

The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-to-Fail Problem

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If the crisis has a single lesson, it is that the too-big-to-fail problem must be solved.¹

—Federal Reserve Board (FRB) Chairman Ben S. Bernanke

Because of this law, the American people will never again be asked to foot the bill for Wall Street’s mistakes.... There will be no more taxpayer-funded bailouts. Period.²

—President Barack Obama

The [Dodd-Frank Act] went from what is best to what could be passed.³

—Former FRB Chairman Paul Volcker

I

INTRODUCTION

The recent financial crisis—widely viewed as “the worst financial crisis since the Great Depression”⁴—inflicted tremendous damage on financial markets and economies around the world. The

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¹ Ben S. Bernanke, Chairman, Fed. Reserve Bd., Causes of the Recent Financial and Economic Crisis, Statement Before the Financial Crisis Inquiry Commission (Sept. 2, 2010), available at <http://www.federalreserve.gov/newsevents/testimony/bernanke20100902a.htm>.

² Stacy Kaper, *Obama Signs Historic Regulatory Reform Bill into Law*, AM. BANKER (July 21, 2010), <http://www.americanbanker.com/news/obama-1022698-1.html> (quoting statement made by President Obama upon signing the Dodd-Frank Wall Street Reform and Consumer Protection Act).

³ Louis Uchitelle, *Volcker: Loud and Clear: Pushing for Stronger Reforms, and Regretting Decades of Silence*, N.Y. TIMES, July 11, 2010, at BU 1.

⁴ Angela Maddaloni & José-Luis Peydró, *Bank Risk-Taking, Securitization, Supervision and Low Interest Rates: Evidence from the Euro Area and the U.S. Lending Standards* 7 (European Cent. Bank, Working Paper No. 1248, 2010), available at <http://ssrn.com/abstract=1679689>; accord Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 CONN. L. REV. 963, 966 n.3 (2009); Ben S. Bernanke, Chairman, U.S. Fed. Reserve, Remarks at the Swearing-In Ceremony, Washington, D.C. (Feb. 3, 2010), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20100203a.htm>.

crisis revealed fundamental weaknesses in the financial regulatory systems of the United States, the United Kingdom, and other European nations. Those weaknesses have made regulatory reforms an urgent priority. Publicly funded bailouts of “too big to fail” (TBTF) financial institutions during the crisis provided indisputable proof that TBTF institutions benefit from large explicit and implicit public subsidies, including the expectation that such institutions will receive comparable public support during future emergencies. TBTF subsidies undermine market discipline and distort economic incentives for large, complex financial institutions (LCFIs) that are viewed by the financial markets as likely to qualify for TBTF treatment.⁵ Accordingly, as I argued in a recent article, a primary objective of regulatory reforms must be to eliminate (or at least greatly reduce) TBTF subsidies, thereby forcing LCFIs to internalize the risks and costs of their activities.⁶

In July 2010, Congress passed and President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act.⁷ Dodd-Frank’s preamble proclaims that one of the statute’s primary purposes is “to end ‘too big to fail’ [and] to protect the American taxpayer by ending bailouts.”⁸ As he signed Dodd-Frank, President Obama declared, “Because of this law, . . . [t]here will be no more taxpayer-funded bailouts. Period.”⁹

Dodd-Frank does contain useful reforms, including potentially favorable alterations to the supervisory and resolution regimes for LCFIs that are designated as systemically important financial institutions (SIFIs). However, this Article concludes that Dodd-Frank’s provisions fall far short of the changes that would be needed to prevent future taxpayer-financed bailouts and to remove other public subsidies for TBTF institutions. As explained below, Dodd-Frank fails to make fundamental structural reforms that could largely eliminate the subsidies currently exploited by LCFIs.

⁵ As used in this Article, the term “large, complex financial institution” (LCFI) includes major commercial banks, securities firms, and insurance companies, as well as “universal banks” (i.e., financial conglomerates that have authority to engage, either directly or through affiliates, in a combination of banking, securities, and insurance activities). See Wilmarth, *supra* note 4, at 968 n.15.

⁶ Arthur E. Wilmarth, Jr., *Reforming Financial Regulation to Address the Too-Big-to-Fail Problem*, 35 BROOK. J. INT’L L. 707 (2010). Portions of this Article are adapted from that previous article.

⁷ H.R. 4173, 111th Cong. (2010).

⁸ *Id.* pmb.; accord S. REP. NO. 111-176, at 1, 4–6 (2010).

⁹ See Kaper, *supra* note 2.

