addition, Treasury will invest \$20 billion in Citigroup from the Troubled Asset Relief Program in exchange for preferred stock with an 8 percent dividend to the Treasury. Citigroup will comply with enhanced executive compensation restrictions and implement the FDIC’s mortgage modification program.

With these transactions, the U.S. government is taking the actions necessary to strengthen the financial system and protect U.S. taxpayers and the U.S. economy.

We will continue to use all of our resources to preserve the strength of our banking institutions and promote the process of repair and recovery and to manage risks. The following

principles guide our efforts:

- We will work to support a healthy resumption of credit flows to households and businesses.
- We will exercise prudent stewardship of taxpayer resources.
- We will carefully circumscribe the involvement of government in the financial sector.
- We will bolster the efforts of financial institutions to attract private capital.

Appendix 2: Bank of America Press Release (January 16, 2009) Treasury, Federal Reserve, and the FDIC Provide Assistance to Bank of America

Washington, DC—The U.S. government entered into an agreement today with Bank of America to provide a package of guarantees, liquidity access, and capital as part of its commitment to support financial market stability.

Treasury and the Federal Deposit Insurance Corporation will provide protection against the possibility of unusually large losses on an asset pool of approximately \$118 billion of loans, securities backed by residential and commercial real estate loans, and other such assets, all of which have been marked to current market value. The large majority of these assets were assumed by Bank of America as a result of its acquisition of Merrill Lynch. The assets will remain on Bank of America’s balance sheet. As a fee for this arrangement, Bank of America will issue preferred shares to the Treasury and FDIC. In addition, and if necessary, the Federal Reserve stands ready to backstop residual risk in the asset pool through a non-recourse loan.

In addition, Treasury will invest \$20 billion in Bank of America from the Troubled Assets Relief Program in exchange for preferred stock with an 8 percent dividend to the Treasury. Bank of America will comply with

**What ensued
was Washington
at its worst:
hastily crafted
legislation,
pork-barrel
politics, fear-
mongering,
unintended
consequences,
and a feeding
frenzy for
lobbyists and
members of
Congress alike.**

enhanced executive compensation restrictions and implement a mortgage loan modification program.

Treasury exercised this funding authority under the Emergency Economic Stabilization Act's Troubled Asset Relief Program. The investment was made under the Targeted Investment Program. The objective of this program is to foster financial market stability and thereby to strengthen the economy and protect American jobs, savings, and retirement security.

Separately, the FDIC board announced that it will soon propose rule changes to its Temporary Liquidity Guarantee Program to extend the maturity of the guarantee from three to up to 10 years where the debt is supported by collateral and the issuance supports new consumer lending.

With these transactions, the U.S. government is taking the actions necessary to strengthen the financial system and protect U.S. taxpayers and the U.S. economy. As was stated in November when the first transaction under the Targeted Investment Program was announced, the U.S. government will continue to use all of our resources to preserve the strength of our banking institutions and promote the process of repair and recovery and to manage risks.

Notes

1. Senator Carter Glass offered these remarks during the Senate debate on the Banking Act of June 20, 1933. Quoted in Rixey Smith and Norman Beasley, *Carter Glass: A Biography* (Manchester, NH: Ayer Publishing, 1970, 1939), p. 357.
2. Amity Shlaes, interview on the *Brian Lehrer Show*, WNYC, October 30, 2008, http://www.wnyc.org/shows/bl/episodes/2008/10/30/segment_s/114094 at 11:30. Shlaes is the author of *The Forgotten Man: A New History of the Great Depression* (New York: Harper Perennial, 2007).
3. Michael M. Phillips, "Government Bailouts: A U.S. Tradition Dating Back to Hamilton," *Wall Street Journal*, September 20, 2008.
4. 12 U.S.C. 347(b). For a detailed description of central bank lender-of-last-resort power see Dong He, "Emergency Liquidity Support Facilities," IMF Working Paper (WP/00/79), April 2000, p. 6.
5. John R. Walter, "Depression-Era Bank Failures: The Great Contagion or the Great Shakeout," *Federal Reserve Bank of Richmond Economic Quarterly* 91, no. 1 (Winter 2005): 39, 41.
6. Milton Friedman and Anna Jacobson Schwarz, *A Monetary History of the United States, 1867-1960* (Princeton: Princeton University Press / National Bureau of Economic Research, 1963), pp. 308-9.
7. Congressional Record 77 (May 19, 1933): S 3728. For a further discussion of bank contagion see George G. Kaufman, "Bank Failures, Systemic Risk and Bank Regulation," *Cato Journal*, Spring/Summer 1996, pp. 17-45.
8. Ronald McDonald, "Consolidated Supervision of Banks," *Bank of England Handbooks in Central Banking* 15, 1998, p. 11.
9. For a questioning of this thesis, see Charles W. Calomiris and Joseph R. Mason, "Contagion and Bank Failures during the Great Depression: The June 1932 Chicago Banking Panic," National Bureau of Economic Research, Working Paper 4934 (November 1994); and Walter, "Depression Era Bank Failures."
10. Clark Nardinelli, "The Reconstruction Finance Corporation's Murky History," Heritage Foundation, December 21, 1983; and Walker F. Todd, "History of and Rationales for the Reconstruction Finance Corporation," *Federal Reserve Bank of Cleveland Economic Review* 28, no. 4 (1992 Quarter 4): 22.
11. Washington Mutual Bank was resolved through purchase and assumption by JPMorgan Chase. Federal Deposit Insurance Corporation, "JPMorgan Chase Acquires Banking Operations of Washington Mutual," September 25, 2008. One form of the P&A is a bridge bank or conservatorship where the FDIC is the purchaser and retains the institution until a purchaser can be found. A bridge bank was used to resolve IndyMac Bank in July 2008 until it could be sold to IMB HoldCo LLC in January 2009. See Federal Deposit Insurance Corporation, "FDIC Establishes IndyMac Federal Bank, FSB as Successor to IndyMac Bank, FSB, Pasadena, California," July 11, 2008; and *ibid.*, "FDIC Board Approves Letter of Intent to Sell IndyMac Federal," January 2, 2009, <http://www.fdic.gov/news/news/press/2008/pr08056.html>.
12. Federal Deposit Insurance Corporation, "Open Bank Assistance," Chapter 5, in *Managing the Crisis: The FDIC and RTC Experience* (Washington: FDIC, 1998), p. 151.
13. Federal Deposit Insurance Act, 12 U.S.C. 1823(c)(1).

