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Origins of Too-Big-to-Fail Policy

George C. Nuriisso and Edward Simpson Prescott

This paper traces the origin of the too-big-to-fail problem in banking to the bailout of the \$1.2 billion Bank of the Commonwealth in 1972. It describes this bailout and those of subsequent banks through that of Continental Illinois in 1984. Motivations behind the bailouts are described with a particular emphasis on those provided by Irvine Sprague in his book *Bailout*. During this period, market concentration due to interstate banking restrictions is a factor in most of the bailouts, and systemic risk concerns were raised to justify the bailouts of surprisingly small banks. Sprague's descriptions are also used to describe the tradeoffs and the time-consistency problem faced by bank regulators. Finally, most of the bailouts in this period relied on the Federal Deposit Insurance Corporation's use of the Essentiality Doctrine. A discussion of this doctrine is provided and used to illustrate how legal constraints on regulators may become less constraining over time.

Key words: Too big to fail, deposit insurance, banking, time consistency.

JEL Codes: G21, G28, N22.

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1. Introduction

In 1984, bank regulators bailed out the Continental Illinois National Bank and Trust Company. Continental Illinois was the largest bank in Chicago and the seventh largest bank holding company in the United States with about \$41 billion in assets at the end of 1983. It suffered a run when mounting problems with the quality of its assets became widely known. The Federal Reserve Bank of Chicago made discount window loans to Continental Illinois to stop the run, while the Federal Deposit Insurance Corporation (FDIC) injected capital into the bank, lent it money, took bad assets, and guaranteed creditors to keep the bank operating.

The Continental Illinois bailout is a significant event in U.S. financial history and led to the widespread use of the term “too big to fail.”¹ It is also often pointed to as the precedent for the bailouts of the recent crisis such as those of Bear Stearns, AIG, and Citibank. Much less well known, however, is that the Continental Illinois bailout itself was preceded by a sequence of bank bailouts in the 1970s and early 1980s.

The purpose of this essay is to describe these early bailouts, connect them to the Continental Illinois bailout, and use them to identify patterns in too-big-to-fail policy. The history will document that too-big-to-fail considerations motivated bailouts well before the Continental Illinois failure and were applied to surprisingly small banks.² It will also show that in states with only a few large banks, restrictions on interstate banking limited the number of banks that could acquire a failing large bank, and the small pool of potential acquirers was a

¹ Usage of the term is first associated with a quote by Congressman Stewart McKinney, who during hearings into the bailout of Continental Illinois said, “We have a new kind of bank. It is called too big to fail.” (Inquiry into Continental Illinois Corp. and Continental Illinois Bank, 1984, pg. 300.)

² Bank bailouts can be traced further back than the 1970s. See, for example, Gorton and Tallman (2016), who document that during the panics of the National Bank era, clearinghouses would sometimes bail out their members. Nevertheless, one important difference was that in the older period, other clearinghouse banks paid for the bailout rather than taxpayers.

major consideration in whether a bailout was done in these states during the 1970s and early 1980s.

The analysis describes bailouts done by both the FDIC and the Federal Reserve. Most of these bailouts were undertaken by the FDIC through its authority under the “Essentiality Doctrine,” which was a 1951 amendment to the 1950 Federal Deposit Insurance (FDI) Act that allowed the FDIC to provide support to a bank to keep it open “... when in the opinion of the [FDIC] Board of Directors the continued operation of such bank is essential to provide adequate banking service in the community.”³ The Federal Reserve’s primary contribution to these bailouts was to lend the troubled bank funds through its discount window, which kept the bank operating until a solution could be found. Discount window lending was extended in four of the bailouts described in this paper, including three in which the Essentiality Doctrine was used or about to be used.

In describing bailouts done through the Essentiality Doctrine, we rely heavily on the descriptions provided by Irvine Sprague in his book *Bailout*. Sprague was on the FDIC’s board of directors in the early 1970s and early 1980s when several of these bailouts were done. His descriptions are invaluable because they provide a view into the thought process behind the bailout decisions. They show that regulators were well aware of the moral hazard costs of a bailout but that short-term considerations dominated. Furthermore, they show how the use of a legal power, possibly intended for a limited purpose, can be expanded over time to suit the

³ Public Law 797–81st Congress, Chapter 967–2D Session.
<https://fraser.stlouisfed.org/files/docs/historical/congressional/federal-deposit-insurance-act.pdf>

momentary needs of regulators. To illustrate this expansion of scope, we describe two times that the Essentiality Doctrine was applied to banks that were not too big to fail.

Our reading of these early decisions is that the Continental Illinois bailout was not a revolutionary action but instead a predictable consequence of structural changes in banking and past behavior by financial regulators. Furthermore, the bailouts of the 1970s and early 1980s are the precedents for the bailouts of the recent crisis. Indeed, many of the instruments used to implement the bailouts in 2008 and 2009, such as capital injections, warrants, taking over a bank's positions, guarantees, and Federal Reserve lending, were used in the earlier bailouts.

2. Bailouts: A Definition

In this essay, we will use the word bailout to mean assistance provided to a failing bank to keep it open. Such assistance could be in the form of capital injections, government lending, or other means. We choose this definition because it provides a clear demarcation between resolution efforts that keep a bank open versus those that close it. We will mainly focus on open-bank assistance provided by the FDIC through its use of the Essentiality Doctrine, but we will also discuss the role played by Federal Reserve lending.

When a bank fails, the FDIC will pay depositors the amount in their insured accounts up to the coverage limit (currently \$250,000 per depositor). We do not consider these payments to be a bailout. They are part of a well-defined, easily understood insurance system, and as long as

deposit insurance is not underpriced, these payments are no more a transfer than a life insurance payment.⁴

Uninsured depositors and other creditors of banks are usually protected indirectly. The FDIC typically resolves a failing bank by facilitating a sale to a healthy bank with direct payments to the acquirer or by keeping some of the undesirable assets and liabilities of the failed bank. In most of these transactions, the healthy bank acquires all of the failed bank's deposits, both insured and uninsured. Consequently, the uninsured depositors do not bear the losses, so they are essentially insured.⁵ Furthermore, as we will see in the case of Franklin National Bank, Federal Reserve discount window lending can keep a failing bank operating long enough to allow some uninsured depositors to get their funds out before the bank is closed, which potentially raises the cost of closing the bank to the FDIC.

These latter payments are a form of bailout, and other than the case of Franklin National Bank, we exclude them from our analysis because the failed bank no longer exists after the transaction.⁶ However, it is important to remember that the payments described in the previous paragraph are also bailouts and that the too-big-to-fail problem is really a manifestation of a larger problem in which bank creditors rarely bear the downside of their

⁴ This does not mean that a fairly priced deposit insurance system does not have significant social costs. Even if insurance premia are set to be actuarially fair, insurance still creates moral hazard. See Prescott (2002).

⁵ Empirically, very few uninsured depositors suffer losses during a bank failure. Stern and Feldman (2009) report that of the about 1,100 commercial banks that failed between 1979 and 1989, 99.7% of all of their deposits did not suffer a loss. We have not seen similar calculations for the recent crisis, but with the emergency expansion of deposit insurance to cover all deposits (and short-term debt) in the fall of 2008—along with the Dodd-Frank law's retroactive increase of deposit insurance coverage to \$250,000 for banks that failed in 2008 before the emergency expansion—we doubt that the percentage of unprotected deposits is any lower than in the earlier period.

⁶ Traditionally, bank deposit insurance premia were assessed based on the quantity of insured deposits. The Dodd-Frank Act changed the assessment base to be that of average assets minus tangible equity though legally only deposits under \$250,000 are still explicitly insured. One interpretation of this change is that the FDIC is just recognizing the reality of historical experience that all bank liabilities are effectively insured, though this raises the question of why even bother with imposing a \$250,000 limit.

investments in banks. While the deposit insurance system was originally designed to protect small depositors, it now in effect provides protection for a much larger group.

*Bank Failure and the Essentiality Doctrine*⁷

When a bank is declared insolvent by its chartering agency, it is turned over to the FDIC. For the period covered in this essay (1971–1984), the FDIC had three options for dealing with a failing bank: it could pay the insured depositors and liquidate the bank, it could facilitate the purchase of the bank by providing financial assistance to the acquiring bank, or it could provide assistance to the failing bank to keep it open, that is, do a bailout.

