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Financial Crisis Inquiry Commission

## *Preliminary Staff Report*

GOVERNMENTAL RESCUES OF “TOO-BIG-TO-FAIL” FINANCIAL INSTITUTIONS

August 31, 2010

This preliminary staff report is submitted to the Financial Crisis Inquiry Commission (FCIC) and the public for information, review, and comment. Comments can be submitted through the FCIC’s website, [www.fcic.gov](http://www.fcic.gov).

This document has not been approved by the Commission.

The report provides background factual information to the Commission on subject matters that are the focus of the FCIC’s public hearing on September 1, 2010. In particular, this report provides information on governmental rescues of “Too-Big-to-Fail” financial institutions. Staff will provide investigative findings as well as additional information on these subject matters to the Commission over the course of the FCIC’s tenure.

Deadline for Comment: September 30, 2010

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## Governmental Rescues of “Too-Big-to-Fail” Financial Institutions

The purpose of this preliminary staff report is to describe governmental rescues of financial institutions during the decades leading up to the financial crisis and during the crisis itself. Section I provides an executive summary of the report. Section II describes how federal regulators justified their rescues of large, failing commercial banks prior to 1991 by invoking a rationale commonly referred to “too-big-to-fail” or TBTF. Section III discusses how Congress attempted to narrow the scope of the TBTF rationale in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), and how TBTF considerations continued to affect the banking system despite FDICIA. Section IV focuses on two government-sponsored enterprises, Fannie and Freddie, and explains why those enterprises were viewed as presumptively TBTF prior to the financial crisis. As Section V explains, interventions by federal regulators in the capital markets between 1970 and 1998 raised questions about whether the federal government might be prepared to support large, nonbank financial institutions during a systemic crisis. Section VI describes how federal regulators and Congress greatly expanded the application of the TBTF policy and created new policy instruments to support large banks, Fannie, Freddie, and major nonbank financial institutions during the peak of the financial crisis in 2008 and 2009.

*Too big to fail* (“TBTF”) refers to a bank or other financial institution that federal regulators determine is too important to fail in a disorderly manner without protecting at least some creditors who are not otherwise protected by the federal safety net for banks. An institution may be considered too important to fail for three separate (but potentially overlapping) reasons. First, the institution may be very large in size and may be a leading participant in one or more important sectors of the financial markets. Second, a financial institution may be closely connected with other important institutions as a significant counterparty in various types of financial transactions – such as lending agreements, over-the-counter derivatives or securities repurchase agreements. Therefore, regulators may fear that a default by the first institution on its financial obligations could set off a “chain reaction” of failures among its counterparties. Third, a financial institution may have a substantial degree of public visibility and may have the same or similar risk exposures as a number of other important institutions. Consequently, regulators may fear that adverse publicity from the failure of the first institution could create a “common shock” that would cause market participants to lose confidence in the solvency of other institutions with the same or similar risk exposures.<sup>1</sup>

TBTF institutions have typically received federal financial support in one of two ways. First, federal regulators may arrange an assisted merger by providing financial support that enables another institution to acquire a TBTF institution that is in danger of default. Second, federal regulators may provide direct assistance to allow the TBTF institution to remain in operation. Federal regulators usually choose the second approach only when no private-sector merger partner is available to acquire the failing TBTF institution. Under either approach, at least some uninsured creditors of the TBTF institution receive protection as a result of federal assistance.

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<sup>1</sup> Kaufman & Scott (2003), at 372-76; Schwarcz (2008), at 198-204; Thomson (2009), at 1-6.

## I. Executive Summary

The U.S. government rescued a number of large banks following the wave of bank failures that occurred during the Great Depression. The first major bank interventions by regulators after World War II occurred in 1974 and 1980. Federal regulators first articulated a TBTF rationale as a justification for the FDIC’s rescue of Continental Illinois in 1984. The TBTF rationale was an outgrowth of (i) a strong consolidation trend in the banking industry after 1980 and (ii) a severe crisis in the banking industry between 1980 and 1992, resulting in large part from problems with loans to commercial real estate developers, energy producers and developing nations. Bank mergers created larger banks, and large banks became potential candidates for TBTF rescues when federal regulators determined that their failure would pose a serious threat to the stability of the banking system or the financial markets.

Congress attempted to narrow the scope of the TBTF rationale when it passed FDICIA in 1991. FDICIA made it significantly harder for federal regulators to protect uninsured depositors and other uninsured creditors in most banks. However, FDICIA included a “systemic risk exception” (“SRE”) that effectively codified TBTF treatment for the largest banks. After FDICIA, many banks continued to grow larger, and some market participants viewed the largest banks as presumptively TBTF. Some analysts argued that creditors and credit ratings agencies (“RAs”) gave favorable treatment to banks that were presumptively TBTF, based on the implicit public subsidies that were available to those banks. Those implicit subsidies helped the largest banks to operate profitably with lower capital ratios and to pay lower rates on their deposits and other liabilities compared with smaller banks. However, other analysts argued that the big banks were able to operate profitably with lower capital ratios and to pay lower rates on their liabilities because they were viewed as safer (due to greater diversification of risk) and more efficient (due to favorable economies of scale and scope).

Many market participants viewed the two government-sponsored enterprises (“GSEs”) that played important roles in residential mortgage financing as having presumptive TBTF status. The Federal National Mortgage Association (“Fannie”) and the Federal Home Loan Mortgage Corporation (“Freddie”) created a secondary market for home mortgages by purchasing mortgages and by securitizing mortgages to create mortgage-backed securities (“GSE MBS”). Fannie and Freddie expanded rapidly after 1985 and financed almost half of the residential mortgage market by 2003. Congress, creditors, and RAs provided favorable treatment that helped the GSEs to operate with capital ratios and costs of funding that were even lower than those enjoyed by the largest banks.

In the 1980s, the Federal Reserve Board (“Fed”) mobilized leading banks to support the stability of the capital markets during two serious disruptions. During the 1990s, two events raised questions about the availability of TBTF support for large nonbank financial institutions. In 1991, following the failure of Drexel Burnham Lambert, large Wall Street firms urged Congress to pass legislation that expanded the Fed’s ability to make emergency loans to nonbanking firms under Section 13(3) of the Federal Reserve Act. Congress included the requested amendment to Section 13(3) in FDICIA. In 1998, the Fed organized a consortium of large banks and securities firms to rescue Long-Term Capital Management, a large hedge fund whose failure threatened the stability of the financial markets.

Those events led some observers to predict, in the early 2000s, that the Fed was prepared to support major nonbanking companies if such support was deemed necessary to preserve market stability during a major crisis.

In response to the financial crisis that began in August 2007, federal regulators used extraordinary measures to prevent the failure of financial institutions that were deemed to be TBTF. The Fed provided emergency loans under Section 13(3) of the Federal Reserve Act to support the rescues of Bear Stearns and AIG. The Fed also used its Section 13(3) authority to provide emergency liquidity support to nineteen large securities firms that were primary dealers in government securities, and to stabilize the commercial paper market. Similarly, the Treasury provided a temporary emergency guarantee to stop investor runs on money market mutual funds. The Treasury, the Fed and the FDIC invoked the SRE under FDICIA on three occasions to (i) assist an emergency takeover of Wachovia, (ii) provide open-bank assistance to Citigroup, and (iii) establish a new program that guaranteed issuances of senior unsecured debt by qualifying FDIC-insured institutions and their parent companies and affiliates.

Acting under new authority granted by Congress in July 2008, federal regulators established conservatorships for Fannie and Freddie in September and subsequently provided extensive support to both GSEs. In addition, based on new authority granted by Congress in October 2008, the Treasury purchased \$260 billion in preferred stock issued by banks, including \$90 billion issued by Citigroup and Bank of America.

Federal regulators did allow two large financial institutions – Lehman Brothers (Lehman) and Washington Mutual (“WaMu”) – to fail in September 2008. However, each of those failures had a serious disruptive impact on the financial markets. The Fed rescued AIG immediately after Lehman’s failure, and the FDIC approved an assisted acquisition of Wachovia soon after WaMu’s failure. The actions of regulators in late 2008 and early 2009 indicated that they were determined not to allow any other important financial institution to fail as long as the financial crisis continued.

## **II. Bank Rescues Before FDICIA**

Following the catastrophic banking crisis of 1930-33, the Reconstruction Finance Corporation (“RFC”) – a federal agency established by Congress in 1932 – rescued a number of large banks by purchasing preferred stock and providing loans. For example, the RFC recapitalized Continental Illinois in 1933, and the RFC also provided funding to support the reorganization of other major banks in Chicago, Cleveland, Detroit, New Orleans and New York City.<sup>2</sup> In order to promote greater stability in the banking system, Congress also passed legislation creating a federal safety net to support banks and protect their insured depositors.<sup>3</sup>

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<sup>2</sup> Jones (1951), at 3-4, 16-53, 66-71; Olson (1988), at 14-18, 28-32, 37-41, 63-82; Sprague (1986), at 232.

<sup>3</sup> As subsequently expanded by Congress and federal regulators, the federal safety net for banks includes: (1) the federal deposit insurance system administered by the Federal Deposit Insurance Corporation (FDIC), (2) discount window advances and other liquidity assistance provided by the Fed as lender of last resort (LOLR), and (3) the Fed’s guarantee of interbank payments made over Fedwire. Peek & Wilcox (2004), at 179-83; Walter (1998), at 2.

The first major bank interventions by regulators after World War II occurred in 1974 and 1980. In 1974, federal regulators implemented an orderly workout that protected uninsured creditors of Franklin National Bank (“Franklin”). Between 1962 and 1973, Franklin tripled in size as it pursued an aggressive growth strategy. Franklin expanded from its original base on Long Island into New York City and subsequently opened foreign branches in Nassau and London. By 1973, Franklin had over \$5 billion of assets and ranked as one of the twenty largest U.S. banks. Many of Franklin’s high-risk loans turned sour, and the bank attempted to recover its losses by making speculative trades in the foreign exchange markets. Franklin also increased its reliance on volatile, wholesale funding from the capital markets. In 1974, more than a third of Franklin’s liabilities consisted of foreign deposits, uninsured domestic deposits, loans from other banks, and securities repurchase agreements (“repos”). When Franklin publicly disclosed large losses from its nonperforming loans and foreign exchange trading in May 1974, uninsured depositors rapidly withdrew their funds and many banks refused to roll over their interbank loans. The Fed provided emergency discount window loans that enabled Franklin to avoid immediate insolvency and remain in operation.<sup>4</sup>

Federal regulators determined that a precipitous failure of Franklin would destabilize international money markets and undermine confidence in the U.S. banking system. A severe global recession had begun in 1973. Due to the recession and the breakdown of the Bretton Woods system of fixed currency exchange rates, international money markets were experiencing severe strains. Federal regulators therefore feared that a disorderly failure of Franklin could cause significant harm to domestic and international financial markets. In particular, regulators feared that a default by Franklin on its foreign exchange contracts could trigger a crisis in foreign exchange markets and the international payments system. The regulators’ fears were confirmed in June 1974, when West German authorities closed Bankhaus I.D. Herstatt and caused the Herstatt bank to default on its foreign exchange contracts with a number of major international banks. The Herstatt failure caused a virtual freezing of global markets for currency exchange and interbank lending. The resulting paralysis strengthened the determination of federal regulators to structure a resolution of Franklin that would improve market confidence by protecting Franklin’s uninsured depositors, interbank lenders and foreign exchange creditors.<sup>5</sup> The Fed’s discount window loans to Franklin increased to \$1.7 billion by October 1974. The Fed also assumed responsibility for honoring and closing out Franklin’s foreign exchange positions. In October 1974, federal regulators closed Franklin, and the FDIC as receiver entered into a purchase and assumption agreement with European-American Bank (EAB). All uninsured depositors, interbank lenders and foreign exchange creditors of Franklin were fully protected, while the FDIC suffered a significant loss after assuming Franklin’s liabilities that EAB did not want. By supporting the orderly resolution of Franklin, the Fed and the FDIC provided a substantial economic subsidy to the bank and its uninsured depositors and other protected creditors.<sup>6</sup>

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<sup>4</sup> Sinkey (1979), ch. 6; Spero (1980), chs. 2 & 3.

<sup>5</sup> Spero (1980), ch. 4.

<sup>6</sup> Sinkey (1979), ch. 6; Spero (1980), ch. 5. See also FDIC (1998), at 530 (noting that “the FDIC protected all depositors, including the uninsured, when Franklin National Bank was declared insolvent by the OCC and closed”).

