Time to kill the big banks?

Two key Republican senators suggest that troubled big banks should be allowed to fail. It is an idea with merit but it may not be that simple.

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NEW YORK (CNNMoney.com) -- What's the best way to fix the nation's banking system? Well, at least two senators making the rounds on the Sunday morning political TV gabfests think it's to let the megabanks fail.

Sen. Richard Shelby, R.-Ala., said on ABC's "This Week" that the most troubled banks are already dead and should be "buried."

Meanwhile, Sen. John McCain, R.-Ariz., added on "Fox News Sunday" that big banks had to fail even if it meant that shareholders will "take a beating." (Note to Sen. McCain: with the stocks of both Citigroup (C, Fortune 500) and Bank of America (BAC, Fortune 500) down more than 90%, shareholders already have taken a beating.)

So is the solution really that simple? After already propping up two huge banks, Citi and BofA, with $90 billion in bailout funds and hundreds of billions of dollars in loan guarantees, should the government just shut them down the same way that the FDIC closes small, community banks?

There is some merit to the idea that Citi, which Shelby derisively referred to Sunday as a "problem child," and BofA have done so much damage to the economy already that they should no longer be allowed to survive -- at least in their current form.

"Letting more banks fail is something we should at least consider. Blanket capital injections for all banks no matter how healthy they appear to be seems to be counterintuitive," said J.W. Verret, senior scholar for the

Mercatus Center at George Mason University. "Some banks need to go through FDIC receivership."

And the Federal Deposit Insurance Corp. does do a good job of taking over small banks and finding a buyer for them quickly -- often a purchaser is announced the same day that the bank fails.

But closing a bank the size of Citi or BofA -- which is what Shelby appeared to suggest Sunday -- is more complicated.

You can't simply let the banks go out of business. Something has to be done with all the deposits, assets and branches. This would not be your typical FDIC bank failure where regulators swoop in on Friday night, slap up a new sign and it's business as usual on Saturday morning.

Consider the size of some of the banks that have failed in recent weeks. Typically, they have just a handful of branches and only a few hundred million dollars in deposits. For example, Freedom Bank of Commerce, Georgia, which failed Friday, had four branches and $161 million in deposits.

Cleaning up a huge money center bank wouldn't be so easy. If BofA or Citi were to be seized by the FDIC, they would likely have to be sold off in pieces, a process that could take months, if not years. And you don't have to look any further than the mess that is AIG (AIG, Fortune 500) to see how difficult (and costly to taxpayers) it is to break up a struggling financial behemoth.

The collapse of Washington Mutual last September, which was taken over by the FDIC and immediately sold to JPMorgan Chase (JPM, Fortune 500), is more likely the exception instead of the rule in terms of big bank failures.

Keep in mind that last year's other large bank failure -- IndyMac -- turned out to be far more complicated. IndyMac failed in July and the FDIC had to run it for several months before agreeing to sell it to a private investment group on the last day of 2008. The FDIC has estimated that the failure of IndyMac will cost it $8.5 billion to $9.4 billion.

IndyMac had deposits of about $19.1 billion at the time it failed. So how much would a shutdown of Citi or BofA, which had worldwide deposits of $774.2 billion and $893 billion as of the end of last year, cost the FDIC?

"There would be a Main Street impact the size that we've never seen before. The FDIC would be stretched beyond belief," said Jess Varughese, managing partner of Milestone, an independent management consulting firm focused on financial services.

And fears of such a big failure could be one reason why Senate Banking Committee chair, Chris Dodd, D-Conn, and Sen. Mike Crapo, R-Idaho, proposed a bill last week that would let the FDIC temporarily borrow up to $500 billion from the government to keep the deposit insurance fund solvent.

Finally, what would the goal of shutting down a big bank be at this point? Shelby said Sunday that the government would be sending a "strong message to the market" and that people might start investing in banks again afterwards.

Varughese wasn't sure that would work out and pointed to the last time a big financial institution was allowed to fail.

"There's a populist message here and there's reality. This idea of letting one of the large global institutions fail does not sit well. Lehman Brothers brought us to the brink of financial Armageddon," he said.

Another financial expert agreed, saying that the damage created by a megabank failure would be "calamitous," since it could lead to more job losses and even tighter credit conditions.

"The economy needs a level of confidence to come back and it would fall even deeper if Bank of America or Citi were allowed to go under," said Bob Hartnett, managing director of Lenox Advisors, a New York-based investment firm with about $1 billion in assets.

So when all is said and done, Hartnett said the government may have to take over failing banks not to put them out of business but to keep them in business and force them to start doing what healthy banks are supposed to do: extend credit to responsible individuals and businesses.

"Everyone is looking to save their own skin and to hell with the borrower. We need to get banks to start lending again. We want them to start lending," he said.

Shameless plug alert: Before I started writing The Buzz, I covered the media business for several years at CNNMoney.com. Some of this reporting is the basis of a book I've written about News Corp. CEO Rupert Murdoch called Inside Rupert's Brain*, which will be published on March 19 by Portfolio, an imprint of Penguin Group (USA).*

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