14. The precise wording is as follows: "In order to reopen a closed insured bank or, when the Corporation has determined that an insured bank is in danger of closing, in order to prevent such closing, the Corporation, in the discretion of its Board of Directors, is authorized to make loans to, or purchase the assets of or make deposits in, such insured bank, upon such terms and conditions as the Board of Directors may prescribe, when in the opinion of the Board of Directors the continued operation of such bank is essential to provide adequate banking service in the community. Such loans and deposits may be in subordination to the rights of depositors and other creditors." United States Code Congressional and Administrative News Annotated, 1950 edition, vol. 1, p. 946.

15. The FDIC sought the power of OBA because of concern that the Federal Reserve was not applying its lender-of-last-resort authority broadly enough, particularly in the case of nonmember banks. These nonmember banks were banks that were not members of the Federal Reserve, but who have FDIC deposit insurance. The Federal Reserve opposed the grant of OBA power to the FDIC, considering it an infringement on its lender-of-last-resort authority. To minimize any potential conflict with the Federal Reserve, the power was restricted to instances where the institution's continued existence was "essential" to providing adequate banking services in the community. FDIC, *Managing the Crisis*, pp. 153–54.

16. *Ibid.*, p. 154. The test of essentiality was met either because the institution served inner-city areas or because of concerns about the bank's role as a state's sole depository.

17. The conditions for invoking the power were revised as follows: "(A) if such action is taken to prevent the closing of such insured bank; (B) if, with respect to a closed insured bank, such action is taken to restore such closed insured bank to normal operation; or (C) if, when severe financial conditions exist which threaten the stability of a significant number of insured banks or of insured banks possessing significant financial resources, such action is taken in order to lessen the risk to the Corporation posed by such insured bank under such threat of instability." United States Code Congressional and Administrative News Annotated, 1982 edition, 96 stat. 1469.

18. "(4)(A) No assistance shall be provided under this subsection in an amount in excess of that amount which the Corporation determines to be reasonably necessary to save the cost of liquidating, including pay the insured accounts of such insured bank, except that such restrictions shall not apply in any case in which the Corporation determines that the continued operation of such

insured bank is essential to provide adequate banking services in the community." United States Code Congressional and Administrative News Annotated, 1982 edition, 96 stat. 1470.

19. The peak years for reliance on OBA were in 1987 and 1988, when 19 and 79 banks, respectively, were resolved through OBA, primarily the BancTexas and First City banking groups that were resolved as part of the banking crisis in Texas. FDIC, *Managing the Crisis*, p. 153.

20. Federal Deposit Insurance Corporation, "Continental Illinois and Too Big to Fail," Chapter 7, in *History of the 80s* (Washington: FDIC, 1997) pp. 236–37.

21. Continental Illinois, p. 242–45.

22. Irvine H. Sprague, *Bailout: An Insider's Account of Bank Failures and Rescues* (New York: Basic Books, 1986), p. 10.

23. Continental Illinois, p. 250–51.

24. *Ibid.*, p. 245.

25. Thomas Labrecque, the chief executive officer of Chase Manhattan Bank, summarized this point: "We must eliminate the . . . 'too big to fail' policy under which the very largest banks are given de facto 100 percent protection of all deposits. Such a policy is inconsistent with the original intent of deposit insurance and is unfair to smaller banks, but big bankers neither want it nor need it." Senate Committee on Banking, Housing and Urban Affairs, *Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1991*, 102nd Cong., 1st sess. 1991, S. Rep. 167, 44.

26. These weaknesses have been cited in FDIC documents, including FDIC, "Open Bank Assistance Transactions," Chapter 5, in *Resolution Handbook* (1998), pp. 54–5; also FDIC, *Managing the Crisis*, pp. 165–66; and Rosalind L. Bennett, "Failure Resolution and Asset Liquidation: Results of an International Survey of Deposit Insurers," *FDIC Banking Review* 14, no. 1 (Fall 2001): 12.

27. Examples of banks that were provided open-bank assistance and had recurring losses that led to a closed-bank transaction include BancTexas Group Inc. (1987 OBA and closed in 1990), Alaska Mutual Bank and United Bank of Alaska (1988 OBA and closed in 1989), and First City Bancorporation of Texas (1988 OBA and closed in 1992). For more information see FDIC, *Managing the Crisis*, pp. 161–63. For a detailed critique of the First City Bancorporation transaction, see United States General Accounting Office, "Failing Banks: Lessons Learned from Resolving First City Bancorpo-

ration of Texas,” GAO/GGD 95-37 (March 1995).

28. Richard Scott Carnell, “A Partial Antidote to Perverse Incentives: The FDIC Improvement Act of 1991,” *Annual Review of Banking Law* 12, (1993), pp. 322-23. Richard Carnell is a former assistant secretary of the Treasury.

29. Public Law 102-242.

30. *Report of the House Banking, Finance and Urban Affairs Committee* no. 102-330, United States Code Congressional and Administrative News 3, (November 19, 1991): 1909, 1917.

31. 12 U.S.C. 1823(c)(4)(G).

