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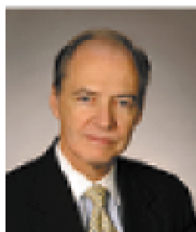
Systemic Risk

A Lesson from the Financial Crisis: The Valuable Role of Large Banking Institutions



BY PAUL L. LEE

In the desperate days of 2008, the U.S. authorities invoked a wide range of emergency measures to avert the collapse of the U.S. financial system and with it the global financial system. The broad outlines of these measures will be familiar to most observers of the financial scene even if some of the details of these measures have begun to recede in memory. Most observers will recall that the Federal Reserve Board implemented a set of emergency funding programs to support not only the banking system, but also the larger financial system, including the commercial paper and asset-backed securities markets, and that the Treasury Department developed an unprecedented program to guarantee (on a temporary basis) money-market mutual funds. At the urging of the Treasury Department and the Federal Reserve Board, the Bush Administration also introduced and promoted the adoption of the Troubled Asset Relief Program legislation, which ultimately provided direct capital support to banks both large and small.[1]

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Emergency Acquisitions

Among the most dramatic and cinematic moments in the crisis were those involving the emergency acquisition of some of our largest and most venerable financial institutions. These were acquisitions actively promoted by the government to forestall a further descent into chaos. Bank of America acquired Merrill Lynch (after initially being encouraged by the Treasury Department to acquire Lehman Brothers), JPMorgan Chase acquired Bear Stearns and Washington Mutual (and was encouraged by the Treasury Department to consider acquiring Morgan Stanley), and Wells Fargo acquired Wachovia. These were extraordinary transactions, accomplished on an expedited basis that did not allow for as extensive a due diligence process as the acquiring parties might have liked. The government's desire to calm the markets took precedence over normal transactional protocols. The drama surrounding these transactions is described by Andrew Ross Sorkin in his book *Too Big To Fail*.[2]

If one were to characterize Andrew Ross Sorkin's book as the first draft of history, one might regard Hank Paulson's book *On the Brink* and Sheila Bair's book

[1] In response to a Congressional request, the United States Government Accountability Office has recently released a report analyzing the effects of these programs on the banking system and focusing particularly on the effects on the largest banks. *See U.S. Gov't Accountability Office*, GAO-14-18, *Government Support for Bank Holding Companies: Statutory Changes to Limit Future Support Are Not Yet Fully Implemented* (Nov. 2013) [hereinafter GAO Report].

[2] *See Andrew Ross Sorkin, Too Big to Fail: The Inside Story of How Wall Street and Washington Fought To Save the Financial System—And Themselves* (2009).

Bull By The Horns as the initial entrants in the second draft of history.[3] Former Secretary of the Treasury Tim Geithner's forthcoming book will provide still another perspective in the third draft of history. Like no less a figure than Churchill, these authors intend history to be kind to them by writing it. The early accounts, however, do not provide much insight into the understanding that these officials had in 2008 of the full range of the consequences of their actions. This is to be expected. A crisis after all requires action, not reflection.[4]

An Instance of Unintended Consequences

Now fully five years after the events, the consequences of some of these actions are coming into much higher relief. One of the consequences that has recently come into very high relief is presumably an unintended consequence. This unintended consequence is the increased exposure of several of the largest U.S. banking institutions to significant liabilities for the mortgage origination and securitization activities of the entities acquired in the crisis. The acquisitions of Countrywide and Merrill Lynch by Bank of America, of Bear Stearns and Washington Mutual by JPMorgan Chase, and of Wachovia by Wells Fargo have exposed each of these acquirers to liabilities arising from the mortgage origination and securitization activities of the acquired institutions. The recent announcement of a $13 billion settlement by JPMorgan Chase with the government related to mortgage origination and securitization activities has highlighted this exposure.[5] JPMorgan Chase had previously disclosed that more than 80 percent of its reserves for mortgage-backed securities litigation related to the activities of Bear Stearns and Washington Mutual.[6] For its own part, Bank of America has already paid almost $50 billion in litigation costs related to its acquisition of Countrywide and those costs continue to mount.[7] It is unlikely that either the government or the acquirers could have accurately assessed the extent of these contingent liabilities at the time that these deals were struck in 2008. It is clear, however, that subsequent government actions as in devising new litigation strategies and theories have increased the exposure on these contingencies.[8]

These acquisitions have resulted in an increased exposure of the banking system to liabilities that would have otherwise been resolved outside the banking system. If Countrywide had not been acquired by Bank of America (or another large banking institution), it would almost certainly have gone into bankruptcy. The contingent liabilities from its mortgage origination and securitization activities would have been resolved in a bankruptcy proceeding likely with a low level of recovery for the claimants as was the case with the other mortgage originators that went into bankruptcy in 2007 and 2008. Similarly, if Bear Stearns had not been acquired by JPMorgan Chase and had gone into bankruptcy, its contingent liabilities would have been resolved in the bankruptcy proceeding with a low level of recovery for the claimants. The outcome for public and private mortgage-backed securities claimants against these entities will be very different because these entities are now part of large, financially secure companies. The public and private litigation claimants against these entities have clearly benefitted from the acquisition of these entities by large banking institutions. These claimants join the long list of other creditors and counterparties in the financial system who have become beneficiaries of acquisitions made by large banking institutions.