Under the 1950 FDI Act, the FDIC was required to pay off closed banks unless it was less costly for them to sell it.⁸ During this period, the FDIC could only do a bailout if the FDIC board of directors found that the bank was in danger of failing and was “essential to provide adequate banking service in the community.”⁹ This part of the FDI Act along with the decision to invoke it is referred to as the “Essentiality Doctrine.” Sprague (1986) says that the law and legislative history of the FDI Act do not give much guidance on how the FDIC board should go about

⁷ Information on FDIC procedures and bailouts is from Sprague (1986). For additional discussion of the history of FDIC resolution procedures, see Caliguire and Thomson (1987).

⁸ Leading up to the 1950 Act, assisted purchases became the main way that the FDIC handled resolutions (Caliguire and Thomson 1987). After the Act, from 1951-1970, the FDIC handled 43 of 79 failures with payoffs and the rest with an assisted purchase. (Author’s calculations from FDIC Historical Statistics on Banking.) However, most of the payoffs were for small banks. The largest payoff in this period was in 1965 for the San Francisco National Bank, which only had \$40 million in assets when it failed.

⁹ In the St. Germain Act of 1982, the FDIC’s bailout authority was expanded. It could now provide assistance without an essentiality finding as long as the amount was not “in excess of that amount which the Corporation determines to be reasonably necessary to save the cost of liquidating.” Later, the Federal Deposit Insurance Corporation Improvement Act of 1991 eliminated the Essentiality Doctrine and required the FDIC to resolve a bank using the method that was the least cost to the FDIC fund. It did allow open bank assistance if the failure of a bank was deemed to be a systemic risk.

making this finding.¹⁰ For example, it does not define the term community. He concludes that it is ultimately a discretionary decision that depends on the judgment of the FDIC board.¹¹

Despite having this power since 1951, the FDIC did not invoke the Essentiality Doctrine until 1971 when it was used to bail out Unity Bank. Including Unity Bank and Continental Illinois, the Doctrine was invoked six times through 1984. The following section describes five of these bailouts¹² as well as the partial bailout of Franklin National Bank, in which the Federal Reserve played a prominent role, and two cases in which the FDIC considered doing a bailout, but did not.

3. Five Bailouts, a Partial Bailout, a Near Bailout, and One Liquidation

The First Use of a Bailout Power: Unity Bank

The first bank to receive aid through the Essentiality Doctrine was Unity Bank of Boston, Massachusetts, in 1971. Unity was not a too-big-to-fail bank since it only had about \$11 million in assets. Rather, it was a too-symbolic-to-fail bank. Unity was a minority-owned bank that opened in 1968 and served a black neighborhood in Boston.¹³ Its opening in 1968, during a period of racial riots in the United States, was enthusiastically supported by the local community and was viewed as an important symbol of hope.

¹⁰ In his review of Sprague (1986), Horvitz (1987) —a former research director at the FDIC—says that the oral tradition at the FDIC was that the essentiality provision was added to the FDIA in 1951 to provide for cases in which a failing bank was the only bank in a small rural town. Heinemann (1971) also believes that was the Congressional intent.

¹¹ Sprague (1986), pg. 28.

¹² The sixth bailout under the Doctrine was in 1974 for the \$150 million American Bank and Trust Company of Orangeburg, South Carolina. The FDIC provided this bank a short-term \$10-million loan for liquidity purposes. Less than three weeks later the bank was closed and sold. Sprague (1986, pg. 272) admits that this bank was not essential, but says that the finding was made to give the FDIC time to find a buyer.

¹³ Sprague (1986), pg. 37.

Unfortunately, the bank quickly ran into trouble because of poor management and an inexperienced staff. The FDIC decided to get involved because it was concerned with the social ramifications of Unity's failure. FDIC Director Irvine Sprague noted that, "In 1971 no one could be sure that the failure of a black bank in a rundown urban center would not touch off a new round of 1960s-style rioting...The Watts; Washington D.C.; and Detroit race riots were not long behind us. These and other riots of the era....came very readily to mind when we thought about Unity."¹⁴

The FDIC determined that it would take around \$2 million to rescue Unity. However, it was not clear whether it had the authority to lend to the bank. Up to that point, the FDIC had only used its funds to pay off depositors or to arrange a merger. The decision hinged on the FDIC board's interpretation of the Essentiality Doctrine, which stated that the FDIC could provide assistance to a bank in danger of failing if the bank is "essential to provide adequate banking service in the community." In the opinion of the FDIC, the wording of the act gave it the ability to both set the terms of any assistance and to define what exactly constitutes a community. Thus, the FDIC was able to conclude that Unity Bank was essential to the African-American community of Boston because there was no other minority-owned bank nearby.¹⁵

The connection of the Unity bailout to too big to fail is not the size of Unity, but rather the precedent it set for how the FDIC might use its essentiality authority in the future. Sprague claimed to have been worried about this. For example, the troubled and much larger Bank of the Commonwealth in Detroit partially served a minority community and Sprague wrote that "if we said 'yes' to Unity, then it would be much more difficult to say 'no' to the much larger

¹⁴ Sprague (1986), pg. 38.

¹⁵ Sprague (1986), pg. 43.

Commonwealth.”¹⁶ The Comptroller of the Currency William Camp, who was an *ex officio* member of the FDIC board, was also concerned by these developments and felt that the first bailout under this authority would inevitably lead to “many more, possibly an uncontrollable flood.”¹⁷

Despite these reservations, the FDIC proceeded with the bailout and approved a \$1.5 million loan to Unity Bank. The loan was unsecured and subordinated to the claims of depositors and other general creditors of the bank. Other banks in Massachusetts provided approximately \$500,000 in additional aid.¹⁸ The loan stabilized the bank in the short term but was ultimately in vain. Unity was unable to pay back the money and was shut down on July 30, 1982, by the Massachusetts State Banking Commissioner. The FDIC recovered only \$200,000 of its \$1.5 million loan.¹⁹ In the end, the FDIC arranged for a closed bank merger with what eventually became the Boston Bank of Commerce.

The First Too-Big-to-Fail Bailout: Bank of the Commonwealth

Sprague’s assessment of the situation with the Bank of the Commonwealth in Detroit proved prescient when the FDIC again used the Essentiality Doctrine to bail out the bank in 1972. The Bank of the Commonwealth was at the center of a network of banking partnerships run by Donald Parsons in Michigan. Parsons used this network to acquire banks and control them because Michigan prohibited bank holding companies and restricted branching.

¹⁶ Sprague (1986), pg. 42.

¹⁷ Sprague (1986), pg. 46. Also, see Heinemann (1971), a reporter at the *New York Times*, who raised similar concerns.

¹⁸ FDIC (1971).

¹⁹ Sprague (1986), pg. 51.

Commonwealth's problems came from a bet on interest rates that did not pay off. In the late 1960s, Commonwealth invested heavily in high-yield, long-term municipal securities with the hope that rates would drop and thus deliver a large capital gain. The bank amplified this bet by pushing tax-deductible expenses into the future.²⁰ Unfortunately for Parsons, interest rates instead rose and the value of the municipal securities plummeted.²¹

Unlike Unity, Commonwealth was a large institution, with total assets of around \$1.2 billion, and there were legitimate concerns that its failure would have serious consequences for the economy. The FDIC's preferred course of action was to arrange a merger, but bank concentration in Detroit along with state banking rules limited the potential pool of acquirers. At the time, Michigan law prevented out-of-state banks from acquiring Michigan banks, so any acquirer would have to come from within the state. However, the three largest banks in Detroit already controlled 77% of deposits, which led Sprague to believe that the market would become too concentrated if one of them added Commonwealth's 10% share.²²

Another issue complicating the matter was the involvement of Chase Manhattan Bank. Chase had enabled Commonwealth to expand rapidly in its early days by lending over \$20 million to Parsons' controlling partnerships. These loans were collateralized by Commonwealth stock, so when Chase foreclosed on the partnerships, it became one of Commonwealth's largest shareholders.²³ This meant that a bailout of Commonwealth would also protect Chase,

²⁰ Sprague (1986), pg. 60.