32. Senate Committee on Banking, Housing and Urban Affairs, *Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1991*, 102nd Cong., 1st sess., S. Rep. 167, 45. Referenced in Carnell, p. 367.

33. 12 U.S.C. 1823(c)(4)(G)(i)(I).

34. 12 U.S.C. 1823(c)(4)(G)(iii), (iv).

35. Section 473 of FDICIA deleted the italicized text as codified under 12 U.S.C. 343: “In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal reserve bank, during such periods as the said board may determine, at rates established in accordance with the provisions of section 14, subdivision (d), of this Act, to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange *of the kinds and maturities made eligible for discount for member banks under other provisions of this Act* when such notes, drafts, and bills of exchange are indorsed or otherwise secured to the satisfaction of the Federal Reserve bank.”

36. *Congressional Record*, vol. 137, pt. 24, 36129 (November 27, 1991). “It [the Senate version of FDICIA] also includes a provision I offered to give the Federal Reserve greater flexibility to respond in instances in which the overall financial system threatens to collapse. My provision allows the Fed more power to provide liquidity by enabling it to make fully secured loans to securities firms in instances similar to the 1987 stock market crash.” This comment did not elicit a comment or discussion and the section in the final Act was in a title on “Miscellaneous Provisions” under a subtitle on “Other Miscellaneous Provisions.” Also see Senate Committee on Banking, Housing and Urban Affairs, *Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1991*, 102nd Cong., 1st sess., S. Rep. 167, 202: “This clarifies that access to

liquidity in special circumstances can be made available directly to a securities dealer to help preserve market liquidity and avoid market disruption.”

37. Much of the material in this section is drawn from Federal Deposit Insurance Corporation, “Other Resolution Alternatives,” Chapter 6, in *Resolution Handbook*, pp. 57-62.

38. The net-worth certificate program was developed in the wake of the deregulation of deposit rates. Institutions that lent on a long-term basis for mortgages or long-term bonds in an inflationary environment suddenly had to pay higher rates for deposits in the more volatile interest-rate environment brought about by inflation. Such institutions were allowed to apply for capital assistance. The FDIC bought the net worth certificates from participating institutions, but no cash was exchanged. The net-worth certificates were considered capital for regulatory purposes and amortized over a set period of years.

39. The capital forbearance program applied to institutions with deteriorated capital positions that were otherwise defined as well-managed institutions whose position was not the result of mismanagement, excessive operating expenses, or excessive dividends. Those institutions with concentrations of 25 percent or more in agricultural or energy loans were temporarily exempted from regulatory capital requirements.

40. Income maintenance agreements were developed to adjust for the effect on large savings banks of deregulation of interest rates. Again, these were institutions that primarily lent out on low-yielding, long-term mortgage loans whose credit quality of the collateral was not a problem.

41. George J. Benston and George G. Kaufman, “FDICIA After Five Years: A Review and Evaluation,” Federal Reserve Bank of Chicago Working Paper 97-1 (June 11, 1997), p. 7.

42. This final characteristic allowed borrowing at rates nearly as low as the U.S. government.

43. Thomas H. Stanton, *A State of Risk—Will Government-Sponsored Enterprises Be the Next Financial Crisis?*, (New York: HarperCollins Publishers, 1991), p. 161.

44. General Accounting Office, “Federal Housing Enterprises: OFHEO Faces Challenges in Implementing a Comprehensive Oversight Program,” GAO/GGP 98-6 (October 1997), p. 21.

45. Bert Ely, “The Farm Credit System—Reinvented and Mission Challenged,” American Bankers Association (November 2002), p. 5. James Bovard,

“Farm Credit Quagmire,” Cato Policy Analysis no. 122, July 27, 1989.

46. House of Representatives, *Agricultural Credit Act of 1987*, 100th Cong., 1st sess., August 28, 1987, H. Rep. 100-295, p. 53.

47. Benston and Kaufman, p. 1.

48. As Drexel Burnham was not seen as a particularly sympathetic recipient of a bailout, this option was not seriously considered.

49. The Federal Reserve Bank of New York coordinated an intervention by a number of Long Term Capital Management’s creditors.

50. See generally Bryan Burrough, “Bringing down Bear Stearns,” *Vanity Fair*, August 2008, http://www.vanityfair.com/politics/features/2008/08/bear_stearns200808.

51. Ben S. Bernanke, “Financial Regulation and Financial Stability” (speech, Federal Deposit Insurance Corporation, Forum on Mortgage Lending for Low- and Moderate-Income Households, Arlington, VA, July 8, 2008). The Federal Reserve supplemented its actions regarding Bear Stearns by establishing the Primary Dealer Credit Facility. Under the Primary Dealer Credit Facility, the Federal Reserve stood ready to make fully collateralized loans to the remaining four largest investment banks plus certain other broker-dealers (called primary dealers) that transact regularly with the Federal Reserve. The Federal Reserve also created the Term Securities Lending Facility, which allows primary dealers to borrow Treasury securities using other types of assets as collateral. These new facilities assured the secured creditors of primary dealers that those firms would have sufficient access to liquidity, thus reducing the danger of runs like the one experienced by Bear Stearns.

52. Federal Reserve Bank of New York, “Summary of Terms and Conditions Regarding the JPMorgan Chase Facility,” March 24, 2008. JPMorgan Chase, “JPMorgan Chase and Bear Stearns Announce Amended Agreement,” March 24, 2008.

53. Ben S. Bernanke (testimony before the Senate Committee on Banking, Housing, and Urban Affairs, April 3, 2008).

54. “Key Bear Deal Players Speak Out,” CNN Money.com, April 3, 2008, http://money.cnn.com/galleries/2008/news/0804/gallery.bear_stearns_hearing/5.html.