An Instance of Intended Consequences

Another consequence – that was obvious at the time of the emergency acquisitions – was that they would contribute to a substantial consolidation of the U.S. banking sector. Three of the four largest U.S. banking institutions grew in size and arguably in complexity as a direct result of their acquisition of other faltering institutions in 2008. These acquisitions were done at the urging of, and with active political and in some cases financial support from, the government. These institutions did not do these acquisitions against their will. But it is clear that the government led them to believe that they were playing an essential role in protecting the financial system by undertaking these extraordinary acquisitions. If there is any doubt about this proposition, one need only read Hank Paulson's book. It is a refreshingly candid and unabashed account by the former Secretary of the Treasury of what he actually did to get these institutions to acquire other faltering firms. The term of choice of the former Secretary is that he "leaned" on the acquiring institutions to do these deals and to do them quickly.[9]

Given the active government encouragement of these acquisitions, it seems a little incongruous and perhaps even a little perverse for the government now to say to these institutions that they have allowed themselves to become too large and too complex. It is very clear that it served the government's interest and the national interest at the time of the financial crisis for these institutions to become larger and more complex. In fact, the problem in September 2008 was that we had just about run out of large U.S. institutions that were strong enough to take over the faltering institutions. It has

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[3] Henry M. Paulson, Jr., On the Brink: Inside the Race to Stop the Collapse of the Global Financial System (2010); Sheila Bair, Bull by the Horns: Fighting to Save Main Street From Wall Street and Wall Street From Itself (2012).

[4] In a prologue to a September 2013 trade edition of his book, Hank Paulson has provided further reflections on the consequences of actions taken during the crisis.

[5] *See* Tom Schoenberg et al., *JPMorgan Reaches Record $13 Billion Mortgage Settlement*, Bloomberg (Nov. 19, 2013), *available at* http://www.bloomberg.com/news/2013-11-19/jpmorgan-settlement-announced-by-u-s-justice-department-1-.html.

[6] *See* JPMorgan Chase & Co., Form 8-K Current Report (Oct. 11, 2013), Exhibit No. 99.1, Earnings Presentation Slides at 2 n.3.

[7] *See* Shayndi Raice, *BofA, AIG Battle Over Settlements*, Wall St. J., Nov. 20, 2013, at C2.

[8] *See, e.g.*, Christopher M. Matthews, *Federal Prosecutors Emerge From Mortgage-Fraud Trial With New Weapon, Influential Judges Have Signed Off on Novel Interpretation of Obscure Law*, Wall St. J. (Oct. 23, 2013), *available at* http://online.wsj.com/news/articles/SB10001424052702304069604579154033805282804.

[9] Paulson, *supra* note 2, at 80, 174 & 347. In some of his descriptions, the former Secretary is even more graphic: "We discussed how we could put pressure on Jamie [Dimon].. . .So I called Jamie and told him we needed him to buy Bear [Stearns]." *Id.* at 110.

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long been government policy in the banking sector to promote the acquisition of failing banks by banks that were not just stronger but larger.[10] We were running out of such options in September 2008. It may be recalled that the U.S. government actively pursued Barclays (and other foreign prospects) as a savior of Lehman Brothers until the U.K. government balked at the risk of a U.K. bank catching (in former Secretary Paulson's words) the ''American disease.''[11] It may also be recalled that Wachovia at approximately $800 billion in assets wound up being acquired with the active encouragement of certain government agencies by Wells Fargo, which at approximately $600 billion in assets was the smaller of the two institutions. The increase in size and complexity of these acquiring institutions was not an unintended consequence of government action. It was an *intended* consequence – at least as that term is defined in the legal lexicon.

These institutions did not do these acquisitions against their will. But it is clear that the government led them to believe that they were playing an essential role in protecting the financial system by undertaking these extraordinary acquisitions.

To offer that observation is not to question the decision of government policymakers that it was essential that our largest institutions play a key role in helping to stabilize the U.S. financial system and in helping, in the words of former Secretary Paulson, to avoid the collapse of the global financial system. It is merely to suggest that an appreciation of history is appropriate here – as it is in virtually any other policymaking environment – in considering the questions that we now face about the size and complexity of U.S. banking institutions. It is also appropriate to consider how current government actions will influence future outcomes, for example, by limiting options to the government for assistance from the U.S. banking industry in whatever form a future crisis may take. If we do not have U.S. banking institutions of sufficient size, strength, and will to assist, we may be forced to rely on the kindness of strangers for assistance in the next crisis.