Parts II and III of this Article briefly describe the consequences and causes of the financial crisis that led up to the enactment of the Dodd-Frank. As discussed in those sections, LCFIs were the primary private-sector catalysts for the crisis, and they received the lion's share of support from government programs that were established during the crisis to preserve financial stability. Public alarm over the severity of the financial crisis and public outrage over government bailouts of LCFIs produced a strong consensus in favor of financial reform. That public consensus pushed Congress to enact Dodd-Frank. As Part IV explains, governmental rescues of LCFIs highlighted the economic distortions created by TBTF policies, as well as the urgent need to reduce public subsidies created by those policies.

In an article written a few months before Dodd-Frank was enacted, I proposed five reforms that were designed to prevent excessive risk taking by LCFIs and to shrink TBTF subsidies. My proposed reforms would have (1) strengthened existing statutory restrictions on the growth of LCFIs; (2) created a special resolution process to manage the orderly liquidation or restructuring of SIFIs; (3) established a consolidated supervisory regime and enhanced capital requirements for SIFIs; (4) created a special insurance fund, pre-funded by risk-based assessments paid by SIFIs, to cover the costs of resolving failed SIFIs; and (5) rigorously insulated FDIC-insured banks that are owned by LCFIs from the activities and risks of their nonbank affiliates.¹⁰

Part V of this Article compares the relevant provisions of Dodd-Frank to my proposed reforms and evaluates whether the new statute is likely to solve the TBTF problem. Dodd-Frank includes provisions (similar to my proposals) that make potentially helpful improvements in the regulation of large financial conglomerates. The statute establishes a new umbrella oversight body (the Financial Stability Oversight Council) that will designate SIFIs and make recommendations for their regulation. The statute also authorizes the FRB to apply enhanced supervisory requirements to SIFIs. Most importantly, Dodd-Frank establishes a new systemic resolution regime (the Orderly Liquidation Authority (OLA)) that should provide a superior alternative to the choice of "bailout or bankruptcy" that federal regulators confronted when they dealt with failing SIFIs during the financial crisis.

¹⁰ See Wilmarth, *supra* note 6, at 747–79.

Nevertheless, Dodd-Frank does not solve the TBTF problem. Congress did not adequately strengthen statutory limits on the ability of LCFIs to grow through mergers and acquisitions. The enhanced prudential standards to be imposed on SIFIs under Dodd-Frank will rely heavily on a supervisory tool—capital-based regulation—that failed to prevent systemic financial crises in the past. Moreover, the success of Dodd-Frank’s supervisory reforms will depend on many of the same federal regulatory agencies that did not stop excessive risk taking by LCFIs in the past and, in the process, demonstrated their vulnerability to political influence from LCFIs and their trade associations.

Dodd-Frank’s most promising regulatory reform—the OLA—does not completely close the door to future transactions that protect creditors of failing LCFIs. The FRB and the Federal Home Loan Banks retain authority to provide emergency liquidity assistance to troubled LCFIs. The FDIC can borrow from the U.S. Treasury and can also use the “systemic risk exception” to the Federal Deposit Insurance Act in order to generate funding to protect creditors of failed SIFIs and their subsidiary banks. While Dodd-Frank has made TBTF bailouts more difficult, the continued existence of these additional sources of financial assistance indicates that Dodd-Frank probably will not prevent TBTF rescues during future episodes of systemic financial distress.

Contrary to my previous recommendation, Dodd-Frank does not require SIFIs to pay risk-based assessments to pre-fund the Orderly Liquidation Fund (OLF), which will cover the costs of resolving failed SIFIs. Instead, the OLF will be obliged to borrow funds in the first instance from the Treasury Department (i.e., the taxpayers) to pay for the costs of such resolutions, with the hope that such costs can eventually be recovered by ex post assessments on surviving SIFIs. Dodd-Frank also does not include my earlier proposal for a strict regime of structural separation between SIFI-owned banks and their nonbank affiliates. Thus, unlike Dodd-Frank, my proposals would (1) require SIFIs to internalize the potential costs of their risk taking by paying risk-based premiums to pre-fund the OLF and (2) prevent SIFI-owned banks from transferring their safety net subsidies to nonbank affiliates.

In combination, my proposals would strip away many of the public subsidies currently exploited by financial conglomerates and would subject them to the same type of market discipline that investors have applied in over the past three decades in breaking up inefficient

commercial and industrial conglomerates. Financial conglomerates have never demonstrated their ability to provide beneficial services to customers and attractive returns to investors without relying on federal safety net subsidies during good times and taxpayer-financed bailouts during crises. I believe that LCFIs are unlikely to produce favorable returns if they lose their access to public subsidies. Accordingly, Congress must remove those subsidies and create a true “market test” for LCFIs. If such a test were applied, I expect that market forces would compel many LCFIs to break up voluntarily.