²¹ Commonwealth's bet on interest rates is consistent with banking models of risk shifting. In these models, because of deposit insurance and limited liability, the owners of a bank have an incentive to take excessive risk because the equity owners don't bear the downside risk of failure and insured deposits don't price in that excess risk. See, for example, Merton (1977) and Kareken and Wallace (1978).

²² Sprague (1986), pg. 69.

²³ Sprague (1986), pg. 65.

one of the largest banks in the country, from incurring losses on its bad loans. Chase pushed the FDIC to do a bailout, but the FDIC was understandably uncomfortable with doing so.

The FDIC eventually ruled that Commonwealth was essential because of its “service to the black community in Detroit, its contribution to commercial bank competition in Detroit and the upper Great Lakes region, and the effect its closing might have had on public confidence in the nation's banking system.”²⁴ The final deal required Commonwealth to reduce the par value of all outstanding stock from \$45.5 million to \$7.9 million and to use the leftover \$37.6 million to absorb the losses from the sale of its municipal securities. That provision was intended to punish the shareholders, Chase in particular, for their role in the matter. The FDIC also agreed to lend the bank up to \$60 million to replenish the bank’s capital.²⁵ While the FDIC assistance kept Commonwealth open, the bank continued to struggle after the bailout and was eventually acquired by Comerica Bank in 1983.²⁶

The bailout of Commonwealth was a significant step in the establishment of too big to fail as a de facto policy. For example, Sprague says that the Federal Reserve brought up the “domino theory” of a large bank failure during its Commonwealth discussions. This theory, that if one large bank failed many more would follow, surfaced again and again over the next forty years as various big banks got into trouble.²⁷ It was Commonwealth, not Continental Illinois, that was the first too-big-to-fail bank bailout.²⁸

²⁴ FDIC (1972).

²⁵ Sprague (1986), pg. 73.

²⁶ Sprague (1986), pg. 76.

²⁷ Sprague (1986), pg. 68.

²⁸ For a different view see the interview with Carter Golembe (Burststein 1988). Golembe argued Commonwealth was bailed out because there was a desire to prevent a bank failure in Michigan, which was an important state in the upcoming national election in 1972, and that the Federal Reserve did not want to have a large state-member

The Second Too-Big-to-Fail Bailout: Franklin National Bank

Franklin National Bank, with assets of nearly \$5 billion in 1973, was the largest bank to fail in the history of the United States up until that point.²⁹ Franklin was originally an institution that focused on retail banking in Nassau County, New York. In the 1960s, it decided to grow by attempting to become a money center bank, so it entered Manhattan, opened overseas branches, and participated in the Eurodollar market. Many of Franklin's troubles were typical of a bank that tried to grow too quickly. It relied heavily on short-term borrowing and used those funds to make loans to risky borrowers at near prime rates.³⁰

The distinguishing feature of Franklin's troubles came from its involvement in foreign exchange markets. With the collapse of the Bretton Woods monetary system in the early 1970s, many nations switched to a floating exchange rate, a system that provided investors with the opportunity to take positions on changes in exchange rates. Franklin, expecting a rise in the dollar, took a large short position in many foreign currencies. Between December 11, 1972, and May 14, 1974, Franklin's net short position in dollar terms grew from \$5.2 million to \$232.6 million.³¹ However, the dollar depreciated, so Franklin lost a substantial amount of money (over \$30 million in the first quarter of 1974 alone).

To make matters worse, Franklin concealed the losses with fraudulent behavior. It would engage in last-minute "transactions" with other banks owned by its majority shareholder, Michele Sindona, to boost profits on its reports. The funds would then be returned

bank fail. He also believes that the service to a minority community cited in the FDIC's finding of essentiality was just an excuse. Nevertheless, he does think that this bailout "inaugurated" too big to fail.

²⁹ Brimmer (1976), pg. 34.

³⁰ Brimmer (1976), pg. 38.

³¹ Spero (1980), pg. 79.

as soon as the report was published.³² Traders would also lie to clerks in the processing and auditing departments about the extent of the foreign exchange losses.³³ Franklin's weakness was inferred by the public when the Federal Reserve rejected Franklin's proposed acquisition of Talcott National Corporation.³⁴

The Board of Governors' Talcott decision indicated that Franklin did not have the managerial or financial resources to successfully handle such an acquisition and that these resources should instead be used to solve the bank's problems. Shortly after the decision was released to the public on May 1, 1974, a run on the bank started. It was primarily concentrated in the money markets.³⁵ Over the next three months, the bank's money market CDs dropped from \$443 million to \$107 million and foreign deposits at its London branch dropped from \$926 million to \$394 million.³⁶ The bank also lost significant amounts of funding from the federal funds market and repurchase agreement markets.

Regulators were worried about how Franklin's failure would impact international finance, particularly because of the recent failure of Herstatt Bank in Germany. Herstatt, one of the largest banks in Germany, was officially shut down at the end of the German trading day on June 26, 1974. However, markets in New York were still open at this time. This was problematic because the bank had many spot foreign exchange trades outstanding, which meant that its

³² Spero (1980), pg. 82.

³³ Spero, (1980), pg. 83.

³⁴ The Federal Reserve was justly worried that the public might draw this inference. Federal Reserve officials informed Franklin that "... the Board might reject the proposal and that Franklin officers might be wise to avoid a denial and the resultant public reaction by withdrawing the proposal. This they refused to do." (Spero 1980, pg. 87.)

³⁵ Brimmer, (1976), pg. 46.

³⁶ Brimmer (1976), pg. 47a.

closure disrupted the settlement process.³⁷ Franklin also had a large foreign exchange portfolio, and the American regulators were worried about adding to the uncertainty in the foreign exchange market. As a result, the Federal Reserve Bank of New York allowed Franklin to borrow money through the discount window to stay liquid until a merger could be arranged. Franklin ended up borrowing \$1.7 billion over a five-month period.³⁸

Franklin's large debt to the Federal Reserve Bank of New York and its messy foreign exchange portfolio made it difficult for the FDIC to arrange a merger. The former issue was resolved when the FDIC agreed to pay off the balance in three years with periodic payments coming from the liquidation of Franklin's assets.³⁹ The latter problem was dealt with when the Federal Reserve Bank of New York assumed Franklin's foreign exchange portfolio with the condition that Franklin pay the New York Fed \$15.645 million as compensation for estimated losses.⁴⁰

With those issues settled, the FDIC was able to sell Franklin. European-American Bank & Trust Company submitted the winning bid at \$125 million and also agreed to assume all deposit liabilities. Franklin's trust business was purchased by Bradford Trust Company.⁴¹

A Bailout of a State: Farmers' Bank of the State of Delaware

At the end of 1975, the Farmers' Bank of the State of Delaware was fast approaching failure due to a severe deterioration in its loan portfolio, which consisted primarily of real

³⁷ Brimmer (1976), pg. 22.

³⁸ FDIC (1984), pg. 92.

³⁹ FDIC (1984), pg. 92

⁴⁰ Later, the Federal Reserve Bank of New York returned nearly \$6 million because the losses were not as severe as anticipated (Spero, pg. 135).

⁴¹ FDIC (1974), pg. 6.

estate-related loans. To keep Farmers' Bank operating, the FDIC purchased \$40 million of bad loans for \$32 million. It then provided liquidity by making secured short-term loans to the bank at the Fed's discount rate.⁴²

Farmers' Bank was not a large bank, having only \$493 million in assets at the end of 1975.⁴³ The FDIC had allowed larger banks to fail and even allowed the similarly sized Hamilton Bank to fail in the same year. Farmers' Bank was bailed out because of its deep connection to the State of Delaware. While Farmers' Bank was chartered as a private bank in 1807, the State of Delaware purchased 40% of the stock in 1837 and acquired even more shares later that century, resulting in a 49.8% ownership stake. Furthermore, the state's general assembly selected several of the bank's directors, and Delaware's funds, including those from school districts, were required to be deposited in the bank. The deposits were not secured, so the State and its school districts would take significant losses if the bank failed.⁴⁴ These close ties contributed to the bank's problems and were a reason it made risky loans to politically connected individuals. In addition, the bank undertook an ill-advised expansion strategy that involved a lot of risky out-of-market real estate loans.⁴⁵

It was the consequences for the Delaware that seemed to have motivated the FDIC's finding of essentiality. Sprague only mentions the bank in passing in a footnote, but he says "The State of Delaware owned 49 percent of the bank stock and by state law the bank was the

⁴² Delaware (1976).