In 1980, the FDIC provided an emergency loan to prevent the failure of First Pennsylvania (“First Penn”). Like Franklin, First Penn suffered large losses after pursuing an aggressive expansion plan that was funded largely by wholesale liabilities. First Penn more than quadrupled in size between 1967 and 1980. By the end of that period, First Penn held \$9 billion of assets and ranked as the 23rd largest U.S. bank. When First Penn’s high-risk loans began to default, it attempted to cover those losses by making speculative investments in government securities. However, interest rates spiked in the late 1970s (rather than declining, as First Penn had expected), and the bank faced imminent failure due to losses from its lending and securities portfolios. The FDIC decided to rescue First Penn (thereby protecting all of First Penn’s depositors and other creditors), based on the FDIC’s determination that First Penn’s continued operation was “essential” to provide adequate banking services to the Philadelphia community and also to maintain confidence in the U.S. banking system.<sup>7</sup> The FDIC could not find any merger partner for First Penn because of the bank’s size and existing legal prohibitions against interstate bank acquisitions. Accordingly, the FDIC structured an “open-bank assistance” package to keep First Penn in operation. The FDIC provided a \$325 million loan to First Penn that was interest-free for five years, and the FDIC received warrants that could be exercised to purchase a majority of First Penn’s stock. The FDIC also replaced most of First Penn’s senior executives and directors. In many respects, the FDIC’s assistance package for First Penn was the prototype for the FDIC’s rescue of Continental Illinois four years later.<sup>8</sup>

Federal regulators first articulated the TBTF rationale as a justification for their rescue of Continental Illinois (“Continental”), the seventh largest U.S. bank, in May 1984. Continental found itself on the brink of failure after pursuing a high-growth, high-risk strategy in the 1970s and early 1980s. Continental more than doubled in size between 1976 and 1981, as its assets grew from \$21 billion to \$45 billion. During that period, the bank expanded its lending to a wide range of risky borrowers, including energy producers, real estate developers and developing nations. Because Illinois law did not permit Continental to establish branches outside of Chicago, the bank funded its growth primarily through uninsured domestic deposits, foreign deposits and interbank loans. By 1984, only \$3 billion of Continental’s more than \$30 billion of deposits were insured by the FDIC. Continental’s growth strategy produced devastating losses, especially after Penn Square Bank, N.A. (“Penn Square”) failed in July 1982. Continental had purchased \$1 billion in energy loan participations from Penn Square, and Penn Square’s failure alerted investors and large, uninsured depositors to the risks inherent in Continental’s portfolio of energy loans.

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<sup>7</sup> Based on the FDIC’s determination that First Penn was an “essential” bank, the FDIC had authority to provide assistance to keep First Penn in operation under the existing provisions of Section 13(c)(4)(A) of the Federal Deposit Insurance Act. Sprague (1986), at 27-29, 90-92. In 1991, FDICIA replaced the “essential” test with the systemic risk exception contained in Section 13(c)(4)(G) of the FDI Act. Stern & Feldman (2004), at 152-55.

<sup>8</sup> Sprague (1986), ch. V. See also *id.* at 97 (stating that the FP transaction was “a megabank rescue that was to be the prototype for the Continental transaction”). Irvine Sprague, who was FDIC chairman when First Penn was rescued, later explained that “runaway interest rates and inflation” in early 1980 created disorder in the capital markets that strongly counseled against allowing any disorderly failure of First Penn: “The stock market was in disarray. The financial markets were, if anything, in a greater state of chaos with the near collapse of the silver market after the Hunt brothers’ speculation.” *Id.* at 83-84.



In May 1984, Continental issued a quarterly earnings report that disclosed more fully the magnitude of its problems. Soon thereafter, Continental’s uninsured depositors began an electronic run (by wiring the bank to withdraw their funds), and that run quickly depleted the bank’s liquidity and created an imminent risk of insolvency. Continental was forced to borrow large sums from the Fed’s discount window to remain in operation.<sup>9</sup>

Federal regulators concluded that Continental’s sudden collapse might cause the failure of numerous community banks that kept substantial deposits with Continental and received check-clearing and other services from Continental. More seriously, regulators feared that Continental’s failure might lead to runs by uninsured depositors against other large U.S. banks that faced similar financial problems with real estate loans, energy loans and loans to developing countries. The potentially threatened banks included Bank of America, First Chicago, and Manufacturers Hanover. As a subsequent FDIC study explained, “the regulators’ greatest concern was systemic risk, and therefore handling Continental through a payoff and liquidation was simply not considered a viable option. . . . [¶] Regulators feared that if Continental were allowed to close, a series of large institutions might be next.”<sup>10</sup> Thus, Continental evidently was deemed TBTF because its risk exposures were very similar to those of other banks that were even larger and more important to the stability of the banking system.

Because of Continental’s size and Illinois’ anti-branching law, no merger partner was available to acquire Continental. The FDIC therefore provided a \$4.5 billion package of open-bank assistance (including a loan and an infusion of capital) to ensure the bank’s survival. The FDIC’s loan enabled Continental to pay off discount window advances it had previously received from the Fed. Continental’s shareholders suffered an 80% dilution of their ownership, because the FDIC received preferred stock and warrants convertible into 80% of Continental’s common stock. The FDIC also replaced Continental’s senior management. However, the FDIC’s assistance package protected all of Continental’s creditors, including uninsured depositors, bondholders, and other uninsured creditors of both the bank and its parent holding company.<sup>11</sup>

During a hearing on Continental’s rescue conducted by the House Committee on Banking, Housing, and Urban Affairs in September 1984, Comptroller of the Currency C. Todd Conover stated that federal regulators would not allow any of the eleven largest “money center” banks to fail. Representative Stewart McKinney of Connecticut, a member of the committee, declared that “[w]e have a new kind of bank. It is called too big to fail. TBTF, and it is a wonderful bank.”<sup>12</sup> Representative McKinney’s term became widely accepted, as economist George Kaufman later explained:

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<sup>9</sup> For discussions of Continental’s problems and the resulting depositor run, see FDIC (1997), at 236-44; FDIC (1998), at 546-49; Sprague (1986), at 149-54.

<sup>10</sup> FDIC (1997), at 250-51.

<sup>11</sup> For discussions of the rescue of Continental, see FDIC (1997), at 242-52; FDIC (1998), Part II, ch. 4; Sprague (1986), chs. VIII-XI.

<sup>12</sup> Kaufman (2002), at 434-35 (quoting from the hearing transcript). See also Stern & Feldman (2004), at 13,

“[T]he next day (September 20, 1984), the *Wall Street Journal* headlined a lengthy article on the hearings ‘U.S. Won’t Let 11 Biggest Banks in Nation Fail – Testimony by Comptroller at House Hearing Is First Policy Acknowledgment’ . . . . And so, the term TBTF was born.”<sup>13</sup>

In a June 1985 speech, FDIC director Irvine Sprague defended the Continental bailout and explained that federal regulators rescued Continental because “[w]e believed the very fabric of our banking system was at stake.”<sup>14</sup>

In fact, TBTF is not a completely accurate description of the types of large bank rescues that federal regulators arranged from the 1970s through the early 1990s. Those federally assisted transactions protected uninsured depositors and (in many cases) at least some other classes of uninsured creditors. In contrast, shareholders typically lost most or all of their investments, and senior executives usually lost their jobs. A 1991 Treasury Department study provided the following, more accurate description of the TBTF policy:

“The phrase ‘too big to fail’ refers to a situation in which the FDIC (or some other governmental unit) is unwilling to inflict losses on uninsured depositors and even creditors in a troubled bank (or bank holding company) for fear of adverse macroeconomic consequences or financial instability of the system as a whole.”<sup>15</sup>

Following its rescue of Continental, the FDIC structured similar bailouts of several other large failing banks during the 1980s and the early 1990s. The banks involved in those transactions included three large Texas banks (First City, First RepublicBank and MCorp) and Bank of New England (“BNE”). The FDIC supported First City with an open-bank assistance package. As in the case of Continental, First City’s shareholders lost most of their investment and First City’s management was replaced. In contrast, the FDIC arranged assisted mergers for First RepublicBank, MCorp and BNE. In all four transactions, the FDIC protected all depositors and general creditors of the failed banks, including trade creditors, unaffiliated interbank lenders, and holders of “qualified financial contracts” (e.g., interest rate swaps, foreign currency swaps and other over-the-counter derivatives). However, the FDIC did not protect holding company bondholders or affiliated banks that held claims against the failed banks. The FDIC’s refusal to protect holding company creditors in all four transactions marked a significant change from the First Penn and Continental rescues, in which the FDIC’s assistance packages had the effect of protecting all creditors of the parent holding companies.<sup>16</sup>

Like Franklin, First Penn, Continental and many other failed banks during the 1970s and 1980s, Bank of New England failed after pursuing an aggressive expansion plan premised on high-risk lending. BNE more than doubled in size (from \$14 billion to \$32 billion in assets) between 1985 and 1989. BNE’s lending was heavily focused in the commercial real estate market. By 1990,

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<sup>13</sup> Kaufman (2002), at 426.

<sup>14</sup> Sprague (1986), at 248-50 (summarizing speech delivered on June 7, 1985).

<sup>15</sup> U.S. Treasury Dept. (1991), at III-29. See also Stern & Feldman (2004), at 12 (“Protection of uninsured creditors of banks is one major feature that underlies any description of too big to fail. The second feature . . . refers to banks that play an important role in a country’s financial system and its economic performance”).

<sup>16</sup> See FDIC (1997) at 252-54, 375-76; FDIC (1998), Part II, chs. 5-8.

nearly half of BNE’s construction loans and almost a fifth of its commercial mortgage loans were delinquent. Thus, a common factor in the failures of all four banks was a rapid growth strategy in which management pursued short-term profits and ignored longer-term risks.<sup>17</sup> Federal regulators rescued BNE in January 1991, after BNE (1) announced a quarterly earnings loss that rendered the bank technically insolvent, and (2) experienced a devastating depositor run that resembled the run on Continental. A notable difference was that BNE’s run included large withdrawals by retail depositors at branches, while Continental’s run primarily consisted of electronic withdrawals by large uninsured depositors. Shortly before BNE’s depositor run began, the governor of Rhode Island closed 45 state-insured credit unions, and depositors at those institutions lost access to their deposits because the state insurance fund was insolvent. In addition, the FDIC closed Capitol Bank & Trust Co., a midsized Boston bank, in December 1990, and the FDIC did not protect the uninsured depositors in that bank.<sup>18</sup>

Thus, the failure to protect all uninsured depositors at smaller institutions during a generalized financial crisis evidently triggered a depositor run at BNE and caused regulators to invoke the TBTF doctrine. The same may have been true in Continental’s case. Continental’s depositor run occurred in May 1984, after the FDIC had refused to protect uninsured depositors and other uninsured creditors when Penn Square failed in July 1982, and also when thirteen smaller banks failed during 1983 and early 1984.<sup>19</sup>

The rescues of TBTF banks during the 1980s and early 1990s occurred during the most serious U.S. banking crisis since the 1930s. In response to a series of regional banking disruptions that spread across the nation, more than 1600 banks failed between 1980 and 1994, at a cost to the FDIC of more than \$36 billion. In addition, 1300 savings associations failed between 1980 and 1994, resulting in total losses of \$160 billion, of which \$132 billion was borne by taxpayers and \$28 billion was borne by the Federal Savings and Loan Insurance Corporation.<sup>20</sup> Several of the nation’s largest banks – including Bank of America, Citicorp and Chase Manhattan – were gravely weakened due to their large portfolios of nonperforming loans to commercial real estate developers, energy producers and developing nations. Thus, the largest banks were exposed to many of the same risks that caused the failures of Continental, First City, First RepublicBank, MCorp and BNE. Regulators feared that the disorderly failure of any large bank would create adverse publicity that might precipitate a run by uninsured creditors against even larger banks that held similar risk exposures. Prior to 1992, Penn Square (with assets of \$510 million) was the largest bank to fail without receiving full protection for all of its depositors, including uninsured depositors.<sup>21</sup>

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<sup>17</sup> See Sinkey (1979), at 158-63; Spero (1980), at 25-47; Sprague (1986), at 84-86, 149-52; FDIC (1997), at 236-41, 370-78; FDIC (1998), at 516-17, 546-47.

<sup>18</sup> FDIC (1997), at 241, 250-51, 375; FDIC (1998), at 638-39; Sprague (1986), at 116-19, 125-26, 133-34; Wilmarth (1992), at 998 n.19.

<sup>19</sup> See Sprague (1986), at 116-19, 252-57; FDIC (1997), at 236, 241, 250-51, 324-25. See also FDIC (1998), at 542: “In the aftermath of Penn Square, the prevalent feeling was that perhaps the FDIC would be a little less ready to protect uninsured creditors at failed depository institutions . . . . [B]efore Penn Square, no bank of that size had ever been handled without protecting all depositors. The next major event was the Continental transaction in 1984”).

<sup>20</sup> FDIC (1997), at 186-87; FDIC (1998), at 4, 28-29, 98, 807-08.

<sup>21</sup> FDIC (1997), at 42-46, 241 & chs. 5-10; Wilmarth (2002), at 302-05, 313-16.