55. Board of Governors of the Federal Reserve System, “Minutes of the Board of Governors of the Federal Reserve System,” March 14, 2008. The

authors have submitted Freedom of Information Act requests to the Federal Reserve Board for details supporting the determination on the Bear Stearns decision, specifically detailing the “contagion” reference from the minutes of the meeting where this reference was made (the meeting of March 14, 2008). The FOIA request for this was filed on December 17, 2008. A request was also filed on December 19, 2008, for information about the AIG decision, which is discussed elsewhere in this policy analysis. The requested information has not been received yet.

56. Walker F. Todd, “FDICIA’s Emergency Liquidity Provisions” *Federal Reserve Bank of Cleveland Economic Review* 29, no. 3 (1993, 3rd quarter):18–20. Also see editorial, “The Fed Takes a Writedown,” *Wall Street Journal*, October 28, 2008: “The Federal Reserve—or shall we say, the taxpayer—bet on Bear Stearn’s mortgage portfolio is now officially underwater. Last Thursday, the Fed wrote down the value of the portfolio of mortgage debt to \$26.8 billion as of September 30, from \$29.5 billion in June. . . . As of the Fed’s latest estimate of value of the portfolio, taxpayers are in for losses of \$2.2 billion.”

57. Vern McKinley, “The Mounting Case for Privatizing Fannie Mae and Freddie Mac,” Cato Institute Policy Analysis no. 293, December 29, 1997 (see footnote 75 and related text).

58. James R. Hagerty, “Fannie, Freddie Executives Knew of Risks,” *Wall Street Journal*, December 10, 2008. Alt-A mortgages either have limited supporting documentation or display some other weakness.

59. Public Law 110-289.

60. Section 1117 of the Housing and Economic Recovery Act of 2008, codified as 12 U.S.C. 1455 and 1719.

61. Quoting from July 15, 2008 testimony. Brendan Murray, “Paulson’s Fannie-Freddie ‘Bazooka’ Shakes Investors,” <http://www.bloomberg.com/apps/news?pid=20601087&sid=aYrNO2nn11BM&refer=home> Bloomberg.com, August 21, 2008.

62. Housing and Economic Recovery Act of 2008, Section 1117, codified as 12 U.S.C. 1719 and 1455.

63. Housing and Economic Recovery Act of 2008, Section 3083.

64. U.S. Department of the Treasury, “Statement by Secretary Henry M. Paulson Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers,” September 7, 2008. The power to place Fannie Mae and Freddie Mac in conservatorship is

- derived from 12 U.S.C. 4617, which gives the director the discretionary power to place a critically undercapitalized enterprise in conservatorship, a procedure that is also detailed in §4617.
65. Paulson, "Statement on Treasury and Federal Housing Finance Agency Action."
66. Senior Preferred Stock Purchase Agreement executed between Treasury and Fannie Mae and Treasury and Freddie Mac, September 26, 2008 (see "maximum amount," p. 3, and "warrant" p. 4). Federal Housing Finance Agency, "Mortgage Market Note 08-4," December 5, 2008.
67. Another change in law under the Housing and Economic Recovery Act of 2008 gave the director authority to place the GSEs under receivership (12 U.S.C. 4617). For a further discussion of this option, see Peter J. Wallison, "How Paulson Would Save Fannie Mae," *Wall Street Journal*, September 12, 2008.
68. Associated Press, "Paulson Says Lehman Bailout Was Never an Option," September 15, 2008, <http://www.youtube.com/watch?v=7nn8N0W903M>. Larry Elliott, Jill Treanor, Andrew Clark, and David Teather "Nightmare on Wall Street," September 16, 2008, <http://www.guardian.co.uk/business/2008/sep/16/marketturmoil.lehmanbrothersguardian.co.uk>.
69. Larry Elliott, Jill Treanor, Andrew Clark and David Teather, "Wall Street Jobs Cull Begins as Lehman Rescue Bid Fails," *guardian.co.uk*, September 15, 2008, <http://www.guardian.co.uk/business/2008/sep/15/marketturmoil.lehmanbrothers>.
70. Ibid.
71. This left investors unlikely to get back all the cash they put in because the fund failed to maintain assets of at least \$1 for every dollar invested. Tim Paradis, "Money Funds 'Break the Buck,' Investors at Risk," Associated Press, September 17, 2008.
72. Carrick Mollenkamp, Mark Whitehouse, Jon Hilsenrath, and Ianthe Jeanne Dugan, "Lehman's Demise Triggered Cash Crunch Around Globe," *Wall Street Journal*, September 29, 2008.
73. Ibid.
74. Ibid.
75. V. V. Chari, Lawrence Christiano, and Patrick J. Kehoe, "Facts and Myths About the Financial Crisis of 2008," Working Paper 666, Federal Reserve Bank of Minneapolis Research Department, October 2008 (Figure 6A).
76. Ibid.
77. Ibid.
78. Ben S. Bernanke, "Economic Outlook" (testimony before the Joint Economic Committee of the U.S. Congress, September 24, 2008). A little-noticed event in the Lehman saga, however, occurred just hours after the firm's bankruptcy filing, when the Fed loaned billions of dollars to a Lehman subsidiary, LBI New York. On Monday, September 15, the Fed lent LBI \$87 billion through JPMorgan Chase. After being repaid on Tuesday, it lent LBI another \$51 billion, roughly the same aggregate amount as the initial \$85 billion bailout for AIG. The loan, according to recently surfaced documents, was a "carefully thought-out decision" to stabilize the market by propping up Lehman's broker-dealer business, so it could stay afloat long enough to "facilitate an orderly wind-down" of tens of thousands of trades with other Wall Street firms. LBI was not part of the Lehman bankruptcy. According to Fed Chairman Bernanke and Treasury Secretary Paulson, the Fed and Treasury lacked the legal authority to lend any money to Lehman because the firm did not have sufficient collateral, yet the LBI loans were apparently backed by the same collateral. The explanation that the Fed loan to LBI was merely part of an "orderly winding down," rather than a loan to a going (or in Lehman's case, insolvent) concern is plausible. Still, the fact remains that the LBI loan represented a deliberate action by the federal government to prevent the bankruptcy of a major financial institution from cascading through the financial system. Andrew Ross Sorkin, "How the Fed Reached Out to Lehman," *New York Times*, December 15, 2008, page B1. Tiffany Kary and Chris Scinta, "JPMorgan Gave Lehman \$138 Billion After Bankruptcy," September 16, 2008, <http://www.bloomberg.com/apps/news?pid=20601087&sid=aX7mhYCHmVf8&refer=home> Bloomberg.com. The apparent legal authority for these loans was section 13(3) of the Federal Reserve Act, referred to elsewhere in this analysis.
79. Mollenkamp, "Lehman's Demise."
80. Matthew Karnitschnig et al., "U.S. to Take Over AIG in \$85 Billion Bailout," *Wall Street Journal*, September 16, 2008.
81. Carrick Mollenkamp, Serena Ng, Liam Plevin, and Randall Smith, "Behind AIG's Fall, Risk Models Failed to Pass Real-World Test," *Wall Street Journal*, October 31, 2008.
82. David S. Hilzenrath and Glenn Kessler, "U.S. Seizes Control of AIG With \$85 Billion Emergency Loan," *Washington Post*, September 17, 2008. Karnitschnig et al.