II

THE SEVERITY AND PERSISTENCE OF THE FINANCIAL CRISIS

The financial crisis caused governments and central banks around the globe to provide more than \$11 trillion of assistance to financial institutions and to spend more than \$6 trillion on economic stimulus programs. The largest financial support and economic stimulus programs were implemented by the United States, the United Kingdom, and other European nations, where the financial crisis caused the greatest harm.¹¹ By October 2009, the United States had provided more than \$6 trillion of assistance to financial institutions through central bank loans and other government loans, guarantees, asset purchases and capital infusions, while the United Kingdom and other European Union (EU) nations gave more than \$4 trillion of similar assistance.¹² In addition to the assistance provided to financial institutions, the U.S. Congress sought to support the general economy by passing an \$800 billion stimulus bill in early 2009, and

¹¹ Adrian Blundell-Wignall et al., *The Elephant in the Room: The Need to Deal with What Banks Do*, 2 OECD J.: FIN. MARKET TRENDS 1, 4–5, 14, 15 tbl.4 (2009), available at <http://www.oecd.org/dataoecd/13/8/44357464.pdf> (showing that leading nations around the world provided \$11.4 trillion of capital infusions, asset purchases, asset guarantees, and debt guarantees to financial institutions through October 2009); *Debate Rages over Stimulus Fallout*, WASH. TIMES, Feb. 23, 2010, http://www.washingtontimes.com/news/2010/feb/23/world-of-debate-rages-over-fallout-from-stimulus/?feat=home_headlines; see also INT’L MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: NAVIGATING THE FINANCIAL CHALLENGES AHEAD 4–5, 6–10, 24–29 (2009), available at <http://www.imf.org/external/pubs/ft/gfstr/2009/02/pdf/text.pdf>; *Tightening Economic Policy: Withdrawing the Drugs*, ECONOMIST (Feb. 11, 2010), <http://www.economist.com/node/15498185>.

¹² Blundell-Wignall et al., *supra* note 11, at 15 tbl.4 (showing that the United States provided \$6.4 trillion of assistance to financial institutions, while the United Kingdom and other European nations provided \$4.3 trillion of assistance).

many other nations approved comparable measures to bolster their economies.¹³

Government agencies acted most dramatically in rescuing LCFIs that were threatened with failure. U.S. authorities provided massive bailouts to prevent the failures of two of the three largest U.S. banks and the largest U.S. insurance company.¹⁴ In addition, (1) federal regulators provided financial support for emergency acquisitions of two other major banks, the two largest thrifts, and two of the five largest securities firms, and (2) regulators approved emergency conversions of two other leading securities firms into bank holding companies (BHCs), thereby placing those institutions under the FRB's protective umbrella.¹⁵ Federal regulators also conducted

¹³ See *Debate Rages over Stimulus Fallout*, *supra* note 11; Michael A. Fletcher, *Obama Leaves D.C. to Sign Stimulus Bill*, WASH. POST, Feb. 18, 2009, at A5; William Pesek, *After the Stimulus Binge, A Debt Hangover*, BLOOMBERG BUSINESSWEEK (Jan. 26, 2010), http://www.businessweek.com/magazine/content/10_04/b4164014458592.htm; *Tightening Economic Policy*, *supra* note 11.

¹⁴ For discussions of the federal government's bailouts of Citigroup, Bank of America, and American International Group (AIG), 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* 373–407, 513–34 (2009); DAVID WESSEL, *IN FED WE TRUST: BEN BERNANKE'S WAR ON THE GREAT PANIC* 3, 25–26, 189–97, 239–41, 259–63 (2009); Patricia A. McCoy et al., *Systemic Risk Through Securitization: The Result of Deregulation and Regulatory Failure*, 41 CONN. L. REV. 1327, 1364–66 (2009); OFFICE OF THE SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, *EMERGENCY CAPITAL INJECTIONS PROVIDED TO SUPPORT THE VIABILITY OF BANK OF AMERICA, OTHER MAJOR BANKS, AND THE U.S. FINANCIAL SYSTEM*, SIGTARP-10-001, at 14–31 (2009), available at http://www.sigtarp.gov/reports/audit/2009/Emergency_Capital_Injections_Provided_to_Support_the_Viability_of_Bank_of_America..._100509.pdf [hereinafter SIGTARP BANK OF AMERICA REPORT]; OFFICE OF THE SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, *EXTRAORDINARY FINANCIAL ASSISTANCE PROVIDED TO CITIGROUP, INC.*, SIGTARP-11-002, at 4–32, 41–44 (2011), available at <http://www.sigtarp.gov/reports/audit/2011/Extraordinary%20Financial%20Assistance%20Provided%20to%20Citigroup,%20Inc.pdf> [hereinafter SIGTARP CITIGROUP REPORT]; CONG. OVERSIGHT PANEL, *JUNE OVERSIGHT REPORT: THE AIG RESCUE, ITS IMPACT ON MARKETS, AND THE GOVERNMENT'S EXIT STRATEGY*, at 58–179 (2010), available at <http://cop.senate.gov/documents/cop-061010-report.pdf>.