Based on the FDIC’s bailouts of major banks during the 1980s and early 1990s, two senior Federal Reserve officials – Gary Stern and Ron Feldman – argued in 2004 that a TBTF rationale had developed, and that TBTF was generally understood as “a policy environment in which uninsured creditors expect the government to protect them from prospective losses from the failure of a big bank.”<sup>22</sup> They further warned that “[t]o the extent that creditors of TBTF banks expect government protection, they reduce their vigilance in monitoring and responding to these banks’ activities . . . [and] the banks may take excessive risks.”<sup>23</sup> Similarly, FDIC officials acknowledged that TBTF bailouts during the 1980s and early 1990s created significant public controversy on the grounds that (1) they weakened incentives for market discipline by uninsured depositors and creditors of large banks, and (2) they resulted in unequal treatment between uninsured depositors at TBTF banks, who received full protection, and uninsured depositors at small banks, who often were not protected.<sup>24</sup>

### III. The Impact of FDICIA on Bank Rescues

Congress attempted to impose strict limits on bank rescues when it passed the Federal Deposit Corporation Insurance Improvement Act of 1991 (“FDICIA”). FDICIA included “prompt corrective action” and “least-cost resolution” requirements that were designed to limit the frequency and scope of TBTF rescues. The prompt corrective action provisions required regulators to impose “progressively harsher sanctions as a bank’s financial condition deteriorated” and to close any bank whose “equity declines to less than a minimum of 2% of its on-balance-sheet assets.”<sup>25</sup> The least-cost resolution provisions barred the FDIC from approving any transaction that would protect uninsured depositors or other uninsured creditors in a failed bank unless that transaction represented the least costly resolution option available to the FDIC.<sup>26</sup> However, FDICIA included a “systemic risk exemption” (“SRE”). The SRE was included in FDICIA after federal regulators (including Fed Chairman Alan Greenspan) urged Congress to give regulators the flexibility and discretion to protect uninsured bank creditors of large failing banks “in the interests of macroeconomic stability.”<sup>27</sup> The SRE permits the FDIC to protect uninsured depositors or other uninsured creditors of a failing bank if such protection would avoid or mitigate “serious adverse effects on economic conditions or financial stability.”<sup>28</sup> In order to invoke the SRE, the Secretary of the Treasury (after consultation with the President) must approve a written recommendation issued by two-thirds of the Board of Directors of the FDIC and two-thirds of the Board of Governors of the Fed. If the Treasury Secretary decides to invoke the SRE, the Secretary’s determination is subject to review by the Government Accountability Office (“GAO”) and by Congress. In addition, the FDIC must impose a special after-the-fact assessment on the banking industry to recover any loss incurred by the FDIC in protecting uninsured creditors.<sup>29</sup>

<sup>22</sup> Stern & Feldman (2004), at 13. Mr. Stern is a former president, and Mr. Feldman is currently senior vice president, at the Federal Reserve Bank of Minneapolis.

<sup>23</sup> *Id.* at 2.

<sup>24</sup> FDIC (1997), at 248-52, 376; Sprague (1986), at 242-56.

<sup>25</sup> Kaufman (2002), at 427. See also Carnell (1993).

<sup>26</sup> Kaufman (2002), at 427; Stern & Feldman (2004), at 78, 154.

<sup>27</sup> FDIC (1997), at 252 (quoting Mr. Greenspan).

<sup>28</sup> 12 U.S.C. §1823(c)(4)(G)(i).

<sup>29</sup> Kaufman (2002), at 427-28; Stern & Feldman (2004), at 154-56; FDIC (1997), at 252-53.

From the enactment of FDICIA in 1991 until the outbreak of the financial crisis in 2007, analysts and policymakers debated whether FDICIA significantly reduced the likelihood of future TBTF bailouts. Economists George Benston, George Kaufman and Larry Wall argued that FDICIA’s least-cost resolution requirements and detailed procedures for invoking the SRE significantly reduced the probability that regulators would approve future TBTF rescues of uninsured creditors.<sup>30</sup>

In contrast, Stern and Feldman maintained that (1) the interagency procedures required by FDICIA for invoking the SRE were closely similar to the procedures that regulators had actually followed in approving TBTF bailouts of Continental and BNE, and (2) prior TBTF rescues had been subject to the same kind of congressional reviews and GAO audits that FDICIA mandated. Accordingly, they argued that the FDICIA’s procedures for SREs essentially codified existing TBTF practices.<sup>31</sup> In addition, they contended that FDICIA’s inclusion of the SRE was important because it provided an explicit statutory foundation for future TBTF rescues.<sup>32</sup> Thus, analysts disagreed about the degree to which FDICIA would restrict the future use of TBTF rescues. In the early 2000s, most observers acknowledged that the impact of FDICIA could not be predicted with confidence, because no bank larger than \$3 billion failed between the enactment of FDICIA in November 1991 and the early years of the 21st century.<sup>33</sup> Most analysts also agreed that the requirements for invoking the SRE under FDICIA had probably increased the size threshold for applying the TBTF rationale.<sup>34</sup>

Some studies have indicated that, post-FDICIA, market participants continued to view the largest banks as presumptively TBTF. Economists Elijah Brewer and Julapa Jagtiani found that acquiring banks paid significantly higher deal premiums to complete mergers that enabled the resulting banks to become larger than \$100 billion.<sup>35</sup> Brewer and Jagtiani inferred that acquiring bank executives were willing to pay a significant bonus to target bank shareholders when the acquisition helped the acquiring bank to become presumptively too big to fail.<sup>36</sup> Their study and two other studies determined that investors received substantial gains from bank megamergers in the 1990s if those mergers created banks with more than 2% of the banking industry’s total assets (approximately \$100 billion).<sup>37</sup> In addition, their study and another study concluded that

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<sup>30</sup> See Benston & Kaufman (1997), at 150; Wall (1993), at 11.

<sup>31</sup> Stern & Feldman (2004), at 77-79, 149-57.

<sup>32</sup> *Id.*, at 156. See also Wilmarth (1992), at 996-97 (noting that FDICIA “for the first time provides a clear statutory basis for the ‘too big to fail’ doctrine”).

<sup>33</sup> Kaufman (2002), at 431; Stern & Feldman (2004), at 78.

<sup>34</sup> Kaufman (2002), at 431 (concluding that future applications of the TBTF doctrine would probably be limited to “the largest and most complex banks”). See also Stern & Feldman (2004), at 70-77, 149-50, 157 (expressing same view).

<sup>35</sup> Brewer & Jagtiani (2009), at 11-22, 31-35. Brewer & Jagtiani wrote that “banks have paid at least \$14 billion in added merger premiums during 1991-2004 for the eight merger deals that allowed the organizations to cross the perceived TBTF size threshold of \$100 billion in assets.” *Id.* at 5. They also stated that the favorable responses of the stock and bond markets to such mergers provided “further support” for their findings of “TBTF subsidies.” *Id.* at 26.

<sup>36</sup> *Id.* See also Stern & Feldman (2004), at 32-33 (stating that “analyses of mergers also support the existence of expectations of TBTF coverage. . . . ‘The gains in wealth from mergers are particularly noteworthy when the resulting banking organization has more than \$100 billion in assets’”).

<sup>37</sup> Brewer & Jagtiani (2009), at 8 n.4 (noting that 2% of banking industry assets ranged from \$77 billion in 1991 to \$142 billion in 1998), 26-29 (showing stockholder gains from large bank mergers between 1991 and 1998,

bank mergers significantly reduced the credit spreads between their bond yields and comparable Treasury bill rates – thereby reducing their funding costs – if the resulting banks reached a size that was presumptively TBTF.<sup>38</sup>

Economists Donald Morgan and Kevin Stiroh found that, even after FDICIA was passed, bond investors applied less severe discipline to banks that seemed assured of TBTF treatment. Morgan and Stiroh examined the reaction of bond investors to negative changes in credit ratings for banks from 1993 to 1998. They determined that bond investors responded less forcefully to negative credit ratings changes when they occurred at the eleven banks that were identified by the *Wall Street Journal* as being TBTF in September 1984.<sup>39</sup> Morgan and Stiroh concluded that, even after FDICIA, bond investors viewed the downside risk of holding bonds issued by the eleven designated banks as being limited by the expected availability of government support.<sup>40</sup> Bertrand Rime found similar evidence of TBTF benefits based on credit ratings assigned by Moody’s and Fitch to banks in 21 industrialized countries between 1999 and 2003. During that period, Moody’s and Fitch gave each bank an “individual” rating based on its “intrinsic” ability to pay its debts from its own resources and an “issuer” rating that took account of the bank’s ability to secure external support from third parties, including governmental agencies. The rated banks ranged in size from \$1 billion to \$1 trillion. Rime determined that RAs gave banks in the range of \$100 to \$400 billion a significant ratings bonus (in the form of a ratings upgrade) compared to smaller banks with similar financial characteristics. RAs gave banks in the range of \$400 billion to \$1 trillion an even larger ratings bonus. Moreover, the biggest ratings bonuses for implicit government support were awarded to the largest banks with the lowest intrinsic financial strength. Rime concluded that “proxies of the TBTF status of a bank (total assets and market share) have a positive and significant effect on large banks’ issuer ratings, and . . . the rating bonus also implies a substantial reduction of the refinancing costs of those banks that are regarded as TBTF by rating agencies.”<sup>41</sup>

A study by the Bank of England determined that RAs gave 26 large global banks an average rating upgrade of almost two notches in 2007, based on the banks’ presumed access to governmental support. The study estimated that the 26 global banks received an implicit subsidy of \$37 billion in 2007 – of which \$18 billion accrued to the five largest banks – in the form of reduced funding costs due to lower rates paid on bonds and other ratings-sensitive wholesale liabilities. The estimated subsidy figure was conservative, because it excluded potential subsidies resulting from lower rates paid by the largest banks on their retail deposits.<sup>42</sup>

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especially for mergers creating banks with more than \$100 billion in assets); Penas & Unal (2004), at 152-64; (documenting wealth gains for stockholders and bondholders in large bank mergers between 1991 and 1998, with the highest gains resulting from mergers that created banks with more than 2% of industry assets); Kane (2000), at 682-89 (finding wealth gains for stockholders in a majority of the largest bank mergers between 1991 and 1998). A fourth study showed that Value Line forecasts predicted larger revenue and cash flow gains for bank mergers between 1983 and 2007 if the mergers created banks holding more than 2% of the banking industry’s assets. Devos et al. (2010).

<sup>38</sup> Penas & Unal (2004), at 164-71; Brewer & Jagtiani (2009), at 29-31.

<sup>39</sup> Morgan & Stiroh (2005).

<sup>40</sup> *Id.* at 7-9, 14-15, 18.

<sup>41</sup> Rime (2005) (quote at 26).

<sup>42</sup> Haldane (2010), at 4-6, 24-25 (tbls. 2 & 4).

Some scholars maintained that the largest U.S. banks received implicit TBTF subsidies because they operated with lower equity capital ratios, and paid lower interest rates on their domestic deposits, compared with smaller banks. Based on Fed data for 1997, economists Gerald Hanweck and Bernard Shull determined that “the ten largest banks paid much less for [deposit] funds than the smallest banks, i.e., those not in the largest 1000,” and the ten largest banks also had a “substantial cost advantage . . . over [banks] ranked in size from 101 to 1000.” Moreover, the largest banks “operate[d] with lower capitalization rates and, therefore, enjoy[ed] lower equity costs of capital.”<sup>43</sup> Hanweck and Shull observed that “inspection of the data for years back to 1988 suggest that 1997 is not an anomaly; the differentials have persisted for at least a decade.”<sup>44</sup> Accordingly, they concluded that “the cost advantage provided by TBTF is likely to be great.”<sup>45</sup>

Fed data show that the same types of cost differentials existed between 1998 and 2007. During those years, the ten largest banks continued to hold lower levels of equity capital, and to pay lower interest rates on domestic deposits, compared with banks ranked below the top 100 in size.<sup>46</sup>

Other scholars, including Charles Calomiris and Jason Karceski, maintained that big banks were fully justified in operating with lower capital ratios, and in paying lower interest rates on their deposits and bonds, without regard to any expected access to TBTF protection. Those scholars pointed out that big banks made significant investments in advanced information systems, specialized staffs and other facilities that enabled them to expand into potentially lucrative, fee-based lines of business that smaller banks could not enter, such as mass-marketing of consumer financial products, securitization of consumer loans, and a wide variety of capital markets activities, including securities underwriting and dealing in over-the-counter derivatives. Proponents of the advantages of large banks argued that those banks (i) were more efficient than smaller banks due to favorable economies of scale and scope, and (ii) were safer than smaller banks due to greater diversification of asset and geographic risks.<sup>47</sup> A recent study by David Wheelock and Paul Wilson concluded, based on a new analytical methodology, that the largest banks produced superior economies of scale compared to smaller banks from 1984 through 2006.<sup>48</sup>

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<sup>43</sup> Hanweck & Shull (1999), at 274-76. See also Stern & Feldman (2004), at 33 (stating that studies “suggest that TBTF protection benefits larger banks by lowering their costs of raising deposits”).

<sup>44</sup> Id. at 275.

<sup>45</sup> Id. at 276.