83. Carrick Mollenkamp, Susanne Craig, Serena Ng and Aaron Lucchetti, "Crisis on Wall Street as Lehman Totters, Merrill Is Sold, AIG Seeks Cash," *Wall Street Journal*, September 15, 2008.
84. Board of Governors of the Federal Reserve (press release, September 16, 2008).
85. Karnitschnig et al.
86. Board of Governors of the Federal Reserve (press release, October 8, 2008).
87. Carol D. Leonnig, "Effectiveness of AIG's \$143 Billion Rescue Questioned," *Washington Post*, November 3, 2008.
88. Board of Governors of the Federal Reserve (press Release, November 10, 2008). Carol D. Leonnig, "AIG Close to Getting New Larger Bailout," *Washington Post*, November 10, 2008. Matthew Karnitschnig, Liam Plevin, and Serena Ng, "U.S. Throws New Lifeline to AIG, Scrapping Original Rescue Deal," *Wall Street Journal*, November 10, 2008. Idem, "AIG Seeks to Ease Its Bailout Terms," *Wall Street Journal*, February 24, 2009.
89. Ben S. Bernanke, "U.S. Financial Markets" (testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, September 23, 2008).
90. Tom Lauricella, Liz Rappaport, and Annelena Lobb, "Mounting Fears Shake World Markets as Banking Giants Rush to Raise Capital," *Wall Street Journal*, September 18, 2008.
91. Vincent R. Reinhart, "A Bill That Deserved to Pass," *American.com*, October 6, 2008, <http://www.american.com/archive/2008/october-10-08/a-bill-that-deserved-to-pass..>
92. Deborah Solomon, Liz Rappaport, Damian Paletta, and Jon Hilsenrath, "Shock Forced Paulson's Hand," *Wall Street Journal*, September 20, 2008.
93. U.S. Department of the Treasury, "Statement by Secretary Henry M. Paulson Jr. on Emergency Economic Stabilization Act Vote," September 29, 2008.
94. "Paulson: Oil, Falling Home Prices to Prolong Slowdown," *Reuters*, July 2, 2008.
95. Jon Hilsenrath, Deborah Solomon, and Damian Paletta, "Paulson, Bernanke Strained for Consensus in Bailout," *Wall Street Journal*, November 10, 2008.
96. Ibid.
97. TPMTV, "President Bush Addresses Nation on Economic Crisis," September 24, 2008, <http://www.youtube.com/watch?v=YsDmPEurfA&feature=related>.
98. Jeff Poor, "Inhofe: Paulson Used Scare Tactics to Force Bailout Legislation," *Business and Media Institute*, November 19, 2008, <http://www.businessandmedia.org/articles/2008/20081119073313.aspx>.
99. Greg Hitt, "Congress Pledges Action," *Wall Street Journal*, September 20, 2008.
100. Greg Hitt, Sudeep Reddy, and Deborah Solomon, "Bernanke, Paulson Face Skeptics on the Hill Despite Dire Warnings," *Wall Street Journal*, September 24, 2008.
101. Jonathan Macey, "The Government Is Contributing to the Panic," *Wall Street Journal*, October 11, 2008.
102. EESA, Public Law 110-343.
103. EESA, §115(a)(3).
104. EESA, §2. United States Department of the Treasury, *Frequently Asked Questions, Capital Purchase Program Q&A*, October 15, 2008.
105. Brian Wingfield and Josh Zumbrun, "Bad News for the Bailout," *Forbes.com*, September 23, 2008, http://www.forbes.com/home/2008/09/23/bailout-paulson-congress-biz-beltway-cx_jz_bw_0923bailout.html.
106. EESA, §§3(5) and 101(a)(1).
107. EESA, §103(4).
108. Nicholas F. Brady, Eugene A. Ludwig, and Paul A. Volcker, "Resurrect the Resolution Trust Corporation," *Wall Street Journal*, September 17, 2008; Michael R. Crittenden and Patrick Yoest, "Resolution Trust Plan is Floated," *Wall Street Journal*, September 18, 2008; L. William Seidman and David C. Cooke, "What We Learned From Resolution Trust," *Wall Street Journal*, September 25, 2008.
109. EESA, §113(a)(2)(A).
110. The relevant wording of the statute is "(i) maximizes the net present value return from the sale or other disposition of institutions . . . or the assets of such institutions; (ii) minimizes the impact of such transactions on local real estate and financial markets; and (iii) makes efficient use of funds obtained from the Funding Corporation or from the Treasury; (iv) minimizes the amount of any loss realized in the resolution of cases; and (v) maximizes the preservation of the availability and affordability of residential real property for low-