¹⁵ For descriptions of the federal government's support for the acquisitions of Wachovia by Wells Fargo, of National City Bank by PNC, of Bear Stearns ("Bear") and Washington Mutual ("WaMu") by JP Morgan Chase ("Chase"), and of Countrywide and Merrill Lynch ("Merrill") by Bank of America, as well as the rapid conversions of Goldman Sachs ("Goldman") and Morgan Stanley into BHCs, see SORKIN, *supra* note 14, at 414–503; DAVID P. STOWELL, *AN INTRODUCTION TO INVESTMENT BANKS, HEDGE FUNDS, AND PRIVATE EQUITY: THE NEW PARADIGM* 182–84, 398–405, 410–17 (2010); WESSEL, *supra* note 14, at 8–9, 18–19, 147–72, 217–26, 239–41, 259–63; Wilmarth, *supra* note 4, at 1044–45; Arthur E. Wilmarth, Jr., *Cuomo v. Clearing House: The Supreme Court Responds to the Subprime Financial Crisis and Delivers a Major Victory for the Dual Banking System and Consumer Protection* 27–30 (George Washington Univ. Law Sch.

“stress tests” on the nineteen largest BHCs—each with more than \$100 billion of assets—and injected more than \$220 billion of capital into eighteen of those companies.¹⁶ Before regulators performed the stress tests, they announced that the federal government would provide any additional capital that the nineteen banking firms needed but could not raise on their own. By giving that public assurance, regulators indicated that all nineteen firms were presumptively TBTF, at least for the duration of the financial crisis.¹⁷

Similarly, the United Kingdom and other European nations implemented more than eighty rescue programs to support their financial systems. Those programs included costly bailouts of several major EU banks, including ABN Amro, Commerzbank, Fortis, ING, Lloyds HBOS, Royal Bank of Scotland (RBS), and UBS.¹⁸

Notwithstanding these extraordinary measures of governmental support, financial institutions and investors suffered huge losses in the United States and in other developed nations. Between the outbreak of the crisis in mid-2007 and the spring of 2010, LCFIs around the world recorded \$1.5 trillion of losses on risky loans and investments made during the preceding credit boom.¹⁹ During 2008 alone, the value of global financial assets declined by an estimated \$50 trillion,

Pub. Law & Legal Theory, Working Paper No. 479, 2009), available at <http://ssrn.com/abstract=1499216>.

¹⁶ Wilmarth, *supra* note 6, at 713, 713 n.11.

¹⁷ In announcing the “stress test” for the nineteen largest banking firms in early 2009, federal regulators “emphasized that none of the banks would be allowed to fail the test, because the government would provide any capital that was needed to ensure the survival of all nineteen banks.” Wilmarth, *supra* note 4, at 1050 n.449 (citing speech by Federal Reserve Bank of New York President William C. Dudley and congressional testimony by FRB Chairman Ben Bernanke); Joe Adler, *In Focus: Stress Tests Complicate ‘Too Big to Fail’ Debate*, AM. BANKER, May 19, 2009, at 1 (stating that “[b]y drawing a line at \$100 billion of assets, and promising to give the 19 institutions over that mark enough capital to weather an economic downturn, the government appears to have defined which banks are indeed ‘too big to fail’”). Based on the stress tests, regulators determined that ten of the nineteen firms required additional capital. Wilmarth, *supra* note 6, at 713, 713 n.12. Nine of those firms were successful in raising the needed funds, but the federal government provided \$11.3 billion of additional capital to GMAC when that company could not raise the required capital on its own. *Id.*

¹⁸ For descriptions of governmental support measures for financial institutions in the United Kingdom and other European nations, see authorities cited in Wilmarth, *supra* note 6, at 714, 714 n.13.