⁴³ Source: Call Report.

⁴⁴ Delaware school districts had \$100 million on deposit in just a few accounts, and deposit insurance at this time would have covered only \$40,000 per account (Danforth 1977).

⁴⁵ New York Times (1977) and Boyer and Ratledge (2016).

sole depositor for state funds. Clearly the essentiality finding went to the state, not the bank, and no one would argue that Delaware is not an essential state.”⁴⁶

As part of the bailout, Delaware was required to purchase preferred stock to help recapitalize the bank and to keep deposits in the bank that would not earn any interest. This latter requirement was a way for Delaware to use foregone interest earnings to increase bank earnings and recapitalize the bank over time. The FDIC also required various operational changes at the bank.⁴⁷ The bailout was then modified in 1977 to deal with higher levels of classified assets than originally anticipated.⁴⁸ These actions stabilized the bank, though it was later sold to Girard Bank in 1981.

The Third Too-Big-to-Fail Bailout: First Pennsylvania Bank

Founded in 1782, First Pennsylvania Bank of Philadelphia, Pennsylvania (First Penn), was the nation’s oldest bank. It was also the 23rd largest with assets exceeding \$8 billion in 1980.⁴⁹ First Penn aggressively expanded its loan portfolio during the years 1966-76 and nearly tripled in size.⁵⁰ However, many of these loans were risky and eventually turned into nonperforming loans. First Penn then followed the example of Commonwealth and gambled on interest rates. It purchased a large quantity of long-term Treasury securities with the hope that rates would

⁴⁶ Sprague probably does not discuss this case in any detail because he was not on the FDIC board of directors during this bailout. He served on that board from 1969 to 1972 and from 1979 to 1986.

⁴⁷ Delaware (1976).

⁴⁸ Wall Street Journal (1977).

⁴⁹ FDIC (1998), pg. 515.

⁵⁰ FDIC (1998), pg. 516.

fall. When the opposite happened, the value of the securities collapsed and the bank struggled to pay the rising cost of deposits.⁵¹

The FDIC hoped to avoid the bailout question by arranging a merger with another bank. However, that proved to be impossible because of First Penn's size and Pennsylvania's restrictions on out-of-state acquisitions. The only Pennsylvania bank large enough to safely absorb First Penn was Mellon Bank of Pittsburgh, and the FDIC believed that such a combination would adversely affect competition.⁵² Thus, the FDIC was left with two options: provide assistance to First Penn or let it fail.

The decision to bail out First Penn was a difficult one. FDIC director William Isaac was against a bailout because of the precedent it would set. He believed that a depositor payoff was the correct move because "how else do you maintain discipline in the marketplace?"⁵³ Isaac also recalled that "most of the FDIC senior staff agreed with my view, but Irv Sprague...had made up his mind to do the transaction."⁵⁴ However, even Sprague expressed some doubts and said that "my preference was any solution but a bailout after the unsatisfactory results at Commonwealth."⁵⁵ On the other hand, Fred Schultz, the vice chairman of the Federal Reserve Board of Governors, was in favor of a bailout.⁵⁶ Adherents to this point of view cited the domino theory and believed that First Penn's failure would result in an international banking crisis.

⁵¹ FDIC (1998), pg. 517.

⁵² FDIC (1998), pg. 518.

⁵³ Sprague (1986), pg. 91.

⁵⁴ Isaac (2010), pg. 14. Nevertheless, Isaac voted in support of the bailout.

⁵⁵ Sprague (1986), pg. 89.

⁵⁶ Sprague (1986), pg. 88.

Once the FDIC decided to go through with the bailout, the legal grounds used to declare First Penn essential were primarily based on the bank's size and the negative impact that its failure would have on financial stability.⁵⁷ The FDIC agreed to provide a five-year subordinated note for \$325 million to go along with a similar note from 27 leading banks for \$175 million. Private sector assistance was important to the FDIC because it believed that such assistance would inspire more public confidence in the bank than government assistance alone. The Federal Reserve Bank of Philadelphia provided a \$1 billion line of credit through its discount window. First Penn was also required to sell enough of its Treasuries to incur a \$75 million loss; this would reduce its interest rate risk. Finally, the FDIC and the 27 banks also purchased 20 million stock warrants in First Penn at an exercise price of \$3 per share.⁵⁸ The purpose of that action was to place a larger burden on First Penn's shareholders. These actions stabilized the bank. Later, First Penn fully paid back the loans and repurchased all of the stock warrants by 1985.⁵⁹

Two Banks That Were Almost Bailed Out: Penn Square Bank and Seafirst

After First Penn, Penn Square Bank and Seafirst were the next two large banks to get in trouble. However, they were not bailed out. We discuss them because there was a desire to do so, and it is worth understanding why the FDIC chose not to in the end.

Penn Square Bank of Oklahoma City had \$484 million in assets at the end of 1981. It was also an institution whose importance to the banking system was masked by its relatively

⁵⁷ FDIC (1998), pg. 520.

⁵⁸ FDIC (1998), pg. 521.

⁵⁹ FDIC (1998), pg. 522.

moderate size. Penn Square came to prominence by making high-risk loans to oil drillers and then selling participations, which did not show up on Penn Square's balance sheet, to other banks around the country. Banks such as Continental Illinois, Chase Manhattan Bank, Michigan National Bank, Seattle First National Bank (Seafirst), and the Northern Trust Company bought these participations. Penn Square then used the revenue from the participations to fund more loans and participations.⁶⁰ It also serviced the loans.

One problem with Penn Square's strategy was that it left Penn Square extremely vulnerable to shocks in the energy sector. Business boomed in the late 1970s when the price of oil skyrocketed. However, many drillers were not finding oil or gas at this time, and they started to miss payments. When energy prices fell in the early 1980s, Penn Square got into severe trouble.⁶¹

There was disagreement among the main regulators about what to do with Penn Square. The Federal Reserve and the Office of the Comptroller of the Currency (OCC) preferred a purchase and assumption transaction or for the FDIC to provide open bank assistance.⁶² The Federal Reserve and the OCC were worried about what would happen to the banks that purchased participations if Penn Square failed, particularly Seafirst and Continental. However, it appeared that Penn Square was involved in many fraudulent activities and that creditors would sue to recover their losses if the FDIC acquired its liabilities.⁶³ Therefore, open bank assistance would expose the FDIC to a large potential liability, one that Sprague thought "could

⁶⁰ Sprague (1986), pg. 111.

⁶¹ FDIC (1998), pg. 529.

⁶² FDIC (1998), pg. 529.

⁶³ Isaac (2010), pg. 30.

not be calculated.”⁶⁴ Other banks had the same fear and were not willing to acquire Penn Square. In addition, it was unlikely that the FDIC could claim that Penn Square was essential to the community since there were 36 other banks in Oklahoma City.⁶⁵ This left a payoff as the only realistic option.

The FDIC created a Deposit Insurance National Bank (DINB) to handle the payoff. The main benefit of the DINB compared to a straight deposit payoff was that the DINB minimized the disruption to customers of the bank. Insured depositors could maintain their accounts at the DINB and gradually transfer them to a new bank when they were ready. Eventually, all depositors moved their funds, and the DINB ceased to exist. The total resolution cost to the FDIC was \$65 million.⁶⁶

As regulators predicted, the failure of Penn Square had a negative impact on other banks. One such bank was Seafirst. Seafirst Corporation was a \$9.6 billion holding company and the largest bank in the Northwest. Seafirst had purchased \$400 million of Penn Square’s participations and originated about \$800 million of its own energy loans, both of which contributed to an operating loss of \$91.4 million in 1982.⁶⁷ Furthermore, Seafirst was going to report larger losses in the first quarter of 1983. Seafirst’s counterparties knew that it was weak and started to run it in early 1983.⁶⁸

Seafirst was too weak to survive on its own, so three strategies were undertaken simultaneously to deal with it. The first was to provide liquidity to keep the bank operating. The

⁶⁴ Sprague (1986), pg. 116.

