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Chapter 7

Banking on the FDIC (Resolution Authority I)

When Harvard Business School Professor David Moss testified at a congressional hearing in October 2009, he argued that there are three possible options for resolving the financial distress of the largest financial institutions: bankruptcy, bailouts, and an administrative resolution process. "The good news," Moss said, is that the Federal Deposit Insurance Corporation (FDIC) has had resolution authority for years with respect to commercial banks, and "it has worked well. . . . What is needed now," he concluded, "is a comparable resolution process for all [systemically important financial institutions], whether they are banks, bank holding companies, or other financial institutions. We need a resolution process that works, so regulators don't have to be afraid to let [them] fail."[1]

The Obama administration made the same argument: Their framework for administrative resolution of large financial institutions didn't "institutionalize bailouts," as critics complained; it would provide the benefits of bankruptcy without the uncertainty. The model, they too argued, is the FDIC's handling of ordinary bank failures. Assistant Treasury Secretary Michael Barr, Timothy Geithner's point person for the legislation, put it this way: "Our proposal does little more than apply to [systemically important financial institutions] the same model that Congress has developed, that the FDIC has executed, and that courts have respected, over the course of more than three-quarters of a century."[2]

The claim is simple and alluring. The FDIC does a great job handling the failures of small and medium-sized banks, the reasoning goes. But the FDIC has authority only over depositary bank subsidiaries. It doesn't have the power to resolve the financial distress of bank holding companies, the affiliates of a depositary bank, or other kinds of financial institutions. Extending the FDIC's power to large financial institutions would fill the gap; it's the perfect alternative to the bailouts of 2008.

Many thoughtful observers were persuaded by the analogy, and are enthusiastic advocates for the new resolution regime. Is the FDIC analogy compelling? To answer this question, we need to examine the key unstated assumptions underlying it: that the FDIC is indeed extremely successful in its current resolution efforts; that the FDIC will have the same role in the new resolution regime as it has with ordinary banks; and that the strategies the FDIC uses for handling small and medium-sized bank failures will be effective when a gigantic firm fails.

As you may have guessed, our topic in this chapter is the FDIC analogy that was used to sell the new resolution regime. In Chapter 8, we will consider the specific details of the new resolution regime in much more detail, focusing in particular on the question whether it will discourage bailouts when systemically important firms fail in the future.

Does the FDIC Play the Same Role in Both Regimes?

It may be useful to begin by considering the basis for the claim that FDIC resolution should provide the template for the new resolution regime. To do this, we will need to separate wheat from chaff in the administration's appeal to the FDIC model by very briefly exploring the basic contours of the FDIC's historical role and its current powers.

In the oral version of the congressional testimony quoted earlier, Michael Barr characterized the FDIC as having seamlessly handled commercial bank failures for more than 75 years, since its creation in the 1930s. The first thing to note is that this statement is more than a little misleading. For nearly 50 years, from its inception to the 1980s, the FDIC had very little resolution business. Banks very rarely failed during this period, thanks to deposit insurance (which made consumers as comfortable banking with small banks as large ones), the postwar economic boom, and the stable demand for traditional banking services. This period tells us very little about the FDIC's prowess with bank resolution.

The first real test came with the savings and loan (S&L) and banking crisis of the 1980s. As a result of a variety of factors—including deregulation of interest rates on deposits, authorization for S&Ls to buy junk bonds, and collapse of the real estate market in Texas—numerous S&Ls and banks failed over the course of the decade. For those of us who lived through it, the S&L crisis was the biggest financial catastrophe in many years. The debacle ultimately cost taxpayers an estimated $124 billion to clean up. There was near-universal agreement that regulators' failure to close the S&Ls and banks in a timely fashion greatly increased the overall cost.[3]

While regulators' handling of the S&L and bank failures was a disaster, the FDIC does not deserve much of the blame. To start, the FDIC had little to do with the handling of S&L failures; that was the job of the Resolution Trust Corporation. And even with bank resolution, which was its responsibility, the FDIC wasn't the one that decided when it was time to step in. The bank's primary regulator made this decision (as did an S&L's primary regulator in the S&L context). Only after the primary regulator gave the okay could the FDIC sell the bank's assets, restructure it, or shut it down. This feature of the resolution process was widely viewed as its fatal flaw. A regulator who is responsible for a bank's safety and soundness, the reasoning went, will naturally drag his feet in the hope that any bank failure will occur on someone else's watch.