- and moderate-income individuals.” (Section 501 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 as amended.)
111. Michael R. Crittenden and Robin Sidel, “Private Banks Vie for Slice of Rescue Pie,” *Wall Street Journal*, October 29, 2008. Difficulties were also confronted in hiring asset managers and other staff. Deborah Solomon, “Rescue Plan Faces Delays in Hiring Asset Managers,” *Wall Street Journal*, October 28, 2008; Michael R. Crittenden, “Rescue Plan Strained by Lack of Staff,” *Wall Street Journal*, November 28, 2008.
112. Greg Hitt, Damian Paletta, and Deborah Solomon, “Lawmakers Battle over Rescue Plan,” *Wall Street Journal*, September 22, 2008.
113. For a discussion of transparency in particular, see United States Government Accountability Office, “Troubled Asset Relief Program: Additional Actions Needed to Better Ensure Integrity, Accountability and Transparency,” GAO-09-161, December 2, 2008.
114. Binyamin Appelbaum, “Banks to Continue Paying Dividends,” *Washington Post*, October 30, 2008.
115. Michael R. Crittenden, “Lawmakers Want Strings Attached,” *Wall Street Journal*, October 31, 2008. Editorial, “Loans? Did We Say Loans?” *New York Times*, October 29, 2008.
116. David Enrich, Robin Sidel, and Michael R. Crittenden, “Much Bank Aid May Not Go to Loans,” *Wall Street Journal*, October 28, 2008; Crittenden, “Loans?”
117. David Enrich and Robin Sidel, “Banks Promise to Use Rescue Funds for New Loans,” *Wall Street Journal*, October 31, 2008.
118. Deborah Solomon, “More Banks to TARP: Thanks But No Thanks,” *Wall Street Journal*, January 31, 2009.
119. Damian Paletta and David Enrich, “Political Interference Seen in Bank Bailout Decisions,” *Wall Street Journal*, January 27, 2009.
120. EESA, §3(9), which included the phrase “any other financial instrument that the Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines is necessary to promote financial market stability.” The Congressional Oversight Board Panel also notes the shifting strategies of the TARP between September and November 2008, from (1) buying mortgage-related assets and (2) purchasing preferred stocks and warrants; to (3) not buying mortgage-related assets, (4) participation in the Federal Reserve’s Term Asset-Backed Securities Loan Facility, and (5) other strategies. The Congressional Oversight Board Panel, “Questions About the \$700 Billion Emergency Economic Stabilization Funds,” December 10, 2008, pp. 12–13.
121. Dana Cimilluca, Sara Schaeffer Muñoz, and Carrick Mollenkamp, “UK Plans to Buy Into Banks in Bold Move,” *Wall Street Journal*, October 8, 2008.
122. Hilsenrath, Solomon, and Paletta, “Consensus in Bailout,”; Edmund S. Phelps, “We Need to Recapitalize the Banks,” *Wall Street Journal*, October 1, 2008. Justin Lahart, “Rescue Plan Comes Around to Views of the Academics,” *Wall Street Journal*, October 11, 2008. This approach uses Sweden and Japan during the 1990s as a model.
123. Treasury, *Capital Purchase Program Q&A*. Additional requirements regarding foreclosure mitigation may also be imposed. Linda Shen, “Banks May Find TARP Comes With Long Strings Attached,” *Bloomberg.com*, December 19, 2008. http://www.bloomberg.com/apps/news?pid=20601087&sid=a_Hb2bLwB9b4&refer=home.
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130. Board of Governors of the Federal Reserve System, Division of Monetary Affairs, “October 2008 Senior Loan Officer Opinion Survey on Bank Lending Practices,” November 3, 2008. Idem, “January 2009 Senior Loan Officer Opinion Survey on Bank Lending Practices,” February 2, 2009.
131. The data have been presented and described inconsistently in the Federal Deposit Insurance Corporation’s *Quarterly Banking Profile* for the most recent two quarters. See FDIC, *Quarterly*

Banking Profile, November 2008, p. 2. See also FDIC, *Quarterly Banking Profile*, August 2008, p. 3: “Despite the slowdown in capital growth and the erosion in capital ratios at many institutions, 98.4 percent of all institutions [accounting for 99.4 percent of total industry assets] met or exceeded the higher regulatory capital requirements at the end of June.”

132. Editorial, “Dining at the Taxpayer Buffet,” *Wall Street Journal*, October 31, 2008. T. W. Farnam, “Mayors Get in Line for U.S. Funds,” *Wall Street Journal*, December 10, 2008. Kevin Modesti, “Porn industry seeks \$5 billion federal bailout,” *L.A. Daily News*, January 8, 2009, http://www.ajc.com/business/content/business/stories/2009/01/08/flynt_porn_bailout.html.

133. Kenneth D. Jones and Chau Nguyen, “Increased Concentration in Banking: Megabanks and Their Implications for Deposit Insurance,” June 2004. This analysis also cites a dated FDIC study that the probability of a top ten bank’s failure in any one year is one percent. Robert Oshinsky, “Effects of Consolidation on the Bank Insurance Fund,” FDIC Working Paper Series no. 99-3 (1999).

134. Federal Deposit Insurance Corporation, *CFO Report—DIF Balance Sheet*, September 30, 2008; June 30, 2008; March 31, 2008.