<sup>46</sup> For each year between 1998 and 2007, the average equity capital ratio of the ten largest banks was at least 140 basis points lower than the average ratio for banks ranked below the top 100 in size. Similarly, for each of those years, the average interest rate paid on domestic deposits by the ten largest banks was at least 35 basis points below the average rate paid by banks ranked from 101 to 1000 in size, and at least 55 basis points below the average rate paid by banks ranked below 1000 in size. Bassett & Thomas (2007), at A31-A32 (tbl. A.1.B) (providing capitalization and deposit interest rate data for the ten largest banks from 1998 through 2007); id. at A35-A36 (tbl. A.1.D. (providing same data for banks ranked in size from 101 to 1000); id. at A37-A38 (tbl. A.1.E. (providing same data for banks ranked in size below 1000)). In 2007, the 10 largest banks each held more than \$140 billion in assets. Banks ranked between 101 and 1000 in size held assets of \$500 million to \$7 billion, and banks ranked below 1000 in size held less than \$500 million in assets. Id. at A1 (Note).

<sup>47</sup> Calomiris & Karceski (2000); Danielson (1999); Hughes & Mester (1998).

<sup>48</sup> Wheelock & Wilson (2009).

Opposing scholars did not agree that the largest banks were more efficient or safer than midsized banks. They pointed out that most empirical studies failed to confirm the existence of favorable economies of scale or scope in banks larger than \$25 billion.<sup>49</sup> In addition, several studies found that big banks assumed greater risks in their lending and capital markets operations during the 1980s and 1990s, and those additional risks more than outweighed any possible gains in safety resulting from asset and geographic diversification. Those studies concluded that big banks were riskier than smaller and midsized banks. The authors maintained that presumptive TBTF status provided the most plausible explanation for the ability of big banks to operate with less capital, and to pay lower interest rates on their deposits and bonds, during the 1990s.<sup>50</sup>

Thus, there was considerable debate among scholars prior to the financial crisis about whether the largest banks received favorable treatment from the capital markets due to their presumptive TBTF status or instead due to their superior efficiency and safety. In addition to any incentives provided by potential TBTF status, public statements by bank executives and analysts indicated that large banks pursued aggressive acquisition strategies to achieve market leadership and to build greater protection against unwanted takeovers.<sup>51</sup>

In any event, seventy-four megamergers (in which the acquiring and acquired banks each held more than \$10 billion in assets) occurred in the U.S. banking industry between 1990 and 2005. During that period, the ten largest banks increased their share of banking industry assets from 25% to 55%.<sup>52</sup> Each of the five largest U.S. banks – Bank of America, Citigroup, JPMorgan Chase, Wachovia and Wells Fargo – was the product of multiple mergers, and their combined assets more than tripled (from \$2.2 trillion to \$6.8 trillion) between 1998 and 2007.<sup>53</sup>

Hanweck and Shull argued in 1999 that a combination of market power and TBTF status gave the largest banks “a strategic advantage” over smaller banks and enhanced their “dominant market position.”<sup>54</sup> In 2000, Edward Kane warned that megamergers in the U.S. banking industry were creating huge institutions that were not only TBTF but also “too big to discipline adequately (TBTDA).”<sup>55</sup>

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<sup>49</sup> Amel et al. (2004); Hanweck & Shull (1999), at 259-63, 273-77; Stern & Feldman (2004), at 66; Wilmarth (2002), at 279-85. Similarly, a recent study concluded that banks larger than \$30 billion in twelve European nations did not produce favorable economies of scale and operated with inferior levels of efficiency between 1998 and 2004. The study’s results indicated that the advantages accruing to the largest banks from technological changes were not sufficient to create favorable economies of scale or superior levels of efficiency for those banks. Papadopoulos (2010), at 288-92.

<sup>50</sup> Boyd & Gertler (1994); Hanweck & Shull (1999), at 273-77; Stern & Feldman (2004), at 18-19, 60-79; Wilmarth (2002), at 300-08, 444-76.

<sup>51</sup> See Wilmarth (2002), at 292-93 (citing statements by bank executives and analysts indicating that “a major growth incentive for bank managers is the widely shared assumption that the biggest banks will achieve *permanent* status at the top of the financial industry. Bank executives and analysts . . . believe that the five or ten largest banks cannot be acquired against the wishes of their management”).

<sup>52</sup> Jones & Oshinsky (2009), at 58.

<sup>53</sup> GAO (2010a), at 19 (Figure 5); Stowell (2010), at 406-07 (Exhibit 1); Wilmarth (2009), at 975-76.

<sup>54</sup> Hanweck & Shull (1999), at 265-79 (quotes at 276-77).

<sup>55</sup> Kane (2000), at 673.



The enactment of the Gramm-Leach-Bliley Act (“GLBA”) in 1999 allowed large banks to become even larger and more complex institutions by merging with securities firms and insurance companies to form financial holding companies. GLBA ratified previous orders by the Fed that allowed bank holding companies to establish a significant presence in the securities industry during the 1990s. Scholars supporting the enactment of GLBA maintained that the new diversified financial holding companies would earn higher profits based on favorable economies of scale and scope, would achieve greater safety due to a broader diversification of activities, and would offer increased convenience and lower costs to customers through “one-stop shopping.”<sup>56</sup> However, Kane warned that “the demise of Glass-Steagall and Bank Holding Company Act restrictions on U.S. banks’ ability to affiliate with other types of financial firms threatens to make TBTF subsidiaries more widely accessible than ever before.”<sup>57</sup> Similarly, Shull and Hanweck contended that “bank-centered financial holding companies, as permitted by [GLBA], are likely to result in a small group of financial organizations . . . that control the preponderance of banking and financial resources in the country, are ‘too-big-to-fail,’ and that dominate most wholesale and retail banking markets.”<sup>58</sup>

#### **IV. Before the Financial Crisis, Many Market Participants Viewed Fannie and Freddie as Presumptively TBTF**

Prior to the financial crisis, Fannie and Freddie were viewed by many market participants as presumptively TBTF. Congress privatized Fannie and Freddie in 1968 and 1989, respectively, and authorized them to operate as privately owned, government-sponsored enterprises or GSEs with a mission to create a secondary market for residential mortgages.<sup>59</sup> Fannie and Freddie carried out that mission by (1) borrowing funds in the capital markets to finance purchases of mortgages from primary lenders, and (2) securitizing purchased mortgages and issuing guarantees on the performance of the resulting mortgage-backed securities. Although their mission was focused on supporting financing for home mortgages, Fannie and Freddie had some similarities to FDIC-insured banks. Like banks, Fannie and Freddie were shareholder-owned, for-profit corporations that received government benefits and were subject to federal regulation.<sup>60</sup>

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<sup>56</sup> Barth et al. (2000); Santos (1998).

<sup>57</sup> Kane (2000), at 674. See also Wilmarth (2002), at 218-21, 300-08, 318-20, 444-51.

<sup>58</sup> Shull & Hanweck (2002), at 214.

<sup>59</sup> Congress established Fannie Mae in 1938 to buy and hold mortgages insured by the Federal Housing Authority (FHA). Congress chartered Freddie Mac in 1970 as a subsidiary of the Federal Home Loan Bank Board to purchase mortgages originated by thrift institutions. Congress privatized Fannie and Freddie in 1968 and 1989, respectively, by converting them into GSEs. When Fannie was privatized in 1968, its secondary market functions with respect to mortgages insured by the FHA and mortgages guaranteed by the Veterans Administration were transferred to the Government National Mortgage Association (Ginnie Mae). An important factor behind the privatization of Fannie Mae was the desire to move its financial obligations off the federal budget. FCIC (2010), at 1-2; GAO (1996), at 2-4, 24-27; GAO (2009b), at 12-14.

<sup>60</sup> One important difference between GSEs and the banks was that the president appointed five of the 18 directors for each of Fannie and Freddie, while all of the directors of FDIC-insured national and state banks are elected by shareholders. GAO (2004), at 3-5, 10-11 & n.3.

Fannie and Freddie enjoyed special privileges from their status as GSEs. For example, each entity held a \$2.25 billion conditional line of credit from the U.S. Treasury. In addition, both entities were exempt from paying state and local corporate income taxes and from registering their securities with the SEC.<sup>61</sup> Most importantly, Fannie and Freddie benefited from a widely shared expectation among market participants that the federal government would not allow them to default on their debt obligations and agency MBS guarantees. In 1996 the GAO reported:

“A major factor that enhances the enterprises’ profitability is the financial market’s perception that there exists an implied federal guarantee of their debt and other obligations (i.e., a perception that the federal government would act to ensure that the enterprises will always be able to meet their financial obligations on their debt and MBS guarantees). Investors perceive that this implied guarantee decreases the risk that the enterprises will ever fail to meet their financial responsibilities.”<sup>62</sup>

Similarly, in 2004, the GAO stated that “[a]lthough the federal government explicitly does not guarantee the obligations of the GSEs, it is generally assumed on Wall Street that assistance would be provided in a financial emergency.”<sup>63</sup> This assumption was strengthened by the federal government’s decisions to provide assistance to Fannie (in the form of tax relief, regulatory forbearance and relaxed capital requirements) and to the Farm Credit System (in the form of emergency funding through the Farm Credit System Financial Assistance Corp.) when both GSEs suffered significant losses during the early 1980s.<sup>64</sup> The GAO concluded in 1996 that market participants viewed Fannie and Freddie as “too big to fail” because the GSEs’ special privileges, “plus each enterprise’s \$2.25 billion conditional line of credit with the Treasury, reinforce the market’s perception that the government will not let the enterprises fail.”<sup>65</sup>

Fannie and Freddie received significant financial benefits from their presumed TBTF status. The GSEs’ implied federal guarantee lowered their costs of funding in terms of interest paid on debt securities and premiums paid on guarantees of GSE MBS. In addition, RAs and federal and state regulators considered GSE MBS to be “low-risk debt” that could be bought and sold by banks, insurance companies and other investors that are required to invest in highly rated securities. Thus, the implied federal guarantee assured “a ready and consistent outlet for the enterprise debt and MBS.”<sup>66</sup>

A study commissioned by the GAO estimated in 1996 that Fannie and Freddie paid interest rates on their debt that were significantly lower than the rates paid by their potential competitors between 1985 and 1994. In addition, the study estimated that Fannie and Freddie paid yields on GSE MBS that were substantially lower than comparable yields on private-label MBS.<sup>67</sup> The 1996 GAO report further concluded that Fannie and Freddie would have to increase their capital

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<sup>61</sup> GAO (1996), at 31-32, 40-45.

<sup>62</sup> Id. at 17. See also id. at 40 (“the most important advantage of the enterprises’ government-sponsored status is the perception of financial market participants that the federal government is likely to act to ensure that the enterprises will meet their debt and MBS obligations”).

<sup>63</sup> GAO (2004), at 6.

<sup>64</sup> FCIC (2010), at 9; GAO (1996), at 27; GAO (2004), at 6.

<sup>65</sup> GAO (1996), at 18.

<sup>66</sup> GAO (1996), at 41 (quote).

<sup>67</sup> Id. at 42-44 (describing results of study by Brent Ambrose and Arthur Warga).

levels if they lost their preferred status as GSEs.<sup>68</sup> Two studies by the Congressional Budget Office in 2001 and 2004 confirmed that Fannie and Freddie received large federal subsidies as a result of their status as GSEs.<sup>69</sup>

The funding and capital advantages of GSEs were even greater than those enjoyed by large banks. For example, Fannie’s and Freddie’s debt obligations traded at spreads above Treasury bills that were even lower than spreads for AAA-rated debt securities, and very few banks received AAA ratings between 1990 and 2005. In addition, the capital regime established in 1992 for Fannie and Freddie enabled them to operate with leverage ratios that were at least twice as high as the leverage ratios of commercial banks.<sup>70</sup>

The GSEs’ privileges enabled them to triple in size from 1995 through 2003. In 1995, Fannie and Freddie either held in their portfolios or guaranteed (via GSE MBS) \$1.3 trillion of home mortgages, representing a third of the \$3.9 trillion of outstanding residential mortgages. By the end of 2003, Fannie and Freddie held in portfolio or guaranteed \$3.6 trillion of mortgages, representing almost half of the \$7.7 trillion mortgage market.<sup>71</sup>

In 2003 and 2004, the Office of Federal Housing Enterprise Oversight (“OFHEO”) placed tighter controls on Fannie and Freddie after finding serious accounting irregularities and other management shortcomings. OFHEO established stricter limits for the GSEs’ retained mortgage portfolios and imposed higher capital requirements on the GSEs. As a result of OFHEO’s directives, the assets of Fannie and Freddie grew more slowly between 2003 and 2007, but their MBS guarantees (which were off-balance sheet commitments) continued to increase substantially. At the end of 2007, Fannie’s and Freddie’s retained mortgage portfolios and MBS guarantees totaled \$5.0 trillion, representing about half of the nation’s outstanding residential mortgages<sup>72</sup>

As the GSEs grew in size and significance, analysts and policymakers expressed growing concerns about their contribution to systemic risk. The GAO concluded in 2004 that Fannie and Freddie “pose potential risks to the stability of the U.S. financial system.”<sup>73</sup> In the same year, the FDIC determined that FDIC-insured institutions held more than \$1 trillion of GSE preferred stock, debt securities and GSE MBS, representing more than 11 percent of the assets of those institutions. The FDIC noted that “some observers . . . view the banking industry as particularly vulnerable to erosion in the benefits of GSE status.”<sup>74</sup>

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<sup>68</sup> Id. at 44-45.