Questions of Size and Complexity

How then are we to address the questions posed about the size and complexity of U.S. financial institutions, including those that grew in size and complexity with the encouragement of the government during the financial crises? The answer - at least in the first instance - is that we have a set of legislative determinations for these questions in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the ''Dodd-Frank Act'').

Title I Prudential Measures

The Dodd-Frank Act contains numerous measures designed to strengthen the overall resilience of the U.S. banking system. Title I of the Dodd-Frank Act also contains measures specifically designed to strengthen on a differential basis the largest banking institutions and other designated systemically important nonbank financial companies. These measures include enhanced capital and liquidity requirements, single counterparty credit exposure limits, stress tests, and early remediation and living will requirements, all of which will encourage the largest banking institutions and other designated nonbank financial companies to weigh carefully the regulatory and business tradeoffs surrounding size and complexity.[12] In fact, in implementing these new enhanced prudential standards, the Federal Reserve Board has said that it is following the legislative direction that the standards should increase in stringency with the ''systemic footprint'' of the covered company. The largest U.S. financial institutions are already responding to these regulatory imperatives as well as to market pressures.[13]

The Dodd-Frank Act authorizes the Federal Reserve Board to impose still other prudential standards on the largest banking institutions. The Federal Reserve Board has indicated that it will be issuing in the next few months proposed rules that will require the largest bank holding companies to maintain a specified minimum level of unsecured long-term debt that would be available for loss absorption or ''bail-in'' in the event that the company had to be resolved.[14] The Federal Reserve Board is also considering regulatory measures that would limit or discourage the issuance of short-term debt at the holding company level. These measures are intended to strengthen the funding structure of these holding companies, making them less susceptible to a market ''run'' on their funding at the holding company level.[15]

Title II Orderly Liquidation Authority

The proposed funding measures are also specifically intended to assist in implementing another singular measure in the Dodd-Frank Act, the Title II Orderly Liquidation Authority regime, which is designed to facilitate the orderly resolution of systemically important fi-

[10] *See, e.g.*, Richard J. Parsons, *Sending a Bad Message to Big Banks*, Wall St. J., Oct. 21, 2013, at A19.

[11] Paulson, *supra* note 2, at 188.

[12] Pub. L. No. 111-203, § 165, 124 Stat. at 1423-1432 (codified at 12 U.S.C. § 5365).

[13] *See, e.g.*, Lewis Krauskopf & Ernest Scheyder, *GE plans credit card unit spinoff to shrink finance arm*, Reuters (Nov. 15, 2013), *available at* http://www.reuters.com/article/2013/11/15/ge-investors-idUSL2N0J00PE20131115; *See also McKinsey & Company, Breakaway: How Leading Banks Outperform Through Differentiation* (2013), *available at* http://www.mckinsey.de/sites/mck_files/files/mckinsey_global_bankin_annual_review_2013.pdf (describing how new global regulatory requirements will require a transformation of global banking institutions).

[14] *See* Governor Daniel K. Tarullo, Address at the Federal Reserve Board and Federal Reserve Bank of Richmond Conference, ''Planning for the Orderly Resolution of a Global Systemically Important Bank'' (Oct. 18, 2013) (transcript available at http://www.federalreserve.gov/newsevents/speech/tarullo20131018a.htm).

[15] *Id.*

nancial institutions. Title II represents one of the great innovations in the design of crisis management and resolution techniques for the U.S. financial sector. As originally conceived by the Treasury Department, Title II was intended as an alternative to the Hobson's choice that confronted government authorities in the 2008 crisis: (i) either a government bail-out of the institution as in the case of AIG; or (ii) a ''disorderly'' bankruptcy of the institution as in the case of Lehman Brothers. Title II is designed to permit an orderly liquidation of systematically important financial institutions by the Federal Deposit Insurance Corporation (the ''FDIC''), applying rules that generally parallel the longstanding rules for the resolution of insured depository institutions under the Federal Deposit Insurance Act.[16]

If we do not have U.S. banking institutions of sufficient size, strength, and will to assist, we may be forced to rely on the kindness of strangers for assistance in the next crisis.