135. EESA, §136.

136. Dan Fitzpatrick and Diya Gullapalli, “Storm of Fear Enveloped Wachovia,” *Wall Street Journal*, September 30, 2008.

137. The authors have submitted Freedom of Information Act requests to the FDIC for details supporting the determination on the Wachovia proposed open-bank assistance transaction (filed on November 18, 2008) and the Citigroup open-bank assistance transaction (filed on December 19, 2008), discussed elsewhere in this policy analysis. These deliberations by the FDIC were undertaken in closed board meetings as defined under the Government in the Sunshine Act (5 U.S.C. 552(b)), and full access to the information has been denied by the FDIC, which cites numerous sections of the Act. As of the publication of this analysis the request for information on Wachovia was appealed internally with the FDIC’s General Counsel under the administrative procedures of the FDIC regarding FOIA requests. Finally, in February 2009, the FDIC released a heavily redacted version of the relevant board minutes, with minimal new information released.

138. FDIC, “Citigroup Inc. to Acquire Banking Operations of Wachovia,” September 29, 2008.

139. *Ibid.*

140. The FDIC has taken the position that the Wachovia transaction does not require a review by the GAO under the OBA provisions enacted under FDICIA, based on mootness. The GAO is reviewing this position and during 2009 will release any reports on emergency determinations it concludes are required, including any reports for Wachovia, Citigroup, and Bank of America. It should be noted that there are no exceptions under the relevant statutory section (12 U.S.C. 1823(c)(4)(G)), and it applies to “any determination.” The purpose of the GAO review is likely for the purpose of making the FDIC accountable for its use of OBA. Carnell, FDICIA, p. 368.

141. David Enrich and Dan Fitzpatrick, “Wachovia Chooses Wells Fargo, Spurns Citi,” *Wall Street Journal*, October 4, 2008. Damian Paletta, “Affidavit Suggests Wachovia Nearing Failure,” *Wall Street Journal*, October 5, 2008. Dan Fitzpatrick, “On Crisis Stage, FDIC Plays the Tough,” *Wall Street Journal*, November 3, 2008.

142. Ben White and Vikas Bajaj, “Woes at Citigroup Began With Failed Bid for Wachovia,” *New York Times*, November 21, 2008; Eric Dash and Julie Creswell, “The Reckoning: Citigroup Saw No Red Flags Even as It Made Bolder Bets,” *New York Times*, November 22, 2008.

143. With the TARP funding provided to cover losses, reportedly \$20 billion in total was provided in the Citigroup transaction which does not fall under the Capital Purchase Program. “Participants in Government Investment Plan,” *Wall Street Journal*, January 22, 2009.

144. Treasury, Federal Reserve, and FDIC (joint statement on Citigroup, November 23, 2008), and attachment on Summary of Terms.

145. *Ibid.*

146. David Cho and Neil Irwin, “Familiar Trio at Heart of Citi Bailout: Rubin, Paulson, Geithner’s Shared History Paved Way for \$300 Billion Federal Guarantee,” *Washington Post*, November 25, 2008.

147. Eric Dash and Louise Story, “Rubin Leaving Citigroup; Smith Barney for Sale,” *New York Times*, January 9, 2009.

148. Treasury, Federal Reserve, FDIC (joint statement on Citigroup).

149. U.S. Change in Bank Control Act, section 2(B)(i), requiring an investigation of the financial capability of any proposed acquirer of “control” of any federally insured depository institution as

- detailed in 12 C.F.R. 225.41 et. seq. This point, which the Citigroup transaction raises concerns about, is also made in the Congressional Oversight Board December Report, p. 30n121: “The Citigroup experience and the AIG experience raise questions about institutional health and need by Treasury and bank regulators.” Damian Paletta, “Banks Die Too Fast for Regulators,” *Wall Street Journal*, January 23, 2009.
150. Andrew Clark, “Citigroup Under Fire Over Baseball Sponsorship,” *guardian.co.uk*, January 30, 2009. <http://www.guardian.co.uk/business/2009/jan/30/citigroup-sponsorship-baseball-banking>. Jonathan Stempel, “Citigroup scraps Primerica Convention, Bahamas trip,” *Reuters*, February 6, 2009. U.S. Department of the Treasury, “Joint Statement by the Treasury, FDIC, OCC, OTS, and the Federal Reserve,” February 23, 2009. Monica Langley and David Enrich, “Citigroup Chafes Under U.S. Overseers,” *Wall Street Journal*, February 25, 2009.
151. Dan Fitzpatrick, Deborah Solomon, and Susanne Craig, “BofA’s Latest Hit,” *Wall Street Journal*, January 16, 2009. Dan Fitzpatrick, Susanne Craig, and Deborah Solomon, “In Merrill Deal, U.S. Played Hardball,” *Wall Street Journal*, February 5, 2009.
152. With the TARP funding provided to cover losses, reportedly \$20 billion in total was provided in the Bank of America transaction, which does not fall under the Capital Purchase Program.
153. Treasury, Federal Reserve, and FDIC (joint statement on Bank of America, January 16, 2009), and attachment on Summary of Terms.
154. *Ibid.*
155. This does not appear to be an isolated incident, as beyond the Freedom of Information Act requests by the authors as discussed previously, Bloomberg and Fox News have filed FOIA suits regarding the financial crisis. See Bloomberg, “Fed Refuses to Disclose Recipients of \$2 Trillion,” December 12, 2008, <http://www.bloomberg.com/apps/news?pid=20601109&sid=apx7XNLnZZlc&refer=home>; and *FOX Business*, “FOX Business Sues Treasury for Failure to Respond to Freedom of Information Act Requests,” December 18, 2008, <http://www.foxbusiness.com/story/markets/fox-business-sues-treasury-failure-respond-freedom-information-act-requests/>.
156. James Surowiecki, “Too Dumb to Fail,” *New Yorker*, March 31, 2008.
157. Brian M. Carney, interview with Anna Schwartz, “Bernanke Is Fighting the Last War,” *Wall Street Journal*, October 18, 2008.
158. Shlaes, *The Forgotten Man*, p. 9.
159. Kevin Carmichael and Peter Cook, “Paulson Says Subprime Rout Doesn’t Threaten Economy,” *Bloomberg.com*, July 26, 2007, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=arhco v9ThQM8>
160. Ben S. Bernanke, “The Subprime Mortgage Market” (statement at the Federal Reserve Bank of Chicago’s 43rd Annual Conference on Bank Structure and Competition, Chicago, Illinois, May 17, 2007).
161. “FDIC Chief: Most Banks Will Survive Credit Crunch,” *Online NewsHour with Judy Woodruff*, (transcript, July 28, 2008): “JUDY WOODRUFF: Are you confident you’ve got enough to cover the coming big losses? SHEILA BAIR: Well, I am. I think—I would be very surprised if institutions approaching the size of IndyMac or bigger than IndyMac would fail. I think we’re looking more at the smaller institutions. Again, the number is going to go up, but it’s historically going to be very low.” Since that time Washington Mutual failed. Citigroup and Bank of America only avoided failure because they were bailed out through OBA. All were many times larger than IndyMac.
162. Although requested through the Freedom of Information Act, the Federal Reserve did not provide details of what contagion would have developed if they did not bailout Bear Stearns. Also, see Peter J. Wallison, “Systemic Risk and the Financial Crisis,” *American Enterprise Institute for Public Policy Research*, October 31, 2008. Wallison makes this distinction by contrasting “systemic risk, which is characterized by some kind of contagion” with “solvency,” which he argues is the source of difficulty in the current crisis. However, in a different article Wallison states that: “because the definition of a systemically significant institution is highly dependent on context, it’s impossible to identify one in advance . . . predicting the true sources of systemic risk in advance of their actual failure is probably impossible.” Peter Wallison, “Not Everything Can Be Too Big to Fail,” *Wall Street Journal*, November 22, 2008.
163. Xavier Freixas, “Optimal Bailout Policy, Conditionality, and Constructive Ambiguity,” Department of Economics and Business, Universitat Pompeu Fabra Economics Working Paper 400. Bob Davis, “IMF Nations Vow to Prevent New Failures,” *Wall Street Journal*, October 13, 2008.
164. Vivian Chua, Ning Gong, and Kenneth D. Jones, “Government Bailout Policy: Transparency versus Constructive Ambiguity,” September 5, 2008. This consists of a one-paragraph abstract for the paper, which is referred to as a “Work in Progress.” The authors of the paper were expected to finalize