<sup>69</sup> CBO (2001, 2004).

<sup>70</sup> FCIC (2010), at 9, 20.

<sup>71</sup> OFHEO (2004), at 2.

<sup>72</sup> FCIC (2010), at 13-14, 21; OFHEO (2008), at 10-11.

<sup>73</sup> GAO (2004), at 6.

<sup>74</sup> Id. at 22 (quoting 2004 FDIC report).

As explained in Part VI.B, Fannie and Freddie became heavily involved in the nonprime mortgage market between 2004 and 2007, as they attempted to recapture market share lost to Wall Street firms that were leaders in originating and securitizing subprime and Alt-A mortgages. Fannie’s and Freddie’s forays into nonprime lending resulted in devastating losses and led to the federal government’s appointment of conservators for both GSEs in September 2008.

## **V. Before the Financial Crisis, Federal Regulators Encouraged Banks to Support Important Institutions in the Capital Markets**

As discussed above, federal regulators’ interventions with large, troubled institutions during the 1980s and early 1990s focused on banks. Regulators never articulated a TBTF rationale for supporting nonbank financial institutions that was similar to their justification for rescuing large failing banks like Continental and BNE. However, regulators did mobilize banks to support leading nonbank participants in the capital markets during several crises between 1970 and 1998. For example, when the commercial paper market shut down following Penn Central’s bankruptcy in 1970, the Fed provided \$600 million of discount window loans that enabled banks to provide credit to large firms that were unable to roll over their commercial paper. In 1980, the Fed organized an emergency loan by a consortium of banks to rescue the Hunt brothers after they failed to corner the silver market. The Fed determined that a default by the Hunts, who owed \$1.4 billion on silver-related loans, would probably bankrupt several leading brokers in securities and commodities and would seriously injure several banks. In order to preserve market stability, the Fed persuaded a group of banks to provide \$1.1 billion of credit to the Hunts, which enabled the Hunts to meet their outstanding credit obligations.<sup>75</sup>

During the stock market crash of 1987, several major banks were reluctant to make loans to large broker-dealers that faced a severe liquidity crisis due to unprecedented settlement demands on trades in securities and futures. The Fed exerted strong pressure on the major banks, and the Fed also provided discount window loans that allowed banks to provide almost \$8 billion in emergency loans to broker-dealers and institutional investors.<sup>76</sup>

In 1990, federal regulators did not intervene to prevent the failure of Drexel Burnham Lambert (“Drexel”), the fifth-largest U.S. securities firm. One reason for the regulators’ lack of intervention was that Drexel was not closely connected to other major financial firms at the time of its failure. In 1989, Drexel had pleaded guilty to criminal violations of the securities laws, and many leading financial institutions and investors had significantly reduced their dealings with Drexel. Accordingly, regulators did not expect a severe market reaction to Drexel’s bankruptcy. To minimize any disruption in the markets, regulators arranged an orderly liquidation of Drexel’s broker-dealer subsidiaries, and regulators also managed an orderly closing out of Drexel’s

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<sup>75</sup> Brimmer (1989), at 3-11; Mishkin (1991), at 98-101; Kaufman (2000), at 208, 265-66; Wilmarth (2002), at 235-36, 370-72.

<sup>76</sup> Brimmer (1989), at 11-15; Mishkin (1991), at 101-04; Wilmarth (2002), at 236.

positions in over-the-counter (“OTC”) derivatives (similar to the Fed’s carefully managed closeout of Franklin National Bank’s foreign exchange positions in 1974).<sup>77</sup>

Notwithstanding the regulators’ careful planning, Drexel’s bankruptcy and the simultaneous collapse of the junk bond market – which Drexel created – caused a serious disruption in the securities markets. Four major securities firms – First Boston, Shearson Lehman Brothers, Bache and Kidder Peabody – suffered large losses from the demise of the junk bond market and the accompanying collapse of the market for corporate leveraged buyouts. Those four firms might have failed if they had not received large capital infusions from their parent companies (Credit Suisse, American Express, Prudential and GE).<sup>78</sup>

In 1991, Goldman Sachs and other large securities firms sought legislation that would give them greater access to the Fed’s emergency lending facility under Section 13(3) of the Federal Reserve Act. Goldman and the other firms were concerned about “the absence of a safety net beneath Wall Street firms” in light of (i) the reluctance of some commercial banks to provide credit to securities broker-dealers during the 1987 stock market crash, and (ii) the failure of Drexel in 1990.<sup>79</sup> At the suggestion of H. Rodgin Cohen, a banking lawyer with Sullivan & Cromwell in New York City, the securities firms urged Congress to include an amendment to Section 13(3) in FDICIA.<sup>80</sup>

The enacted 1991 amendment to Section 13(3) authorized the Fed to make emergency loans to nonbanking firms as long as those loans are “secured to the satisfaction of the [Fed],” and the amendment also gave the Fed broad discretion to accept almost any type of collateral from the borrowing firms. Senator Christopher Dodd, the amendment’s sponsor, explained that the amendment would give the Fed “greater flexibility to respond in instances in which the overall financial system threatens collapse” and would thereby enable the Fed “to make fully secured loans to securities firms in instances similar to the 1987 stock market crash.”<sup>81</sup>

Thus, the 1991 amendment to Section 13(3) was designed to give the Fed greater authority to support Wall Street firms and maintain market stability.<sup>82</sup> As explained below in Part VI, the Fed repeatedly used its expanded authority under Section 13(3) to establish far-reaching assistance programs for Bear Stearns, AIG and other nonbank financial institutions during 2008. In August 1998, Russia devalued the ruble and defaulted on part of its debt. The Russian default created a panic among investors and paralyzed global financial markets. Investors dumped all types of higher-risk securities and sought safety by purchasing U.S. Treasury bills and FDIC-insured certificates of deposit.

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<sup>77</sup> Greenspan (1990); Haraf (1991); Smith (1990), at 225-27, 250-56. See also GAO (1994), at 43 (explaining that federal regulators ensured an orderly closing out of Drexel’s obligations to derivatives counterparties and thereby avoided “financial system gridlock” after Drexel failed).

<sup>78</sup> Gibson (1993), at 54-55, 65-69, 184-86, 201-02; Smith (1990), at 250-56; Wilmarth (2002), at 327-28, 356 n.591, 411-12.

<sup>79</sup> Appelbaum & Irwin (2009). See also Wessel (2009), at 160-61.

<sup>80</sup> Appelbaum & Irwin (2009); Wessel (2009), at 160-61.

<sup>81</sup> 137 Cong. Rec. S 18619 (daily ed. Nov. 27, 1991). See also S. Rep. No. 102-167, at 202-03 (1991).

<sup>82</sup> Johnson (2010); Todd (1993).

The Russian debt crisis threatened to bankrupt Long-Term Capital Management (“LTCM”), a large hedge fund. LTCM held about \$125 billion of securities, many of which were borrowed under repurchase agreements (repos) with banks and securities firms. LTCM also was a party to over-the-counter derivatives that represented potential claims on assets worth \$1.25 trillion. Most of LTCM’s investments were relatively illiquid positions in, or related to, high-risk securities such as junk bonds and emerging market debt. LTCM expected that the yield spreads between higher-risk and lower-risk securities would narrow or “converge” in 1998, so that LTCM could profitably sell both its long positions in higher-risk debt and its short positions in lower-risk bonds. However, Russia’s devaluation and debt default caused a global “flight to safety” as investors frantically sought to buy “safe” securities (especially U.S. Treasury bills) and to sell risky securities and derivatives. Those developments dealt a fatal blow to LTCM’s investment strategy. During the month that followed Russia’s devaluation and debt default, LTCM suffered a loss of \$4.4 billion. LTCM was on the verge of insolvency by mid-September.<sup>83</sup>

Federal regulators feared that a default by LTCM on its repos and derivatives could paralyze global financial markets and trigger a “fire-sale” liquidation of investments held by large financial institutions that were similar to LTCM’s positions. Federal regulators also believed that LTCM’s default on its obligations could threaten the solvency of several major banks and securities firms that were counterparties of LTCM, potentially resulting in a “systemic meltdown in the global financial system.”<sup>84</sup> The Fed therefore organized an emergency meeting of fourteen major banks and securities firms that held large credit and derivatives exposures to LTCM. After considerable urging from the Fed, the fourteen institutions agreed, on September 23, 1998, to organize a consortium that injected \$3.6 billion of capital into LTCM in exchange for 90% of LTCM’s stock. This emergency capital infusion, together with the Fed’s other efforts to stabilize the financial markets in the fall of 1998 (including three reductions in short-term interest rates), allowed LTCM to carry out an orderly liquidation of its portfolio of securities and derivatives. Fed officials subsequently insisted that they never pressured the consortium’s members or offered public funds to support LTCM. However, some analysts concluded that the Fed had exerted a powerful influence in advocating and organizing the rescue of LTCM.<sup>85</sup>

At a congressional hearing in October 1998, Fed chairman Alan Greenspan testified that the Fed had organized an “orderly resolution” of LTCM because it believed that LTCM’s default could have triggered “cascading cross defaults” and a “contagion” of panic leading to a “fire-sale liquidation” of assets throughout the financial system.<sup>86</sup> Some observers warned that the Fed’s involvement in LTCM’s rescue could lead market participants to believe that the Fed would be prepared in the future to provide direct assistance to large, systemically important nonbank financial institutions if their failure threatened to undermine the stability of the capital markets.<sup>87</sup>

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<sup>83</sup> Edwards (1999), at 197-205 (1999). Lowenstein (2000), at 36-54, 77-84, 94-105, 123-30.

<sup>84</sup> Edwards (1999), at 201-02. See also Lowenstein (2000), at 186-96.

<sup>85</sup> Edwards (1999), at 200, 203-04 (arguing that the Fed’s actions were “implicitly coercive”); Lowenstein (2000), at 188-99, 230 (contending that “the banks would not have come together [to rescue LTCM] without the enormous power and influence of the Fed behind them”).

<sup>86</sup> Greenspan (1998), at 1046-48.

<sup>87</sup> Hu (2000), at 865-73, 883-84; Kaufman (2000), at 208-16, 226-28, 238-40, 310-12; Wilmarth (2002), at 371-72, 471-73.

## **VI. Federal Regulators Used Extraordinary Measures to Protect TBTF Institutions During the Financial Crisis**

### **A. The Rescue of Bear Stearns and the Primary Dealer Credit Facility**

In March 2008, the Fed exercised its expanded authority under Section 13(3) of the Federal Reserve Act to support the acquisition by JPMorgan Chase (JPMorgan) of Bear Stearns (Bear), the fifth largest U.S. securities firm. Bear grew rapidly during the credit boom that led up to the financial crisis. The firm’s assets more than doubled from \$185 billion in 2003 to \$400 billion in February 2008, and its leverage (debt-to-equity) ratio rose above 30:1. The firm was one of the top underwriters of subprime MBS and collateralized debt obligations (CDOs) between 2004 and 2007.<sup>88</sup>

On March 10, 2008, Moody’s downgraded more than 160 tranches of MBS that Bear had underwritten. Moody’s report, in combination with other adverse public reports about Bear’s mortgage-related exposures, caused Bear’s hedge fund clients and other counterparties to withdraw their accounts from Bear. In four days, Bear spent virtually all of its liquid assets in order to meet its investors’ and counterparties’ demands for withdrawals.

To prevent Bear’s imminent failure, the Fed provided a \$30 billion discount window loan to JPMorgan on March 14, 2008, which enabled JPMorgan to extend a \$30 billion short-term line of credit to Bear. During the following weekend, JPMorgan agreed to acquire Bear and eventually paid Bear’s shareholders \$10 per share (compared with Bear’s closing price of \$32 per share on March 15). The Fed assisted JPMorgan’s acquisition by making a ten-year, \$29 billion loan to a newly established, special-purpose vehicle (Maiden Lane, LLC), which acquired a designated portfolio of mortgage-related Bear assets, after JPMorgan absorbed the first \$1 billion in losses. The terms of the Fed’s loan to Maiden Lane exposed the Fed to a potential loss of up to \$29 billion if the designated assets declined in value. The Fed provided the loan to Maiden Lane based on its authority to make loans in “exigent and unusual circumstances” under Section 13(3) of the Federal Reserve Act, as amended in 1991.<sup>89</sup>

At the time of Bear’s rescue, Bear reportedly had 150 million trades with 5,000 other firms, including 750,000 derivatives contracts with an aggregate notional value of \$14.2 trillion.<sup>90</sup> On April 2, 2008, Fed chairman Ben Bernanke defended the Fed’s rescue of Bear at a hearing before the Joint Economic Committee, with the following explanation:

“Normally, the market sorts out which companies survive and which fail, and that is as it should be. However, the issues raised here extended well beyond the fate of one company. Our financial system is extremely complex and interconnected, and Bear Stearns participated extensively in a range of critical markets. With financial conditions fragile, the sudden failure of Bear Stearns likely would have led to a chaotic unwinding

<sup>88</sup> Applin (2010); Jaffee et al. (2009), at 68-69; Lowenstein (2010), at 50-51, 76, 116 n.\*; Wilmarth (2009), at 989.