To remedy this and other regulatory flaws, Congress radically restructured banking and S&L regulation, particularly with respect to the resolution process, through the enactment of two laws—the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and the FDIC Improvement Act (FDICIA) of 1991. Together, these laws sharply expanded the FDIC's powers. Not only was the FDIC given responsibility for S&L as well as bank resolution, but it also was given the power to close a bank or exercise its other insolvency powers if the bank's primary regulator failed to step in.[4]

Congress didn't simply leave things to the FDIC, however. Congress also enacted (as part of FDICIA) a new set of rules—known as prompt corrective action—that require regulators to take a series of actions as a bank's financial condition deteriorates. The fine details of the prompt corrective action rules need not concern us here, but it may be worth noting that they are keyed to five levels of bank capital, ranging from well-capitalized (Zone 1) to insolvency or nearly so (Zone 5). Starting with Zone 3, FDICIA imposes explicit and increasingly severe sanctions, beginning with a requirement that the bank submit a plan for restoring its capital to appropriate levels. If a bank's net worth falls to 2 percent—that is, its assets are worth 2 percent more than its obligations—or less, regulators are required to step in, take over, and resolve the financial distress.

These rules were intended to ensure that banks would be closed promptly and that their failure would never again impose a serious cost on taxpayers. Because of deposit insurance, the government (and thus taxpayers) is on the hook if a failed bank does not have enough assets to pay its depositors in full. But if banks are closed at or before they become insolvent, the FDIC shouldn't need to tap its deposit insurance fund to pay depositors. This has been especially true since 1993, when deposits were given priority in bank insolvency proceedings.

When advocates of the new Dodd-Frank resolution rules extolled the FDIC, it was this post-1991 framework they really had in mind—the framework that gives the FDIC more authority, and prods regulators with a set of explicit rules as to when and how they should intervene.

At this point, I should briefly describe how the resolution framework is triggered under the new legislation. (For now, I'll be brief. We'll have plenty of space for a more complete overview in Chapter 8.) The rules are designed for the kinds of systemically important institutions we discussed in Chapter 5, although they are not limited to firms that automatically qualify (that is, bank holding companies with $50 billion in assets) or that have been formally designated as systemically important. The decision whether to put a financial company into the resolution regime is governed by a process that has become known as "three keys turning." The three keys are the secretary of the Treasury, the Federal Reserve Board, and the FDIC board. (For investment banks, the third key is the Securities and Exchange Commission [SEC], and for insurance companies it is the director of the new Federal Insurance Office.) If the secretary of the Treasury concludes that the company is "in default or in danger of default," two-thirds of the Federal Reserve Board and two-thirds of the FDIC board have recommended resolution, and the Treasury secretary has also consulted with the President, the secretary can initiate the new resolution process. At this point, the secretary appoints the FDIC as receiver, and the resolution is under way.[5]

You will immediately note, as I did when I began wondering if the FDIC analogy was too good to be true, that the FDIC's role in the process looks rather different in the new resolution regime than with ordinary bank failures. Indeed, the new resolution process begins in an altogether different way. Rather than a series of strict rules dictating when and how they must respond to a company's financial distress, regulators are given substantial discretion whether or when to intervene. And unlike with ordinary bank failures, the FDIC cannot intervene by itself. Nor can anyone else. Under "three keys," there are three decision makers (actually four, if we count the consultation with the President).

If you have followed the discussion thus far especially closely, you may have noticed an irony in the claim that the new resolution regime simply expands the FDIC approach to systemically important institutions. The process for putting a company into resolution doesn't look very much like current FDIC resolution. It looks a lot more like the old, pre-1991 bank insolvency regime—with an ad hoc decision when to intervene and the FDIC initially in a secondary role—than like the current approch.

I should be clear about the point here. I am simply showing how quickly the FDIC analogy breaks down: from the very beginning, with the initial issue of when and how regulators should intervene. I am *not* arguing that the FDIC should have as much control over the decision when to take over a struggling financial giant as it does with ordinary banks. That would make sense only if the FDIC-style resolution will work as well for the largest financial institutions as it does with small and medium-sized banks.

Unfortunately, it won't.

How (and How Well) Does FDIC Resolution Work?

To this point, we have limited our attention to the initial decision whether and when to trigger an insolvency regime. We turn now to the heart of the resolution process. As we consider how current FDIC resolution works, it will quickly become apparent just how much gets lost in translation if we extend the approach to the largest financial institutions, as Dodd-Frank did (though with adjustments, as we explore in Chapter 8).