the work at some point in February 2009.

165. Assistant Treasury Secretary Neel Kashkari, in a speech at the Brookings Institution, January 8, 2009, said: “We said this is a healthy bank program. We want healthy banks across the country to apply to the program. . . . Banks must be deemed viable without government assistance to be eligible for the program.” On the C-SPAN video, this question-and-answer is from the time segment 27:15 to 31:00, <http://www.c-span.org/Watch/watch.aspx?MediaId=HP-A-14161>. Kashkari previously emphasized this limitation under questioning from Congressman Dennis Kucinich (D-OH) regarding the government’s unwillingness to provide TARP funding to National City Corporation of Ohio, a troubled bank: “the regulators do go to some banks they think are not solvent institutions and discourage them from applying to the program [TARP]. . . . Congressman, we review applications that the regulators submit to us with their recommendation. If a regulator does not submit an application to Treasury because a regulator deems a financial institution is going to fail, we can’t review it. And I don’t think it’s a good use of taxpayer money to put taxpayer capital into an institution that’s going to fail.” “Taxpayers \$\$ Not Going into Failing Banks’ Kashkari, Kucinich,” *VoiceofAmericans2008*, November 14, 2008, <http://www.youtube.com/watch?v=r5GW2uh0k4A>.

166. “Paulson Says U.S. Lacked Tools to Tackle Crisis: Report,” *Reuters*, December 30, 2008. Henry M. Paulson Jr., “Fighting the Financial Crisis, One Challenge at a Time,” *New York Times*, November 17, 2008.

167. One exception is the power to place Fannie Mae and Freddie Mac in receivership, which was a power added under the Housing and Economic Recovery Act of 2008.

168. Jonathan Weisman and Deborah Solomon, “Obama Keeps His Distance from Treasury on

TARP,” *Wall Street Journal*, December 4, 2008.

169. Maya Jackson Randall and Michael Crittenden, “Geithner Unveils Rescue Plan, but Details Are Scarce,” *Wall Street Journal*, February 10, 2009.

170. U.S. Department of the Treasury, *Fact Sheet: Financial Stability Plan*, February 10, 2009.

171. Carnell, FDICIA.

172. Section 2A of the Federal Reserve Act codified as 12 U.S.C. 225(a).

173. See Ben S. Bernanke, Thomas Laubach, Frederic S. Mishkin, and Adam S. Posen, *Inflation Targeting* (Princeton: Princeton University Press, 1999), p. 296: “Why spend so much effort on clarity and communication? The efforts by the inflation-targeting central banks to improve transparency and communication have been crucial to the success of the targeting regimes. They have improved private sector planning by reducing uncertainty about monetary policy, interest rates and inflation; they have promoted useful public debate of monetary policy in part by educating the public about what a central bank can and cannot achieve; they have increased the central banks’ freedom of action in the longer run, for example by making temporary deviations from target possible without adverse effects on inflation expectations; and they have helped clarify the responsibilities of the central bank and of politicians in the conduct of monetary policy. Transparency and communication together enhance accountability.”

174. Timothy Geithner (testimony before the Senate Finance Committee, January 21, 2009).

175. For a discussion of how to wind down the two, see McKinley, “Privatizing Fannie Mae and Freddie Mac,” in the section entitled “How to Fully Privatize Fannie Mae and Freddie Mac.”

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