⁶⁵ FDIC (1998), pg. 531.

⁶⁶ FDIC (1998), pg. 539.

⁶⁷ Sprague (1986), pg. 141.

⁶⁸ Sprague (1986), pg. 139. According to Brimmer (1984, pg. 19), in the first half of 1983 Seafirst’s CD’s fell by 42% while deposits in foreign offices (Eurodollar deposits) fell by 43%.

second was to find a healthy bank to acquire it. The third was for the FDIC to develop a contingency plan of providing aid in case Seafirst could not find an acquirer.

The Federal Reserve took an active role in finding liquidity sources for Seafirst. First, the president of the Federal Reserve Bank of New York led the organization of a 15-bank consortium that provided liquidity to Seafirst.⁶⁹ Second, when several banks dropped out of the consortium, the Federal Reserve Bank of San Francisco began lending to make up for the lost funds.⁷⁰ This kept the bank operating until a buyer could be found.

The FDIC's main role was to help find an acquirer, or in the absence of finding one, arrange the bailout. As with Commonwealth and First Penn, a complication in finding an acquirer was that Washington state law would not allow an out-of-state bank to acquire a Washington bank. This was problematic because the only banks large enough to acquire Seafirst were located out of state.

Because the acquisition might fall through, the FDIC prepared to provide a bailout for Seafirst. In this case, the FDIC did not need to use the Essentiality Doctrine to do the bailout. A 1982 addition to section 13 (c) of the FDI Act permitted the FDIC to provide temporary assistance in order to "arrange in an orderly fashion the merger, consolidation, or sale of the Bank's assets and assumption of the Bank's liabilities." The FDIC legal division interpreted this law to mean that the FDIC could provide assistance to sustain a bank until a suitable partner was found. The FDIC was ready to assist Seafirst with a \$250 million loan, and the papers to do the bailout were prepared, signed by the CEO of Seafirst, and left undated, so that the FDIC could immediately make the loan if need be. This proved unnecessary, as state lawmakers met

⁶⁹ Brimmer (1984), pg. 19.

⁷⁰ Brimmer (1984), pg. 20.

in an emergency session and changed the state's banking laws, relaxing the restriction on out-of-state banks and allowing the California-based Bank of America to purchase Seafirst. Such a consolidation of banking assets would normally be considered anticompetitive, but the ramifications of Seafirst's failure overrode those concerns.⁷¹

While Seafirst was not bailed out in the end, it is clear that regulators were prepared to do so. Their fear was that Seafirst's failure would be a shock to the domestic and international money markets. Similar concerns were raised in the Franklin and First Penn cases, which show how important these considerations were to regulators.

The Big One at the Time: Continental Illinois

As a nearly \$40 billion bank holding company, Continental Illinois was substantially larger than First Penn and Seafirst. Like many other troubled banks, Continental Illinois sought to grow at a rate that its basic business could not sustain. It was heavily involved in commercial and industrial lending, loans to less-developed countries, and the Penn Square participations. It became clear after the fact that Continental Illinois had made many poor loans.⁷² Furthermore, it borrowed heavily in wholesale markets, including the Eurodollar market, which consists of uninsured deposits. Eventually, Continental Illinois's loan troubles became apparent, which prompted an electronic run on the bank. Foreign customers withdrew over \$6 billion, and domestically, the Chicago Board of Trade Clearing Corporation alone withdrew an additional

⁷¹ Sprague (1986), pg. 136.

⁷² FDIC (1998), pg. 546.

\$50 million.⁷³ The bank was forced to borrow \$3.6 billion from the Federal Reserve Bank of Chicago to stay liquid.⁷⁴

A payoff was never seriously considered by the FDIC because of the potential ramifications on financial stability. Over 2,000 banks had correspondent accounts at Continental Illinois, and there was a concern that funding lines for other big banks would be restricted in the event of a Continental Illinois failure. At a meeting of senior bank regulators, Sprague claims that the consensus was that two large troubled institutions would not survive a Continental Illinois failure.⁷⁵ In addition, Continental Illinois' size combined with the presence of interstate branching restrictions made it difficult for the FDIC to quickly arrange a merger. Therefore, a bailout was once again the FDIC's only realistic option. However, it is important to note that the Garn-St. Germain Depository Institutions Act was passed by this time, which changed the nature of the Essentiality Doctrine. The FDIC could now provide open bank assistance without an essentiality finding as long as the amount given did not exceed the estimated cost of a payoff.⁷⁶ This act gave the FDIC more flexibility in its actions as it no longer needed to have its legal staff conjure up a justification for finding a bank essential.⁷⁷

The assistance package contained many of the same features seen in the bailout of First Penn and the near bailout of Seafirst. First, the FDIC sought the help of other major banks. Sprague believed that Commonwealth struggled after its bailout because the assistance came

⁷³ FDIC (1998), pg. 547.

⁷⁴ Hetzel (1991) argues that this also occurred with the failure of the much smaller National Bank of Washington in 1990. For more details, see Broaddus (2000).

⁷⁵ Sprague (1986), pg. 155.

⁷⁶ FDIC (1998), pg. 549.

⁷⁷ The FDIC did nevertheless make an essentiality finding to justify its first round of assistance to Continental in May 1984.

entirely from government funds. He noted that “the fact was that government money seemed to have made the bank suspect in the eyes of depositors and private investors. Rather than restoring confidence among the public, the federal assistance by itself seemed to have had the opposite effect.”⁷⁸ The FDIC made sure to correct this mistake when structuring the bailouts of First Penn and Continental Illinois. Indeed, the FDIC arranged for seven banks to grant a \$500 million subordinated loan to Continental Illinois to go along with its \$1.5 billion contribution. The FDIC also continued to place an emphasis on punishing a bank’s shareholders in the event of a bailout. In the First Penn assistance package, the FDIC purchased enough stock warrants to potentially take a controlling interest. This decision was challenged in court by a First Penn shareholder who believed that the FDIC did not have the right to hold stock in a bank. However, a federal judge ruled in favor of the FDIC and confirmed a broad interpretation of the FDIC’s assistance powers.⁷⁹ This precedent was used in the Continental Illinois case when the FDIC gave itself the right, in the event of substantial losses on the assets it purchased from Continental Illinois, to acquire the entirety of the common stock in Continental Illinois’s holding company.⁸⁰ The FDIC also provided the holding company with \$1 billion in capital through the purchase of junior preferred stock (\$720 million convertible to an 80% stake) and adjustable rate preferred (\$280 million) stock.⁸¹

The final arrangement had the FDIC assume Continental Illinois’ \$3.5 billion debt to the Federal Reserve Bank of Chicago in addition to the \$1 billion capital infusion. In exchange, the FDIC acquired \$4.5 billion (\$5.1 billion face value) of Continental Illinois’ assets, of which it

⁷⁸ Sprague (1986), pg. 75.

⁷⁹ Sprague (1986), pg. 103.

⁸⁰ FDIC (1998), pg. 553.

⁸¹ FDIC (1984).

recovered approximately \$2 billion. It also received \$1.2 billion from the sale of stock and \$200 million from the dividends of said stock. In total, the cost of the Continental Illinois bailout was \$1.1 billion dollars.⁸²

4. Discussion

Bank Structure Then and Now

As mentioned earlier, the FDIC had three methods for dealing with a failing bank during the 1970s and early 1980s: it could pay off the depositors, arrange a sale of the bank, or do a bailout. It is clear that the FDIC and other financial regulators preferred to resolve a failing bank by finding another bank to acquire it. Between 1970 and 1984, about 72% of commercial bank failures were resolved this way.⁸³ Conversely, regulators wanted to avoid a payoff for all but the smallest banks. The largest bank that was paid off in this period was Penn Square in 1982, a \$484 million bank that was, as we discussed, only paid off because fraud and poor accounting at the bank made the FDIC's liability in the case of an assisted acquisition or a bailout hard to estimate.⁸⁴ These observations suggest that the Essentiality Doctrine can be viewed as a means for dealing with the unusual cases in which an assisted acquisition was not possible.

An acquisition of Unity or Farmers would have been difficult because of their unique positions in their respective communities. Unity was the only minority-owned bank in Boston

⁸² FDIC (1998), pg. 560.