Unlike bankruptcy, which relies on negotiations between the debtor's managers and its creditors and other stakeholders, with clear rules and opportunities for judicial review throughout the process, commercial bank resolution is a secret, opaque, highly discretionary administrative process centralized in the FDIC. Ordinarily, the FDIC negotiates with one or more healthy banks, and arranges for one to acquire either the troubled bank's deposits (an "insured deposit transfer," which the FDIC uses 34 percent of the time) or the deposits together with some or all of the troubled bank's assets and other liabilities (a "purchase and assumption," used for 54 percent of bank failures). To minimize disruption to depositors' access to their funds and to the payment system generally, regulators typically descend on the troubled bank on a Friday afternoon, and then effect the transfer over the weekend so that the transfer will be complete before the start of business on Monday. The sole constraint on the FDIC's decision about how to resolve the bank's distress is an obligation—another legacy of FDICIA—to select the resolution mechanism that will impose the least cost on the deposit insurance fund.[6]

In arranging the resolution, the FDIC has unfettered control over the treatment of the troubled bank's creditors. Depositors, and the deposit insurance fund, come first for the FDIC, a priority that Congress enshrined in law in 1993 by codifying depositor preference. Deposits are invariably a bank's largest liabilities, dwarfing its other obligations. More than 96 percent of the liabilities of banks with less than $100 million in assets that failed between 1995 and 2009 were deposits. For banks with between $100 million and $500 million in assets the percentage was 92.85 percent; it was roughly 88 percent for banks up to $5 billion, and 70.39 percent for the five megabanks that exceeded $5 billion in assets. Because such a large percentage of a bank's obligations are its deposits, and because depositors get paid before other creditors, most failures do not result in payments to any creditors other than secured creditors and the bank's depositors. But occasionally there is a prospect that other creditors will receive a payout, and in these cases the FDIC determines what that payout will be.[7]

In theory, a disgruntled creditor can challenge either the resolution or the FDIC's treatment of its particular claim. But such a challenge is fraught with obstacles. Because the FDIC acts secretly, creditors cannot question an FDIC action in advance. Any challenge must thus come after the fact. Moreover, the banking laws constrain the grounds for recovery in important respects—limiting it to damages, for instance, and to the difference between the claimant's payout and its likely treatment in a liquidation—and the FDIC's determinations are given de facto deference. In the words of one former FDIC official in an e-mail to my co-author on another project, "there are few cases and changes in the outcome are rare."[8]

While the special FDIC resolution regime for commercial banks is defensible and probably deserves continuing, it is closely tied to the distinctive profile of deposit-taking banks. In any other context, the secretive, ad hoc nature of FDIC resolution would be deeply problematic. But banks have several qualities that make them special. Their financial distress needs to be resolved immediately, because of banks' importance to the nation's payment system and so that consumers need not worry about losing access to their deposits even temporarily. The quick, secretive FDIC process makes this possible.

In addition, because deposits make up such a large percentage of a bank's liabilities, and because the FDIC is responsible for making sure that depositors are paid, it makes sense to let the FDIC decide what to do with the bank's assets. The FDIC and the deposit insurance fund are, in a sense, the only creditors with a real interest in the outcome. Even if the FDIC does not handle the resolution effectively, the harm to the bank's other creditors (or the windfall, in the event the FDIC decides to protect them) is quite limited in most cases.

This, then, is the basic process that was used as the foundation for the new resolution regime. The cases that proponents of Dodd-Frank had in mind when they extolled FDIC resolution were the small and medium-sized bank closings that make up the bulk of the FDIC's work. Between 1995 and 2009, for instance, the FDIC closed 99 banks with assets less than $1 billion (89 of which had assets less than $500 million) and only 20 that exceeded $1 billion in assets.[9]

Even here, with its bread-and-butter bank closings, FDIC resolution has hardly been an unqualified success. Under the mandates of the prompt corrective action rules, the FDIC theoretically should intervene early and should never lose money. But in many cases, things have not worked out this way in practice. In more than two-thirds of the bank closures during the recent crisis, the FDIC's first intervention came when the bank was put in resolution. It never imposed the earlier warning obligations specified by the banking rules. Moreover, the FDIC has lost money in a significant number of these bank closings.[10]