In its developmental work under Title II, the FDIC has incorporated a new concept into its thinking and into its planning process. It is the concept of single-point-of-entry recapitalization. The single-point-of-entry concept envisions that a Title II proceeding would be commenced only for the top-tier holding company in the group. The top-tier holding company would be placed into a Title II receivership proceeding and substantially all of its assets, including the shares of all or virtually all of its operating subsidiaries, would be transferred to a new bridge financial company over the resolution weekend.[17] Subordinated debt and senior unsecured debt of the holding company would be left behind in the receivership. Losses at the operating subsidiaries would be simultaneously ''pushed up'' to the top-tier holding company.[18] These losses would be absorbed by converting the subordinated debt and unsecured long-term debt left behind in the receivership proceeding into equity of the bridge company or successor company. This conversion or bail-in allows the rapid capitalization of the bridge company and recapitalization of the operating subsidiaries. One of the key preconditions to a single-point-of-entry model is that the top-tier company will have enough subordinated debt and senior unsecured debt to absorb all the losses at the top-tier company and at its operating subsidiaries. Another precondition is that the top-tier company (or its successor bridge company) will have sufficient assets (including intercompany loans to its operating subsidiaries) to allow the top-tier-company (or its successor bridge company) to recapitalize the operating subsidiaries. These preconditions are expected to be the subject of the proposed rulemaking from the Federal Reserve Board, which it is undertaking in consultation with the FDIC.[19]

Large Banking Institutions Are Still Handy To Have Around in a Financial Crisis

The single-point-of-entry bail-in strategy is envisioned to have substantial advantages over other possible approaches. Ideally, it would avoid the need for multiple resolution or bankruptcy proceedings at the level of the operating subsidiaries, with the attendant complexities and conflicts that would inevitably arise even in a domestic context. These complexities and conflicts would of course be compounded in a cross-border context. This strategy would also allow for continuity in the provision to the markets of critical financial functions by these subsidiaries. It should also maximize the going concern value of these subsidiaries. Finally, it would minimize the imperative of finding a single savior for the failed institution over a resolution weekend. It introduces the prospect of a more ''orderly'' disposition process for parts of the failed entity as part of the ongoing resolution process for the successor bridge company.

The single-point-of-entry strategy, coupled with a required minimum loss absorbing capacity at the top-tier holding company, is one of the most promising developments in resolution strategy for systemically important financial institutions. The FDIC has indicated that it would likely be the ''preferred'' path for a Title II resolution proceeding.[20] There are nonetheless many contingencies imbedded in the planning and execution process for a single-point-of-entry resolution beyond those outlined above. Moreover, even in a successful single-point-of-entry resolution, a relatively rapid disposition of major operating subsidiaries may still be necessary or desirable. The availability of other large banking institutions as potential acquirers of components of the recapitalized or recapitalizing successor entity may prove critical to the success of the process.

Conceding the desirability, indeed the necessity, of the additional option provided by Title II of the Dodd-Frank Act, a policymaker should nonetheless conclude that it would be wise to retain as many options as possible and specifically to preserve the option for the use of a combination of options in any future crisis.[21] The

[16] For a detailed discussion of the considerations underlying the enactment of Title II, see Paul L. Lee, *The Dodd-Frank Act Orderly Liquidation Authority: A Preliminary Analysis and Critique—Part I*, 128 Banking L. J. 771 (2011).

[17] *See* James R. Wigand, Director, Office of Complex Financial Institutions, Statement on Improving Cross Border Resolution to Better Protect Taxpayers and the Economy to the Subcommittee On National Security and International Trade and Finance, U.S. Senate (May 15, 2012) (transcript available at http://www.fdic.gov/news/news/speeches/spmay1513_2.html) (describing the proposed operation of the single-point-of-entry approach).

[18] *See Bipartisan Policy Ctr., Too Big to Fail: The Path to a Solution*, 25-27 (May 2013), *available at* http://bipartisanpolicy.org/sites/default/files/TooBigToFail.pdf.

[19] Tarullo, *supra* note 14.

[20] *See* Martin J. Gruenberg, Chairman, FDIC, Remarks at the Volcker Alliance Program (Oct. 13, 2013) (transcript available at http://www.fdic.gov/news/news/speeches/spoct1313.pdf); Martin J. Gruenberg, Acting Chairman, FDIC, Remarks at the Federal Reserve Bank of Chicago Bank Structure Conference (May 10, 2012) (transcript available at http://www.fdic.gov/news/news/speeches/chairman/spmay1012.html).

[21] Several options that were available in 2008 have been foreclosed or significantly limited by other provisions of the Dodd-Frank Act. For example, open bank assistance, which

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experience in the 2008 crisis demonstrated that multiple and in some instances cumulative approaches to stabilizing the financial system were necessary and might again be necessary in the future. Reliance on a single strategy would be self-limiting and dangerous. The experience in the 2008 crisis also confirmed the long historical experience that large banking institutions can play a key role in a financial crisis. Based on his own experience, former Secretary Paulson might say that large strong banking institutions are handy to have around in a financial crisis. Indeed, more than handy, they may be indispensable.

was used to assist Citigroup during the crisis, is no longer available. In addition, the emergency lending authority of the Federal Reserve Board under Section 13(3) of the Federal Reserve Act has been limited. These changes are discussed in the GAO Report, *supra* note 1, at 47-55. These limitations make it even more important for policymakers to retain other options.