⁸³ Authors' calculations from FDIC Historical Statistics on Banking.

⁸⁴ For failed commercial banks, a payoff on a bank with over \$1 billion in assets was not done until 2009 when the First Bank of Beverly Hills failed. For savings institutions, larger payouts were done earlier. In 1991 a payoff was done for the \$5 billion Columbia Savings and Loan Association. The largest to date is the resolution of Indymac Savings Bank, which had about \$30 billion in assets when it failed in 2008 (authors' calculations from FDIC Historical Statistics on Banking). Indymac was resolved by creating a depositor national bank that the FDIC operated until it was able to sell a much reduced version of the bank to OneWest bank.

and Farmer's was essentially owned by the State of Delaware. The other too-big-to fail banks, however, had an important feature in common. At the time of their troubles, the states in which they were located had restrictive branching laws that prevented an out-of-state bank from acquiring an in-state bank. This restriction, in addition to the failing banks' large size, made it hard to find an acquirer.

Tables 1, 2, 3, and 4 report the size and within-state market share of each of these four too-big-to-fail banks around the time of their bailouts or near bailout. Commonwealth had only a 5% market share, but it was still the fifth-largest bank in Michigan and, as discussed earlier, its acquisition would have made the Detroit market particularly concentrated. Concentration was also a concern in the case of Pennsylvania and Washington State, but there was also a lack of potential acquirers. In Pennsylvania, the only bank larger than First Penn was Mellon and acquiring First Penn would have increased Mellon's market share in the state to 26%.⁸⁵ In Washington State, Seafirst was the largest bank with a 37% market share and was almost twice the size of the next-largest bank. This means that even without concentration concerns, none of the other Washington State banks would have had the size and managerial expertise required to run the merged institution. Seafirst was only acquired by an out-of-state bank when the State of Washington changed its law at the last minute. Finally, Illinois had only one other bank even close in size to Continental Illinois, and a merger would have given the combined entity nearly a 50% market share.⁸⁶

⁸⁵ Mellon was interested in purchasing First Penn and made a proposal to the FDIC. However, because of antitrust considerations, the FDIC did not accept the proposal (Sprague 1986, pg. 83).

⁸⁶ Illinois did change its law to allow for out-of-state mergers in June 1984, but at that point Continental's size, complexity, and condition made it hard to quickly find an acquirer. The 1982 law change allowed out-of-state acquisitions in the case of a failing bank precisely to solve this problem.

The state branching restrictions in place in the 1970s and early 1980s were gradually removed and finally dismantled by the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. One result of this period of deregulation was that the pool of potential acquiring banks greatly expanded. If out-of-state acquisitions had been allowed during the 1970s and 1980s, it is possible that Commonwealth, First Penn, and Continental Illinois could have been able to find a buyer, an option which would have allowed regulators to avoid a direct bailout. However, this particular benefit of the Riegle-Neal law was not a permanent one.

Since the end of branching restrictions, there has been an enormous amount of consolidation in the banking industry.⁸⁷ Figure 1 shows how the market share of the largest ten commercial banks has changed over time and how it increased rapidly during the early 1990s. Table 5 breaks down the market share numbers by bank in 2016. At the end of 2016, the market share of the four largest commercial banks in the United States is 45%, which is not too different than what the within-state market share of the four largest banks was in the states we just discussed. If one of these banks got into trouble today, regulators would face the same concern they faced earlier, namely the lack of potential acquirers. We think that this means that the financial system would have to be in bad shape for regulators to allow one of these firms to merge with another.⁸⁸

⁸⁷ See Janicki and Prescott (2006) and McCord and Prescott (2014).

⁸⁸ The largest bank acquisition to date was the Wells Fargo acquisition of Wachovia during the fall of 2008. Not only did that acquisition help prevent a run on a weakened Wachovia, but Wells Fargo and Wachovia had very little geographic overlap in their retail operations.

Limited Commitment

In reading Sprague, one can see him and other regulators struggling with the tradeoffs in doing a bailout. Do the short-term costs of a failure, particularly if a panic ensues, outweigh the long-term costs of increased moral hazard and a decline in market discipline? If we bail out this bank, what stops us from bailing out banks in the future? This tradeoff underlies the well-known time-consistency problem identified by Kydland and Prescott (1977) in which decisions that are ex post optimal are not necessarily ex ante optimal. If policymakers cannot stick with a strategy in the face of short-term costs, then policies that are harmful in the long run may be implemented. Time consistency has been identified as an issue in policy decisions as varied as monetary policy and flood insurance.

In the bank resolution context, the questions are how much of these short-term costs are worth bearing in return for reducing the long-term moral hazard costs and then whether the regulatory and political institutions can actually commit to imposing those short-term costs. With bank failures, the short-term costs of a panic as well as the potential shutdown of the payment system are viewed to be potentially very high, and this suggests one reason why it can be hard to credibly commit (or even not desirable) to not bail out large banks.

Several approaches for dealing with the commitment problem have been presented over the years. One strategy is to hire a tough regulator. For example, in the case of monetary policy, Federal Reserve Board Chairman Paul Volcker's willingness in the early 1980s to raise short-term interest rates at an enormous short-term cost to the economy can be viewed as a successful attempt at demonstrating that the Federal Reserve could commit to a long-term

strategy for keeping inflation low.⁸⁹ Another strategy is to directly address the incentives that lead to bailouts in the first place, namely, the fear of a panic. Stern and Feldman (2009) argue that this strategy is the right way to deal with too big to fail. They believe that if reforms can make it less likely that a single bank failure will spill over to other banks, regulators will be more likely to impose losses on uninsured creditors.⁹⁰

Stern and Feldman also believe that simply issuing a blanket statement that the FDIC will never do another bailout is not a credible solution since it is doubtful that regulators would stick to it if a bank that truly is too big to fail fails.⁹¹ Evidence supporting this view can be found in the results of a modified insurance plan that the FDIC implemented in 1984 in an attempt to impose some market discipline on uninsured bank creditors. The plan was for the FDIC to handle a failed bank by first paying off all insured depositors. It would then estimate how much it could get for the bank's assets and immediately pay the uninsured their pro-rata share. Additional payments would be made if the FDIC collected more than it expected. The main benefit of this plan is that it provides liquidity to uninsured creditors while still making them bear losses if there are any.

The modified insurance plan was tried on eight banks in 1984 and was relatively successful on these banks.⁹² However, the FDIC scrapped the plan once Continental Illinois came into the picture. The short-term costs and consequences of Continental Illinois' failure

⁸⁹ Rogoff (1985) is an example of a model of a "tough" central banker being hired to mitigate the time-consistency problem.

⁹⁰ Stern and Feldman (2009), pg. 148. For additional analysis of the application of time consistency to bank regulatory problems see Goodfriend and Lacker (1999) and Hetzel (2012).

⁹¹ Stern and Feldman (2009), pg. 147. For these reasons, they are supportive of the living will provisions in the Dodd-Frank Act but less optimistic about the effectiveness of the orderly liquidation authority also created by the Act (Feldman and Stern, 2010).

⁹² Sprague (1986), pg. 253.

were viewed to be so high that the FDIC believed that it had no choice but to bail the bank out. FDIC director William Isaac later recalled, “while I was confident that the system could withstand the failure of Penn Square, I was even more confident that the system could not withstand the failure of Continental.”⁹³ Whether the FDIC made the correct choice is an entirely different discussion, but its decision to bail out Continental Illinois illustrates how difficult it can be for regulators to commit to not using their powers.⁹⁴

The Essentiality Doctrine also imposes few restrictions on the regulators’ power. The wording used in the 1951 amendment to define acceptable open-bank assistance is “essential to provide adequate banking service in the community.” In practice, these nine words did not provide much of a constraint on the FDIC’s ability to do a bailout, which only exacerbated the commitment problem. The FDIC used its increasingly broad interpretation of the word “community” to justify the rescue of many of the banks discussed in this essay. By the time the Continental Illinois bailout comes along, Sprague says about the Essentiality Doctrine, “We didn’t even bother to discuss “community” in our press release. After our lengthy and agonizing deliberations about the community finding at Unity, it was clear that we could do whatever we wanted, so in the three following bailouts we had only perfunctory discussions. At Commonwealth we defined it as the “upper Great Lakes region.” At First Pennsylvania we defined it as the “Delaware Valley region.” At Continental we defined it as “the trade area it serves, plus the regional and national banking community.” – Sprague (fn, pg. 164).