<sup>89</sup> Brunnermeier (2000), at 88; Cecchetti (2009), at 69-70; Johnson (2010), at 17; Stowell (2010), at 394-405; Wessel (2009), at 152-73.

<sup>90</sup> Brunnermeier (2009), at 88; Cecchetti (2009), at 69; Wessel (2009), at 159.

of positions in those markets and could have severely shaken confidence. The company’s failure could also have cast doubt on the financial positions of some of Bear Stearns’ thousands of counterparties and perhaps of companies with similar businesses. Given the current exceptional pressures on the global economy and the financial system, the damage caused by a default by Bear Stearns would have been severe and extremely difficult to contain. Moreover, the adverse effects would not have been confined to the financial system but would have been felt broadly in the real economy through its effects on asset values and credit availability.”<sup>91</sup>

Similarly, Federal Reserve Bank of New York President Timothy Geithner testified on April 3, 2008, that:

“Bear’s involvement in the complex and intricate web of relationships that characterize our financial system, at a point in time when markets were especially vulnerable, was such that a sudden failure [of Bear] would likely lead to a chaotic unwinding of positions in already damaged markets. Moreover, a failure by Bear to meet its obligations would have cast a cloud of doubt on the financial position of other institutions whose business models bore some superficial similarity to Bear’s, without due regard for the fundamental soundness of those firms.”<sup>92</sup>

Thus, the Fed considered Bear to be “too interconnected” to fail. The Fed evidently saw two types of interconnections that led it to rescue Bear. First, Bear’s failure might cause a “chain reaction” of failures among its counterparties, and second, Bear’s collapse could create a “common shock” leading to failures among financial institutions that held risk exposures similar to Bear’s.<sup>93</sup>

On March 16, 2008, immediately after its approval of the loan to Maiden Lane, the Fed established the Primary Dealer Credit Facility (PDCF), again relying on its Section 13(3) authority. The PDCF authorized the Federal Reserve Bank of New York (FRBNY) to make overnight, fully collateralized loans to primary dealers – a group of nineteen large securities firms that included independent investment banks and subsidiaries of financial holding companies. Primary dealers trade U.S. government securities and other securities directly with the FRBNY. The PDCF provided primary dealers with access to a Fed liquidity facility that was closely analogous to the discount window.<sup>94</sup>

Prior to the PDCF, primary dealers did not have access to any overnight liquidity facility similar to the discount window (except indirectly if they were affiliated with a commercial bank). During the fall of 2007 and first two months of 2008, primary dealers faced increasing difficulty

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<sup>91</sup> Bernanke (2008a).

<sup>92</sup> Geithner (2008).

<sup>93</sup> Brunnermeier (2009), at 88; Lowenstein (2009), at 130-31. See also *supra* note 1 and accompanying text (describing “chain reaction” and “common shock” concerns that may lead regulators to treat a financial institution as TBTF).

<sup>94</sup> Adrian et al. (2009). For a list of the 19 primary dealers as of March 16, 2008, see “Primary Dealers List” (effective as of Nov. 30, 2007), available at <http://www.newyorkfed.org/newsevents/news/markets/2007/an071130.html>, and subtract Bear Stearns.



in financing their holdings of longer-term assets through the triparty repo market.<sup>95</sup> “In the two weeks prior to the creation of the PDCF on March 16, 2008, liquidity conditions in the repo market grew very strained.”<sup>96</sup> The purpose of the PDCF “was to shore up confidence in the remaining investment banks by making clear that they could borrow directly from the Fed.”<sup>97</sup> Distress in the interbank lending market also increased between the end of 2007 and the rescue of Bear, as shown by the spread between the three-month London Inter-Bank Offered Rate (LIBOR) and the expected interest rate for a loan at the overnight federal funds rate for three months (the Overnight Indexed Swap or OIS rate). The LIBOR-OIS spread rose sharply between December 2007 and March 2008 and then declined somewhat after the Fed rescued Bear and established the PDCF. However, the LIBOR-OIS spread remained at elevated levels during the summer of 2008, compared to the first half of 2007.<sup>98</sup>

## B. The Conservatorships of Fannie and Freddie

From 2004 to 2007, Fannie and Freddie rapidly expanded their purchases of subprime and Alt-A mortgages as well as their investments in private-label MBS (PLS). According to the GAO, Fannie and Freddie held more than \$600 billion of nonprime mortgages and PLS by 2008. Losses on those investments threatened the solvency of Fannie and Freddie when defaults on nonprime mortgages rose sharply and the financial crisis reached a critical stage during the summer of 2008.<sup>99</sup>

In July 2008, Congress passed the Housing and Economic Recovery Act (HERA), which established the Federal Housing Finance Agency (FHFA) as the new regulator for Fannie and Freddie. On September 6, 2008, acting pursuant to authority granted under HERA, the FHFA established conservatorships for Fannie and Freddie to prevent their default on \$5.4 trillion of debt and other financial obligations. On September 7, 2008, the Treasury Department (Treasury) agreed to purchase up to \$100 billion of preferred stock in each GSE. In December 2009, the Treasury announced it would provide unlimited capital support to Fannie and Freddie. By August 2010, the Treasury had bought \$145 billion of preferred stock in the GSEs. In addition, the Treasury and the Fed purchased more than \$1.6 trillion of debt and MBS issued by the GSEs to support the markets for GSE-issued securities and improve the availability of housing credit.<sup>100</sup>

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<sup>95</sup> The triparty repo market is a market for securities repurchase agreements in which the borrower posts securities as collateral at one of two clearing banks – Bank of New York or JPMorgan – and receives cash from the lender. The clearing bank determines the value of the borrower’s collateral and applies a “haircut” – the percentage difference between the market value of the collateral and the amount the borrower can receive in cash from the lender. The borrower agrees to repay the loan by repurchasing the collateral from the lender at a fixed price on a predetermined date (frequently overnight). Adrian et al. (2009), at 2.

<sup>96</sup> *Id.*

<sup>97</sup> Wessel (2009), at 170.

<sup>98</sup> Cecchetti (2009), at 58-60, 69-72.

<sup>99</sup> GAO (2009b), at 7, 26-28.

<sup>100</sup> *Id.* at 7-10; GAO (2010b), at 4-5, 45-46.

### C. The Failure of Lehman Brothers and the Rescue of AIG

Shortly after the Fannie and Freddie were placed in conservatorship, Lehman Brothers (Lehman), the fourth-largest U.S. securities firm, faced intense pressure from the capital markets. Like Bear, Lehman had been a top underwriter of subprime MBS and CDOs. Lehman had also made large investments in commercial real estate. As a result of Lehman’s high-risk, high-growth strategy, the firm’s assets more than doubled (from \$354 billion to \$814 billion) between 2003 and 2007, and its leverage ratio increased to more than 30:1 during the same period. In early 2008, Lehman carried about \$80 billion of commercial and residential real estate assets on its balance sheet.<sup>101</sup>

Lehman’s position weakened during the summer of 2008, and it failed to agree on a sale of either the entire company or its portfolio of illiquid real estate assets. On September 9, 2008, Lehman reported a \$3.9 billion third-quarter loss and received a warning from Moody’s that it would lower Lehman’s credit rating three notches unless Lehman found an acquirer by September 15, 2008. According to some analysts, such a downgrade would have triggered collateral calls by creditors that would have made it impossible for Lehman to survive.<sup>102</sup>

During the weekend of September 12-14, 2008, federal regulators attempted to orchestrate a sale of Lehman to avoid its failure. However, regulators were unable to arrange such a sale, and Lehman filed for bankruptcy early in the morning on September 15, 2008.<sup>103</sup> Shortly before Lehman filed for bankruptcy, Merrill Lynch, the third-largest U.S. securities firm, agreed to sell itself to Bank of America.<sup>104</sup>

On the evening of September 14, the Fed used its Section 13(3) authority to expand the PDCF by accepting all collateral used in triparty repo transactions. The Fed’s action ensured that primary dealers who were “unable to find financing for their collateral in private markets could turn to the Fed.” Lending by the Fed through the PDCF “exploded” after September 15, because “[i]n the wake of Lehman Brothers’ failure, other primary dealers experienced severe difficulties obtaining funding in the capital markets. . . . [B]orrowing through the PDCF soared to \$59.7 billion on Wednesday, September 17, from no activity during the previous week.”<sup>105</sup>

The bankruptcy of Lehman – the largest in U.S. history – inflicted a serious shock on domestic and global financial markets. The Dow Jones Industrial Average fell 504 points (4.4%) on September 15, 2008, its worst drop since the terrorist attacks on September 11, 2001. Interbank lending markets experienced severe strains, and credit default swap premiums for major banks rose sharply. Many hedge funds and other investors were unable to access funds that were held by Lehman and became embroiled in Lehman-related bankruptcy proceedings in the U.S., the United Kingdom and other jurisdictions. Probably the most significant shock from Lehman’s bankruptcy was that it caused the Reserve Primary Fund (RPF), a large money market mutual

<sup>101</sup> Jaffee (2009), at 68-69; Lowenstein (2010), at 48-51, 91-93, 100-01, 116 n.\*, 118; Stowell (2010), at 408-10; Wilmarth (2009), at 989.

<sup>102</sup> Lowenstein (2010), at 134-38, 144-46, 164-69; Stowell (2010), at 409-12.

<sup>103</sup> Lowenstein (2010), at 179-201; Sorkin (2010), at 283-369; Wessel (2009), at 9-20.

<sup>104</sup> Lowenstein (2010), at 192-93; Sorkin (2010), at 359-61, 454; Stowell (2010), at 413-15.

<sup>105</sup> Adrian et al. (2010), at 6-7.

fund (MMMF), to “break the buck.” RPF held almost \$800 million of Lehman’s commercial paper. Following Lehman’s default on that paper, RPF was unable to redeem its investors’ shares at a net asset value of \$1.00 per share. The “break the buck” event at RPF triggered a run by investors on many other MMMFs. To stop that run, the Treasury Department established an emergency guarantee program to protect MMMFs on September 19, 2008.<sup>106</sup>

Lehman’s default on its commercial paper also caused a severe disruption in the commercial paper market, thereby preventing many corporate issuers from renewing their commercial paper when it expired. To stabilize that market, the Fed established the Commercial Paper Funding Facility (CPFF) on October 7, 2008, acting under its Section 13(3) authority. Like the PDCF, the CPFF was designed not to support an individual institution but instead to help a group of firms and a market that were collectively considered to be systemically important.<sup>107</sup>

Immediately after Lehman’s failure, the Treasury and the Fed confronted another severe crisis at AIG, the world’s largest insurance organization, with more than \$1 trillion in assets and operations in more than 130 countries. AIG was a diversified financial conglomerate, but it was not a financial holding company and therefore was not regulated by the Fed. Its Financial Products subsidiary (AIGFP) was a leading underwriter of credit default swaps (CDS), which provided protection against credit default events with respect to a variety of corporate debt obligations and structured securities, including AAA-rated tranches of nonprime-related CDOs. AIG (with its strong credit rating) guaranteed the CDS underwritten by AIGFP. However, AIG was required to post additional collateral with the CDS counterparties if its credit rating declined.<sup>108</sup>

A number of the CDOs protected by AIGFP’s CDS began to suffer ratings downgrades and losses by late 2007, and some of the counterparties demanded collateral from AIG. Standard & Poor’s downgraded AIG from its previous “AA” rating in May 2008, and CDS counterparties increased their demands for collateral from AIG. By September 2008, AIG was forced to post more than \$30 billion of collateral to meet its CDS obligations.<sup>109</sup>

In addition, AIG was exposed to significant losses from its securities lending operation. That operation pooled investment securities held by AIG’s life insurance subsidiaries and lent out those securities in exchange for cash collateral. The securities lending operation invested that cash collateral in a variety of securities, including \$45 billion of MBS. As the MBS became illiquid in 2007, AIG was unable to sell the MBS to raise the cash needed to repay its securities lending counterparties. In early September 2008, counterparties demanded that AIG return \$24 billion in cash, thereby aggravating AIG’s liquidity problems.<sup>110</sup>

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<sup>106</sup> Adrian et al. (2010), at 1-2, 4-5; Brunnermeier (2009), at 89-90; Lowenstein (2010), at 201-06, 223-24, 229-30, 241-42; Sorkin (2009), at 393-94, 409-13, 418-19, 446; Wessel (2009), at 22-23, 189, 206-08.