I do not want to denigrate the work done by the FDIC under chairwoman Sheila Bair. Bair has done a tremendous job, and she bravely challenged many of the most problematic features of the early versions of the financial reform legislation. But the suggestion that FDIC resolution is flawless is inaccurate even in ordinary cases. Much more importantly, the FDIC has struggled mightily in nearly all of its larger cases. In these cases, the FDIC has tended to delay intervention, with a strong inclination toward bailouts. The FDIC and thrift regulators waited far too long to close IndyMac, the giant thrift that collapsed in 2008, for instance, and its sale of IndyMac's assets is expected to cost taxpayers roughly $9 billion. It also stumbled in its attempt to resolve Wachovia, brokering a sale to Citigroup that was quickly trumped by Wells Fargo. The sale of Washington Mutual to JPMorgan Chase can perhaps be seen as an exception to the FDIC's difficulties with big banks, but it raises its own concerns, as we will see in a moment.

One obvious reason for the FDIC's poor track record with big banks is that the resolution process is spectacularly ill-suited to large institutions. When the FDIC arranges a purchase and assumption transaction, it ordinarily looks for a larger, healthy bank to acquire the deposits and assets. While this works tolerably well with small and medium-sized commercial banks, the FDIC may find it much more difficult to locate an appropriate buyer for a large bank. There are simply too few possible buyers for the FDIC to consider; and in some cases, there may not be any truly appropriate buyer.

To make matters worse, the FDIC faces a "damned if they do, damned if they don't" predicament. If it finds a buyer, the FDIC will have made a big bank even bigger, thus potentially either creating a bank that is too big to fail or solidifying the too-big-to-fail status of a bank that already fits this description. When the FDIC sold the assets of Washington Mutual to JPMorgan for $1.9 billion, for instance, it made JPMorgan even larger than it already was. No wonder JPMorgan's CEO Jamie Dimon is on so many White House and Washington guest lists.

There is yet another problem with the resolution of a large financial institution like Washington Mutual. A large bank's or S&L's liabilities include far more than deposits alone. In these cases, the FDIC isn't the only real creditor with an interest in the outcome. As a result, the FDIC's dictatorial powers in deciding how to treat particular claims can have a major effect on the bank's creditors. With the Washington Mutual sale, for instance, the FDIC essentially wiped out the subordinated bondholders, arguably giving them much less of a recovery than they would have received in an ordinary bankruptcy proceeding that honored creditors' priorities.[11]

If the FDIC cannot find a buyer, as will often be the case, the "damned if they don't" scenario comes into play. Absent a prospective buyer, the only obvious options are delaying intervention, a bailout, or both. This, in effect, was the government's decision as Citigroup struggled during the financial crisis. Because no one could realistically buy Citigroup, the government propped the giant bank up.

In short, both the unique qualities of commercial banks and the awkward fit between the FDIC's standard resolution techniques and the realities of large banks suggest that the FDIC model—however praiseworthy it may be for smaller banks—cannot comfortably scale up to handle the financial distress of large financial institutions with the requisite transparency and certainty. The new resolution regime thus extends FDIC oversight to precisely the kinds of financial institutions the FDIC has been least effective in handling. The laudable aspects of the FDIC's track record are a tribute to its handling of small and medium-sized bank failures, not the large ones.

Moving Beyond the FDIC Analogy

I have come down hard on the FDIC analogy in this chapter because it played such an insidious role in the debate over the new resolution rules. Like the serpent's appeal to Adam and Eve in the Garden of Eden, it had a seeming logic that derived from the partial truths underlying it. The FDIC has done a reasonably good job of handling bank failures over the past 20 years, as proponents of FDIC-style resolution suggested. But the FDIC does not have the same authority to invoke the new resolution procedures that it has with ordinary banks, and the new provisions extend FDIC-style resolution to precisely the kinds of cases where it is least effective.

Critics of my analysis will no doubt have an important objection at this point. While conceding that the new resolution rules are based on the FDIC's powers for dealing with insolvent banks, they will point out that the Dodd-Frank Act also incorporates many features that are not found in bank insolvency law. Indeed, the drafters of Dodd-Frank borrowed numerous provisions from bankruptcy law, precisely to make the new regime function more like the bankruptcy cases that are my own preferred strategy for handling troubled nonbank financial institutions. Dodd-Frank's resolution rules move well beyond the FDIC analogy, in other words, and need to be considered on their own terms.

This is a fair point, so the next chapter does just this.