One implication of the commitment problem is that smaller banks are bailed out when they would not be otherwise. Table 6 lists three different measures of each bailed out bank’s

⁹³ Isaac (2010), pg. 67.

⁹⁴ For arguments that financial markets could have handled Continental’s failure, see Kaufmann (1990) and Wall and Peterson (1990).

size: its assets in the year before it failed, its assets relative to gross domestic product, and its size in 2016 dollars deflated by the growth in banking industry assets. For example, Commonwealth had \$1.25 billion in assets at the end of 1971, which makes it comparable to a bank with \$25.8 billion in assets today. By the GDP measure, its assets in 1971 were only 0.1% of GDP. First Penn, while larger, was also not as big as one would expect. Its assets at the end of 1979 were \$8.4 billion, which is roughly equivalent to a \$72.7 billion bank today. By the GDP measure, its assets were only 0.3% of GDP. Those 2016 figures would make Commonwealth and First Penn the 53rd and 32nd largest commercial banks in the United States today, respectively.⁹⁵

We find it hard to believe that financial markets could not have handled a failure by First Penn, let alone Commonwealth, so we take these bailouts as evidence that the lack of commitment lowers the too-big-to-fail threshold.⁹⁶ Even so, regulators in 1972 did view a bank the size of Commonwealth as too big to fail. Sprague says about the Commonwealth bailout decision,

“...and I still felt uncomfortable with the whole idea of the bailout proposal. My thoughts kept coming back to Chase having that big stake. So I just stalled for time until I could find a way to deal with it. I knew that eventually I would. There were real pressures. Arthur Burns called me several times to insist that I acquiesce. ‘We need your vote,’ he said. Nobody wanted to face up to the biggest bank failure in history, particularly the Fed.” – Sprague (pg. 70)

Some further evidence that this view was not an aberration can be found from the case of U.S. National Bank in San Diego (USNB). This bank was similar to Commonwealth in that it

⁹⁵ Federal Reserve Board: Large Commercial Banks Q2 2016.

⁹⁶ The Dodd-Frank Act set \$50 billion as its threshold for a bank to be considered systemically important. By this standard First Penn would be considered systemic while Commonwealth would not.

also failed in the early 1970s and had assets of just over \$1 billion. USNB was ultimately acquired in an FDIC-assisted transaction by Crocker Bank of California, but there were some difficulties in arranging this merger due to the fraudulent behavior of USNB's owner, C. Arnholt Smith.⁹⁷ Consequently, alternative resolution strategies such as a payoff were discussed before the final deal was arranged. In a collection of papers belonging to the former Federal Reserve Board Chairman Arthur Burns, there exists a summary of a meeting conducted by various high-level regulators on USNB. In this document it is revealed that, "Comptroller Smith stated that in his view, it was inconceivable that a bank of this size would be permitted to fail."⁹⁸ While this is just one man's position, it is still surprising to see such a blanket statement made about \$1 billion banks, even if it was in 1972.

6. Conclusion

The Bank of the Commonwealth in 1972 was the first too-big-to-fail bailout of the modern era. It was followed by a sequence of too-big-to-fail bailouts by the FDIC and the Federal Reserve that culminated in the Continental Illinois bailout in 1984.⁹⁹ Most of the too-big-to-fail bailouts of this period arose because the most effective way of dealing with a failing

⁹⁷ Spero (1980), pg. 93.

⁹⁸ The Arthur F. Burns Papers at the Gerald R. Ford Presidential Library
<https://www.fordlibrarymuseum.gov/library/document/0001/4511185.pdf>.

⁹⁹ An important historical question is why too-big-to-fail problems were first observed in the 1970s rather than earlier. After all, there were large banks in the 1950s and 1960s. Horvitz (1975) argues that two developments led to the timing. The first was that starting in the 1960s, particularly with the support of Comptroller James Saxon, large banks began to aggressively grow, expanding their activities and taking more risk. The second was that starting in the late 1960s, the macroeconomic environment became more volatile. For example, there were large oil price shocks, a less-developed country debt crisis that impacted many of the money center banks, and a lot of volatility in exchange rates, inflation, and interest rates. Without the latter two sources of volatility, neither Commonwealth nor First Penn could have taken the large bets on interest rate changes that sunk them.

bank, an assisted merger, was not possible due to banking concentration and state branching restrictions.

The removal of interstate branching restrictions during the 1980s and 1990s expanded the pool of acquirers and may have contributed to the “quiet” period in U.S. banking between the end of the commercial banking crisis of the early 1990s and the recent financial crisis that started in 2007.¹⁰⁰ Now, after a 25-year long merger wave, concentration at the national level is similar to what it was within the states that had a large bank bailed out during the 1970s and early 1980s. Based on our analysis of this earlier period, we expect that if a large bank gets into financial trouble today, the concentration concerns that motivated many of these earlier bailouts will be a factor in decisions once again.

The significance of the Commonwealth bailout raises an important counterfactual question, “What would have happened if regulators had not bailed out Commonwealth in 1972?” Would that have led to large banks taking less risk, staying smaller, or relying less on uninsured deposits? Would that have made it easier for regulators to not bail out other large banks such as Franklin or First Penn?

For the first question, we think the answer is yes. The First Penn case is illustrative. It first got into trouble from poor lending, but even in its weakened state it was able to fund a bet

¹⁰⁰ It is not only the number of potential acquirers that matters, but their location. Potential acquirers from different regions would have been exposed to different geographic shocks and thus been better able to absorb a weak regional bank.

on interest rates. If its lenders had been more worried about losing their money, they likely would have been less willing to fund this bet.¹⁰¹

For the second question, we think it is safe to conclude that allowing Commonwealth to fail would have raised the too-big-to-fail threshold but would not have eliminated the problem. We doubt that even if Commonwealth had been allowed to fail in 1972 that financial regulators would have allowed Continental Illinois to fail in 1984. For example, William Isaac, who was on the FDIC board of directors during the First Penn and Continental Illinois bailouts, claims that, unlike Sprague, he would have been willing to let First Penn fail. Nevertheless, he is quite clear that he viewed the consequences of a Continental Illinois bailout as too severe to be worth risking.¹⁰²

The bailouts of the 1970s and the early 1980s led directly to several reforms, particularly FDICIA in 1991. This law eliminated the Essentiality Doctrine and restricted open bank assistance to cases in which a systemic risk determination was made.¹⁰³ This systemic risk determination was not used prior to the fall of 2008 because, as we discussed earlier, the banking industry was healthy during this period and the pool of banks that could acquire a weak bank was large. Nevertheless, other than the bailouts of Unity and Farmers, systemic risk considerations were used to justify each of the other bailouts, so we think that this change would not have been that constraining in the earlier period.

¹⁰¹ For an argument along these lines, see Prescott (2013). He examines too-big-to-fail policies in a model with endogenous bank size and finds that the too-big-to-fail banks become inefficiently larger and riskier than they would otherwise. He also provides two case studies of troubled large financial firms in which he ties their troubles to becoming inefficiently large and risky.

¹⁰² Isaac (2010), pg. 67.

¹⁰³ FDICIA also put restrictions and sanctions on Federal Reserve lending that were tied to the capital level of a borrowing bank (Wall, 2010). These constraints were not relevant in the recent crisis because book capital levels substantially lagged economic conditions.

It is an open question whether the most recent financial reforms, such as those in the Dodd-Frank Act, will effectively deal with the “too-big-to-fail” problem.¹⁰⁴ However, any analysis needs to evaluate how those changes would have handled the problems that regulators faced in the 1970s and early 1980s. The problems identified in this essay include the role of concentration, the limits of commitment, the flexible interpretation of laws, and the fear of a panic.

¹⁰⁴ Though see Feldman and Stern (2010) for an early assessment.