<sup>107</sup> Adrian et al. (2010), at 1-2, 4-8 (explaining that the CPFF created a special-purpose vehicle, CPFF LLC, “to purchase ninety-day commercial paper from highly rated U.S. issuers and effectively pledge [that paper] to the Federal Reserve Bank of New York in exchange for cash,” *id.* at 6).

<sup>108</sup> COP (2010b), at 18-36; Lowenstein (2010), at 51-55, 121; Sorkin (2009), at 152-58.

<sup>109</sup> COP (2010b), at 25-42; Lowenstein (2010), at 112-14, 121-22.

<sup>110</sup> COP (2010b), at 42-46.

On September 12, FRBNY President Geithner and Treasury Secretary Henry (or Hank) Paulson learned that AIG would be insolvent within a week if it could not raise additional capital. On September 16, Paulson and Geithner were advised that AIG could not secure the necessary funding to continue in operation. Faced with the imminent failure of AIG, the Fed decided to exercise its authority under Section 13(3) to make an emergency \$85 billion loan to AIG, secured by the stock of AIG’s major insurance subsidiaries and certain other financial instruments. In return, AIG gave the Treasury preferred stock and warrants convertible into a 79.9% ownership stake in AIG.<sup>111</sup>

The rescue of AIG raised immediate questions as to why the Fed and the Treasury decided to save AIG and not Lehman. Fed chairman Bernanke addressed those questions in the following testimony he delivered at congressional hearings on September 23 and 24, 2008:

“In the case of AIG, the Federal Reserve, with the support of the Treasury, provided an emergency credit line to facilitate an orderly resolution. 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. . . .

“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.

“While perhaps manageable in itself, Lehman's default was combined with the unexpectedly rapid collapse of AIG, which together contributed to the development last week of extraordinarily turbulent conditions in global financial markets. These conditions caused equity prices to fall sharply, the cost of short-term credit – where available – to spike upward, and liquidity to dry up in many markets. Losses at a large money market mutual fund sparked extensive withdrawals from a number of such funds. A marked increase in the demand for safe assets – a flight to quality – sent the yield on Treasury bills down to a few hundredths of a percent. By further reducing asset values and potentially restricting the flow of credit to households and businesses, these developments pose a direct threat to economic growth.”<sup>112</sup>

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<sup>111</sup> COP (2010b), at 58-72, 128-30; Lowenstein (2010), at 190, 207-14; Sorkin (2009), at 207-08, 235-37, 364-65, 381-406.

<sup>112</sup> Bernanke (2008b).

In a contemporaneous interview, Bernanke further explained:

“AIG was bigger than Lehman and was involved in an enormous range of both retail and wholesale markets. For example, they wrote hundreds of billions of dollars of credit protection to banks, and the company’s failure would have led to the immediate write-down of tens of billions of dollars by banks. It would have been a major shock to the banking system. . . . Since nobody knew the exposures of specific banks to AIG, confidence in the entire banking system would have plummeted, putting the whole system at risk.”<sup>113</sup>

Thus, the Fed and Treasury were greatly concerned by the exposures of major U.S. and European banks and securities firms to AIG, especially through CDS and securities lending contracts. The Fed later arranged for AIG to make payments of about \$80 billion to more than twenty major U.S. and European financial institutions in order to satisfy the full amount of AIG’s obligations to those institutions under CDS and securities lending transactions.<sup>114</sup>

The Fed and Treasury had additional serious concerns about the potential impact of an AIG bankruptcy on MMMFs and the commercial paper market. AIG had issued \$20 billion of commercial paper, four times as much as Lehman. By September 16, 2008, an investor run on MMMFs had already begun as a result of Lehman’s default and the “break the buck” event at RPF. Federal officials therefore feared that an AIG bankruptcy would do even greater harm to MMMFs and the commercial paper market. Interest rates on commercial paper and spreads between yields on one-month commercial paper and Treasury bills increased dramatically during September 2008, and the amount of outstanding commercial paper issued by financial institutions dropped by one-sixth during that month.<sup>115</sup>

Some analysts have concluded that, because the market reaction to Lehman’s bankruptcy was more severe than Fed and Treasury officials had anticipated, those officials decided that they could not risk allowing another major financial institution to fail.<sup>116</sup> Fed chairman Bernanke gave some support to that view in a subsequent interview with David Wessel. In that interview, Bernanke stated that “[w]e did [AIG] very unhappily. . . . But we thought that on top of Lehman, this would be just a complete disaster for the markets and the banking system.”<sup>117</sup> In another interview, Bernanke stated that “[w]e would have saved” Lehman if Congress had enacted the Troubled Asset Relief Program (TARP) before Lehman collapsed. However, Bernanke noted that “if Lehman hadn’t failed, the public would not have seen the resulting damage and the story line would have been that such extraordinary intervention was unnecessary.”<sup>118</sup>

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<sup>113</sup> Wessel (2009), at 25-26 (quoting from interview with Bernanke).

<sup>114</sup> COP (2010b), at 87-94, 131-33.

<sup>115</sup> *Id.* at 131-33, 156-61.

<sup>116</sup> Lowenstein (2010), at 202-16; Sorkin (2009), at 390-407; Wessel (2009), at 190-206.

<sup>117</sup> Wessel (2009), at 194.

<sup>118</sup> *Id.* at 25.

On several occasions after the rescue of AIG in September 2008, the Fed and the Treasury increased and restructured the terms of federal aid to AIG to deal with AIG’s continuing problems and losses. As of May 27, 2010, the total amount of funds invested in AIG by the U.S. government, through both the FRBNY and the Treasury, was \$132.4 billion.<sup>119</sup>

#### **D. The Failure of Washington Mutual and the Rescue of Wachovia**

On September 21, 2010, the Fed approved expedited applications by Goldman Sachs and Morgan Stanley – the last remaining large securities firms – to convert into bank holding companies. Morgan Stanley faced intense pressure (including short selling) in the financial markets during the week after Lehman filed for bankruptcy, and federal officials also had concerns about Goldman Sachs’s future if Morgan Stanley failed. The Fed’s approval of bank holding company status for both firms was interpreted by many observers as an implicit commitment that the federal government would not allow either firm to fail.<sup>120</sup>

On September 25, the FDIC placed Washington Mutual (WaMu) in receivership and approved the sale of most of WaMu’s assets (including all of its branches and deposits) to JPMorgan. WaMu was the largest U.S. thrift and one of the ten largest U.S. depository institutions, with over \$300 billion of assets. Its collapse was the largest bank failure in U.S. history. WaMu had suffered large losses from its massive exposures to subprime and Alt-A residential mortgages. JPMorgan assumed all of WaMu’s deposits and its obligations to financial counterparties. However, JPMorgan did not assume WaMu’s obligations to its unsecured bondholders. WaMu’s parent holding company declared bankruptcy, and the FDIC did not protect either the holding company’s creditors or the unsecured bondholders of WaMu.<sup>121</sup>

WaMu’s failure and the losses suffered by its bondholders had an immediate and negative impact on Wachovia Bank, the fourth-largest U.S. bank. Wachovia had reported large losses in 2008 from its exposures to subprime and Alt-A residential mortgages, commercial mortgages and CDOs. The greatest threat to Wachovia was its \$120 billion portfolio of option ARM mortgages, mostly inherited from Wachovia’s acquisition of Golden West (a large California thrift) in 2006. On Friday, September 26, 2008, the day after WaMu’s failure, CDS premiums on Wachovia’s debt more than doubled and Wachovia’s stock price dropped 27%. Wachovia’s corporate customers pulled out billions of dollars of uninsured deposits, and other counterparties backed out of financial trades with Wachovia. Wachovia’s management and regulators determined that Wachovia might not be able to fund its normal banking activities the following Monday.<sup>122</sup>

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<sup>119</sup> COP (2010b), at 84-98.

<sup>120</sup> Lowenstein (2010), at 230-34; Sorkin (2009), at 466-83; Wessel (2009), at 217-18 (noting that the conversions of Goldman Sachs and Morgan Stanley into bank holding companies “gave them the Fed’s public promise of protection and a permanent source of lending in a crisis”); see also Horwitz (2009), at 21 (“the conversions made a statement that . . . the government would go to any lengths to prevent another failure the size of Lehman”).

<sup>121</sup> Horwitz (2009), at 21; Lowenstein (2010), at 239-40; Wessel (2009), at 218-20.

<sup>122</sup> Horwitz (2009), at 22; Lowenstein (2010), at 239-41; Wessel (2009), at 220-22. An option ARM is an adjustable-rate mortgage in which the borrower has the option to pay less than the accrued interest during an introductory period, in which case the unpaid interest is added to the mortgage’s principal. When the introductory period ends, or when the principal amount of the mortgage increases to a specified level (e.g., 120% of the original principal), the borrower is obligated to make a significantly higher monthly payment, thereby increasing the likelihood of default. Wilmarth (2009), at 1021-24.

After receiving the required recommendations from the FDIC and the Fed, the Treasury invoked FDICIA’s systemic risk exception (SRE) to authorize FDIC assistance for an acquisition of Wachovia by either Citigroup or Wells Fargo. The FDIC approved Citigroup’s assisted bid for Wachovia because it was less costly to the FDIC than Wells Fargo’s assisted bid. The Wachovia transaction represented the first use of the SRE since the enactment of FDICIA in 1991.<sup>123</sup>

A subsequent GAO report explained that federal regulators invoked the SRE after concluding that a failure to protect all of Wachovia’s depositors and creditors could “weaken confidence and exacerbate liquidity strains in the banking system.” According to the GAO, federal regulators determined that imposing “large losses on Wachovia’s creditors and foreign depositors could intensify liquidity pressures on other U.S. banks, which were vulnerable to a loss of confidence by creditors and uninsured depositors (including foreign depositors), given the stresses already present in the financial markets at that time.” Regulators also concluded that “a Wachovia failure could intensify pressures on other large banking organizations that, like Wachovia, reported they were well capitalized but continued to face investor concerns about deteriorating asset quality.” In addition, “[t]heir concerns about the possible significant losses to creditors holding Wachovia subordinated debt and senior debt were reinforced by the recent failure of [WaMu].”<sup>124</sup>

On October 3, 2008, after a favorable change in tax law, Wells Fargo made an unassisted takeover offer for Wachovia and received approval for the bid from the FDIC and from Wachovia’s directors and shareholders. Wells Fargo’s unassisted offer provided a higher value to Wachovia’s shareholders and therefore pre-empted Citigroup’s assisted bid.<sup>125</sup>

## **E. TARP and Other Assistance for Banks**

On October 3, 2008, Congress passed the Emergency Economic Stabilization Act, which established TARP. TARP authorized the Treasury to make equity investments in, purchase assets from, and provide loans to a variety of entities, including financial institutions. On October 14, 2008, Treasury Secretary Paulson announced that the Treasury had created a new program under TARP to purchase preferred stock in banks, thrifts and their parent holding companies. Paulson also announced that the Treasury had agreed to buy \$125 billion of preferred stock from nine major banks – Bank of America, Bank of New York, JPMorgan, Citigroup, Goldman Sachs, Merrill Lynch, Morgan Stanley, State Street and Wells Fargo. The preferred stock carried a dividend rate of 5% for the first five years and 9% thereafter. Also on October 14, the Treasury stated that it had approved recommendations by the FDIC and the Fed to invoke the SRE under FDICIA in order to authorize the FDIC to establish a new Temporary Liquidity Guarantee Program (TLGP). The TLGP was intended to supplement the

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<sup>123</sup> In accordance with the terms of Citigroup’s assisted bid, the FDIC entered into a loss-sharing agreement with Citigroup, under which Citigroup agreed to absorb the first \$42 billion of losses on a \$312 billion pool of Wachovia’s loans and the FDIC agreed to assume the remaining losses. GAO (2010b), at 13-15; Lowenstein (2010), at 244-46; Wessel (2009), at 222-23.

<sup>124</sup> GAO (2010b), at 13-14.

<sup>125</sup> Horwitz (2010), at 23-24; Lowenstein (2010), at 251-54; Wessel (2009), at 224-26; Sorkin (2009), at 501-03.