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Table 1: Ten largest commercial banks in Michigan 1971

#	Bank	Assets (\$ Billion)	% State Assets
1	NATIONAL BANK OF DETROIT	5.666	21%
2	DETROIT B&TC	2.440	9%
3	MANUFACTURERS NB	2.382	9%
4	MICHIGAN NATIONAL BANK	1.304	5%
5	<i>BANK OF THE COMMONWEALTH</i>	<i>1.257</i>	<i>5%</i>
6	MICHIGAN BK NA	0.804	3%
7	CITY NATIONAL BANK OF DETROIT	0.755	3%
8	OLD KENT B&TC	0.717	3%
9	CITIZENS COMMERCIAL & SVG B	0.572	2%
10	GENESEE MERCHANTS B&TC	0.420	2%

Notes: Only assets held under the commercial bank charter are counted.

Source: Authors' calculations using Call Report data.

Table 2: Ten largest commercial banks in Pennsylvania 1979

#	Bank	Assets (\$ Billion)	% State Assets
1	MELLON BANK, N.A.	13.291	16%
2	<i>FIRST PENNSYLVANIA BANK, N.A.</i>	<i>8.406</i>	<i>10%</i>
3	PHILADELPHIA NATIONAL BANK	5.632	7%
4	PITTSBURGH NATIONAL BANK	5.310	6%
5	GIRARD BANK	4.306	5%
6	FIDELITY BANK, THE	2.728	3%
7	EQUIBANK, N.A.	2.563	3%
8	PROVIDENT NATIONAL BANK	2.362	3%
9	INDUSTRIAL VALLEY BANK AND TRUST COMPANY	1.893	2%
10	AMERICAN BANK AND TRUST COMPANY OF PENNSYLVANIA	1.793	2%

Notes: Only assets held under the commercial bank charter are counted.

Source: Authors' calculations using Call Report data.

Table 3: Ten largest commercial banks in Washington state 1982

#	Bank	Assets (\$ Billion)	% State Assets
1	<i>SEATTLE-FIRST NATIONAL BANK (Seafirst)</i>	9.842	37%
2	RAINIER NATIONAL BANK	5.543	21%
3	FIRST INTERSTATE BANK OF WASHINGTON, N.A.	2.455	9%
4	PEOPLES NATIONAL BANK OF WASHINGTON	1.966	7%
5	OLD NATIONAL BANK OF WASHINGTON	1.304	5%
6	PUGET SOUND NATIONAL BANK	1.000	4%
7	SEATTLE TRUST AND SAVINGS BANK	0.592	2%
8	WASHINGTON TRUST BANK	0.386	1%
9	OLYMPIC BANK	0.308	1%
10	FIRST INDEPENDENT BANK	0.239	1%

Notes: Only assets held under the commercial bank charter are counted.

Source: Authors' calculations using Call Report data.

Table 4: Ten largest commercial banks in Illinois 1983

#	Bank	Assets (\$ Billion)	% State Assets
1	<i>CONTINENTAL ILLINOIS NATIONAL BANK & TRUST</i>	40.670	25%
2	FIRST NATIONAL BANK OF CHICAGO, THE	35.540	22%
3	HARRIS TRUST AND SAVINGS BANK	6.974	4%
4	NORTHERN TRUST COMPANY, THE	5.955	4%
5	AMERICAN NATIONAL BANK AND TRUST COMPANY OF CHICAGO	3.066	2%
6	LASALLE NATIONAL BANK	1.289	1%
7	EXCHANGE NATIONAL BANK OF CHICAGO	1.133	1%
8	NORTHWEST NATIONAL BANK OF CHICAGO	0.625	0%
9	LAKE VIEW TRUST AND SAVINGS BANK	0.558	0%
10	SPRINGFIELD MARINE BK	0.554	0%

Notes: Only assets held under the commercial bank charter are counted.

Source: Authors' calculations using Call Report data.

Table 5: Ten largest commercial banks in the USA 2016

#	Bank	Assets (\$ Billion)	% National Assets
1	JPMORGAN CHASE BANK	2219.0	14%
2	WELLS FARGO BANK	1755.5	11%
3	BANK OF AMERICA	1701.5	11%
4	CITIBANK	1350.1	9%
5	U.S. BANK	441.0	3%
6	CAPITAL ONE	399.2	3%
7	PNC BANK	356.0	2%
8	TD BANK	292.3	2%
9	BANK OF NEW YORK MELLON	284.3	2%
10	STATE STREET BANK AND TRUST COMPANY	239.2	2%

Notes: Only assets held under commercial bank charters are counted. Commercial bank charters under a common bank holding company are added together and treated as a single bank, though only the name of the largest commercial bank is listed above. Finally, no adjustment is made for off-balance sheet activities done under commercial bank charters. With that adjustment, these shares would be higher. See McCord and Prescott (2014).

Source: Authors' calculations using Call Report data.

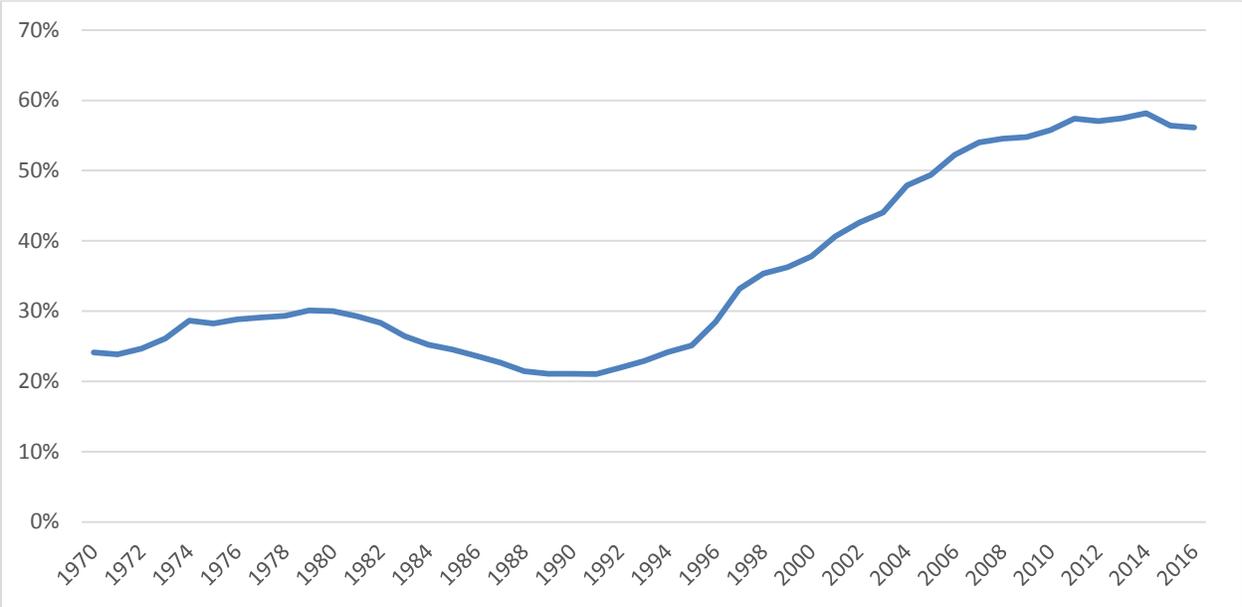
Table 6: Several measures of bank size in year before failure

Bank	Year of failure	Assets (\$ Billion) year before failure	% of GDP	Assets in 2016 dollars (Billion)	% State Assets
Unity	1971	0.011	0.001%	0.25	0.1%
Commonwealth	1972	1.257	0.105%	25.78	4.6%
Franklin	1974	4.996	0.338%	78.99	2.3%
Farmers'	1976	0.494	0.028%	6.67	20.1%
First Penn	1980	8.406	0.308%	72.65	9.9%
Penn Square	1982	0.484	0.015%	3.57	1.7%
Seafirst	1983	9.842	0.289%	68.84	37.4%
Continental Illinois	1984	40.670	1.071%	256.25	24.8%

Notes: Only assets held under the commercial bank charter are counted. Assets in 2016 dollars are calculated by deflating bank assets by the growth in total bank assets.

Source: Authors' calculations using Call Report data.

Figure 1: Percentage of Total Banking Assets Belonging to the Ten Largest Banks



Notes: Assets held by the ten largest commercial bank charters are added together. Unlike in Table 5, commercial banks charters under the same bank holding company were not combined into a single bank.

Source: Authors' calculations using Call Report data.