Treasury’s capital purchase program by providing liquidity assistance to banks and thrifts as well as their holding companies and certain affiliates.<sup>126</sup>

The TLGP consisted of two new programs. Under the Debt Guarantee Program (DGP), the FDIC guaranteed future issuances of senior unsecured debt by qualifying institutions. Under the Transaction Account Guarantee Program, the FDIC provided unlimited temporary deposit insurance coverage for non-interest-bearing transaction accounts in FDIC-insured institutions. The purpose of the TLGP was to improve the ability of banks to fund their operations by selling debt and by attracting large deposits from transaction account customers (primarily business firms).<sup>127</sup> According to the GAO, federal regulators were concerned that “the reluctance of banks and investment managers to lend to other banks and their holding companies made finding replacement funding at a reasonable cost difficult for these financial institutions.” For example, the TED spread – the spread between the three-month LIBOR rate and the three-month Treasury bill yield – “peaked at more than 400 basis points in October 2008, likely indicating an increase in both perceived risk and in risk aversion among investors. . . . In addition to disruptions in interbank lending, financial institutions also faced difficulties raising funds through commercial paper and asset-backed securitization markets.”<sup>128</sup>

Federal regulators invoked the SRE on a blanket basis to authorize the TLGP for all qualifying financial institutions because “large outflows of uninsured deposits could strain many banks’ liquidity” and “the threat to the market for bank debt was a systemic problem that threatened the stability of a significant number of institutions.” Regulators concluded that an individualized response to liquidity problems at particular banks “would not sufficiently address the systemic threat to bank funding and the broader economy.”<sup>129</sup>

Analysts generally agree that the Treasury’s announcement of its preferred stock purchase program and the TGLP on October 14, 2008 had a significant calming effect on highly stressed credit markets. One analyst wrote that the two programs indicated that “the United States was rescuing both Wall Street and the banking system.”<sup>130</sup> The LIBOR-OIS spread, which had reached a record high of 364 basis points in October 2008, declined to approximately 100 basis points in early 2009. The TED spread, which also reached a record high of 450 basis points in October 2008, declined to its pre-crisis levels by 2009.<sup>131</sup> Roger Lowenstein has described the impact of the Treasury’s October 14 actions as follows:

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<sup>126</sup> For discussions of the Treasury’s actions on October 14, 2008, see COP (2009), at 16-19; GAO (2010b), at 2, 16-18; Lowenstein (2010), at 255, 268-72; Sorkin (2009), at 504, 513-28; Wessel (2009), at 227, 232-38.

<sup>127</sup> GAO (2010a), at 2, 16-18.

<sup>128</sup> *Id.* at 16.

<sup>129</sup> *Id.* at 17.

<sup>130</sup> Lowenstein (2010), at 268-72 (quote at 271). See also *id.* at 271-72 (stating that the TARP preferred stock purchases and the TLGP debt guarantees represented “the greatest [government] intervention in the financial system in seventy years” and were similar to actions taken by the RFC to rescue banks between 1932 and 1936).

<sup>131</sup> COP (2009d), at 83-86; GAO (2009c), at 34-37.



“The injection of TARP capital proved to be the nadir of the financial crisis. In the significant sense of halting the plunge in credit markets, the program had an immediate and salutary effect: for banks and many corporations, borrowing costs would never again return to the skyscraper levels of mid-October.”<sup>132</sup>

However, as Lowenstein also noted, the TARP capital purchase program and the TLGP did not prevent the U.S. economy from falling into a severe recession.<sup>133</sup>

Notwithstanding the Treasury’s initial purchase of \$25 billion of preferred stock from Citigroup, Citigroup continued to suffer large losses, and federal regulators felt obliged to provide significant additional support to that institution. In November 2008, Treasury bought \$20 billion of additional preferred stock from Citigroup. Additionally, acting on the FDIC’s and Fed’s recommendations, the Treasury invoked the SRE under FDICIA to approve a loss-sharing agreement covering a \$310 billion portfolio of troubled assets held by Citigroup. Under that agreement, the Treasury, the FDIC and the FRBNY each committed to protect Citigroup by absorbing a portion of future losses on the designated portfolio.<sup>134</sup> When Citigroup experienced further problems during 2009, the Treasury exchanged its preferred shares for a combination of common stock and trust preferred shares that gave the U.S. government a 34% ownership stake in Citigroup.<sup>135</sup>

In its report on the SRE with regard to Citigroup, the GAO noted that “[s]imilar to Wachovia, Citigroup had suffered substantial losses on mortgage-related assets and faced increasing pressures on its liquidity as investor confidence in the firm’s prospects and outlook for the economy declined.”<sup>136</sup> According to the GAO, federal regulators were convinced that a failure of Citigroup would have serious systemic repercussions:

“As was the case with Wachovia, Treasury, FDIC and the Federal Reserve were concerned that the failure of a firm of Citigroup’s size and interconnectedness would have systemic implications . . . [thereby] threatening to further undermine confidence in the banking system. According to Treasury, a least-cost resolution would have led to investor concerns about the direct exposures of other financial firms to Citigroup and the willingness of U.S. policymakers to support systemically important institutions. . . . Given Citigroup’s substantial international presence, imposing losses on uninsured foreign depositors under a least-cost framework could have intensified global liquidity pressures and increased funding pressures on other institutions with significant amounts of foreign deposits.”<sup>137</sup>

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<sup>132</sup> Lowenstein (2010), at 273.

<sup>133</sup> *Id.* at 273-75.

<sup>134</sup> COP (2009c), at 16-21; GAO (2010a), at 24-27.

<sup>135</sup> GAO (2010b), at 16. Prior to the end of 2009, Citigroup repurchased \$20 billion of preferred stock from the Treasury and terminated the loss-sharing agreement. At the end of May 2010, the Treasury continued to own approximately 21% of Citigroup’s common stock. *Id.*

<sup>136</sup> GAO (2010a), at 24.

<sup>137</sup> *Id.* at 24-25.

Like Citigroup, Bank of America encountered serious problems after its original sale of \$25 billion of preferred stock to the Treasury and was forced to seek additional assistance. Bank of America discovered, after agreeing to purchase Merrill Lynch in September 2008, that Merrill’s losses were much higher than expected. Following extensive discussions with federal regulators, Bank of America agreed to complete the Merrill acquisition but requested federal help. The Treasury agreed to purchase \$20 billion of additional preferred stock from Bank of America. In addition, the Treasury, the FDIC and the Fed agreed in principle on a loss-sharing agreement covering about \$120 billion of troubled assets (mostly acquired from Merrill). The FDIC and the Fed recommended that the Treasury invoke the SRE in order to authorize the loss-sharing agreement, but the agreement was never finalized and Treasury never formally invoked the SRE.<sup>138</sup> Accordingly, Bank of America’s loss-sharing agreement was never put into effect. The Treasury purchased \$261 billion in equity stock from banks and thrifts under TARP. Banks and thrifts also issued \$303 billion of guaranteed debt under the DGP.<sup>139</sup> Studies have shown that the terms of the TARP preferred stock program and the DGP were generous and provided substantial subsidies to the participating banks.<sup>140</sup> Although TARP and the DGP were open to participation by qualified financial institutions of all sizes, the largest banks received most of the benefits under both programs. The 19 largest banking organizations sold \$220 billion of preferred stock to the Treasury under TARP, compared to \$41 billion for smaller banks and thrifts. In addition, the 19 largest banks issued \$235 billion of guaranteed debt under the DGP, compared to \$55 billion issued by GE Capital, a large commercial finance subsidiary of GE, and \$13 billion issued by smaller banks and thrifts.<sup>141</sup> The Treasury also purchased \$50 billion of preferred stock from AIG.<sup>142</sup>

## F. The Impact of the Stress Tests on the 19 Largest Banks

In the spring of 2009, federal regulators performed “stress tests” to determine whether any of the 19 largest banking organizations (each with more than \$100 billion of assets) should be required to raise additional capital. Before conducting the stress tests, federal regulators announced that the Treasury would provide any needed capital that the institutions could not raise on their own.<sup>143</sup> In this regard, FRBNY President William Dudley stated:

“The point of the stress assessment is not to pick winners or losers, but instead to ensure that the banking system and all the major banks have sufficient capital to withstand a very adverse environment. Following the conclusion of the stress assessment process,

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<sup>138</sup> COP (2009c), at 23-26; GAO (2010a), at 2; Wessel (2009), at 259-63. In September 2009, Bank of America paid a \$425 million fee to the Treasury in connection with the cancellation of the tentative loss-sharing agreement. COP (2009a), at 25-27. In December 2009, Bank of America repurchased all of the \$45 billion of preferred stock held by the Treasury. GAO (2010b), at 14.

<sup>139</sup> COP (2009c) at 74-77.

<sup>140</sup> COP (2009a), at 4-11 (finding that the Treasury provided a significant subsidy through its purchase of preferred stock from the nine largest banks); Veronesi & Zingales (2009) (same); COP (2009c), at 68 (concluding that the FDIC provided a substantial subsidy to banks that issued guaranteed debt under the DGP).

<sup>141</sup> COP (2009c), at 37, 69 (Figure 6), 74-77; Gerth (2010).

<sup>142</sup> COP (2010b), at 97-98.

<sup>143</sup> COP (2009a), at 12-27; COP (2010a), at 88-89. Ultimately, the Treasury did purchase more than \$11 billion of additional stock in GMAC, one of the 19 largest banks, when GMAC was unable to raise the additional capital required by its stress test. COP (2010a), at 47-53, 88-93.

the government is committed to supplying whatever amount of capital is needed to ensure that all the major banks will remain viable.”<sup>144</sup>

The regulators’ statements and actions in connection with the stress tests created the impression that the 19 largest banks were TBTF, at least for the duration of the financial crisis. In a December 2009 speech, Charles Plosser, president of the Federal Reserve Bank of Philadelphia, remarked that “rather than limiting moral hazard and the too-big-to-fail problem, we have made them worse during the crisis. . . . [¶] During this crisis and through the implementation of the stress tests, we have effectively declared at least 19 financial institutions as too big to fail.”<sup>145</sup> Similarly, a financial journalist commented that “[b]y drawing a line at \$100 billion in assets, and promising to give the 19 institutions over that mark enough capital to weather an economic downturn, the government appears to have defined which banks are indeed ‘too big to fail.’”<sup>146</sup> Following the stress tests, RAs gave highly favorable treatment to the largest U.S. banks, based on their access to extensive support from the federal government. During 2009, Moody’s assigned ratings for bank debt based on a combination of two factors: (i) “Bank Financial Strength Ratings,” which measured the bank’s internal financial strength derived from its own resources, and (ii) “support assumptions,” which included expectations of support from the bank’s parent company or from governmental authorities.<sup>147</sup>

In February 2009, Moody’s provided the following explanation for Moody’s increased emphasis on governmental support as a crucial factor in determining credit ratings for major banks in advanced economies:

“Over the short run, government support is highly probable for all the major banks. Over the longer run, we believe that banks will continue to receive government support until they either achieve investment-grade strength on a stand-alone basis or are otherwise resolved in a manner that is likely to protect the interests of depositors and senior debt holders. . . .

“[D]emonstrated or anticipated systemic support continues to argue for high relative deposit and senior debt ratings for most banks in the advanced economies, albeit not to the same levels as today in all cases. Therefore, a widening of the gap between Bank Financial Strength Ratings and deposit and senior debt ratings is expected. In this environment, the senior debt and deposit ratings of systemically important banks are naturally less sensitive than they would otherwise be to changes in their intrinsic financial strength.”<sup>148</sup>

In 2009, Moody’s gave the following upgrades for deposits and senior debt issued by the six largest U.S. banks, based on Moody’s expectation of “a very high probability of systemic support” for such banks from the U.S. government:

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<sup>144</sup> Dudley (2009).

<sup>145</sup> Plosser (2009).

<sup>146</sup> Adler (2009).

<sup>147</sup> Moody’s debt ratings for bank deposits did not consider deposit insurance as a relevant factor to the extent that such insurance was generally available to depositors of all banks. Moody’s (2009a), at 1-2, 4-5, 9.

<sup>148</sup> Id, at 1-2 (emphasis added).

- Bank of America – a five-notch upgrade for the bank’s deposits above its “unsupported” or “stand-alone” rating;<sup>149</sup>
- Citibank – a four-notch upgrade for the bank’s deposits and senior debt above its unsupported rating;<sup>150</sup>
- Goldman Sachs – a one-notch upgrade for the bank’s deposits and senior debt above its unsupported rating;<sup>151</sup>
- JP Morgan Chase – a two-notch upgrade for the bank’s deposits above its unsupported rating;<sup>152</sup>
- Morgan Stanley – a two-notch upgrade for the bank’s deposits and senior debt above its unsupported rating;<sup>153</sup> and,
- Wells Fargo – a four-notch upgrade for the bank’s deposits above its unsupported rating.<sup>154</sup>

Similarly, a newspaper article in November 2009 stated that Standard & Poor’s, the other leading RA, gave Bank of America, Citigroup, Goldman Sachs and Morgan Stanley ratings upgrades of three notches, four notches, two notches and three notches, respectively, because of their presumed access to governmental assistance.<sup>155</sup> Thus, the largest banks benefited significantly during the financial crisis from their presumptive status, or – in the case of Bank of America and Citigroup – their actual status, as TBTF institutions.

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<sup>149</sup> Moody’s (2009c).

<sup>150</sup> Moody’s (2009e).

<sup>151</sup> Moody’s (2009b).

<sup>152</sup> Moody’s (2009f).

<sup>153</sup> Moody’s (2009b).

<sup>154</sup> Moody’s (2009d).

<sup>155</sup> Eavis (2009).

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