¹⁹ Rodney Yap & Dave Pierson, *Subprime Mortgage-Related Losses Exceed \$1.77 Trillion: Table*, BLOOMBERG NEWS, May 11, 2010 (showing that global banks, securities firms, and insurers incurred \$1.51 trillion of write-downs and credit losses due to the financial crisis, while Fannie Mae and Freddie Mac suffered an additional \$270 billion of losses).

equal to a year of the world's gross domestic product.²⁰ Household net worth in the United States fell by more than one-fifth (from \$64.2 trillion to \$48.8 trillion) from the end of 2007 through the first quarter of 2009.²¹ The financial crisis pushed the economies of the United States, the United Kingdom, and other European nations into deep recessions during 2008 and the first half of 2009.²²

Economies in all three regions began to improve in the second half of 2009, but the recoveries were tentative and fragile.²³ During the first half of 2010, economies in all three areas continued to face significant challenges, including (1) high unemployment rates and shortages of bank credit that caused consumers to reduce spending and businesses to forgo new investments, and (2) large budget deficits, caused in part by the massive costs of financial rescue programs, which impaired the ability of governments to provide additional fiscal stimulus.²⁴

²⁰ Shamim Adam, *Global Financial Assets Lost \$50 Trillion Last Year, ADB Says*, BLOOMBERG (Mar. 9, 2009), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aZ1kcJ7y3LDM>.

²¹ BD. OF GOVERNORS FED. RESERVE SYS., FEDERAL RESERVE STATISTICAL RELEASE: FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: FLOWS AND OUTSTANDING, SECOND QUARTER 2010, at 104 tbl.B.100 (2010), available at <http://www.federalreserve.gov/RELEASES/z1/20100917/z1.pdf>.

²² See INT'L MONETARY FUND, WORLD ECONOMIC OUTLOOK, APRIL 2009: CRISIS AND RECOVERY 1–96 (2009), available at <http://www.imf.org/external/pubs/ft/weo/2009/01/pdf/text.pdf>. A recent study concluded that the recession of 2007–2009 was much more severe, both in the United States and globally, than the preceding recessions of 1975, 1982, and 1991. Stijn Claessens et al., *The Global Financial Crisis: How Similar? How Different? How Costly?* 3, 19–20 (Mar. 17, 2010) (unpublished manuscript), available at <http://ssrn.com/abstract=1573958>; see also Steve Matthews, *Longest U.S. Slump Since '30s Ended in June '09, Group Says*, BLOOMBERG (Sept. 20, 2010), <http://www.bloomberg.com/news/2010-09-20/u-s-recession-ended-in-june-2009-was-longest-since-wwii-nber-panel-says.html> (reporting that, according to the National Bureau of Economic Research, the U.S. economy “shrank 4.1 percent from the fourth quarter of 2007 to the second quarter of 2009, the biggest slump since the 1930s”).

²³ INT'L MONETARY FUND, WORLD ECONOMIC OUTLOOK, OCTOBER 2009: SUSTAINING THE RECOVERY 1–92 (2009), available at <http://www.imf.org/external/pubs/ft/weo/2009/02/pdf/text.pdf>; Timothy R. Homan, *U.S. Economy Grew at 2.2% Annual Rate Last Quarter (Update2)*, BLOOMBERG (Dec. 22, 2009), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aVeAMaVRygoM> (reporting that the U.S. economy grew during the third quarter of 2009 “at a slower pace than anticipated” following a steep decline during the previous year); Marcus Walker & Brian Blackstone, *Euro-Zone Economy Returns to Expansion*, WALL ST. J., Nov. 14, 2009, at A6 (reporting that “[t]he euro-zone economy returned to modest growth in the third quarter [of 2009], marking an apparent end to five quarters of recession, but the region’s recovery looks set to be anemic”).

²⁴ Peter Coy & Cotton Timberlake, *Funny, It Doesn't Feel Like a Recovery*, BLOOMBERG BUSINESSWEEK May 31–June 6, 2010, at 9; Rich Miller, *U.S. Rebound Seen*

A major threat to economic recovery appeared in the spring of 2010, as Greece and several other deeply indebted European nations struggled to avoid defaulting on their sovereign debts.²⁵ In May 2010, the EU and the International Monetary Fund (IMF) announced a \$1 trillion emergency package of loan guarantees to reassure investors that EU nations would continue to meet their debt obligations.²⁶ However, many analysts questioned the rescue package's adequacy, and bond investors shunned financial institutions with large exposures to heavily indebted countries.²⁷ The European sovereign debt crisis—along with high unemployment rates, growing budget deficits, and shortages of bank credit—created serious concerns about the prospects for continued economic growth in both the United States and Europe during the second half of 2010.²⁸

Slowing Most Since 2002 on Europe Debt Woes, BLOOMBERG (June 7, 2010), <http://www.businessweek.com/news/2010-06-07/u-s-rebound-seen-slowing-most-since-2002-on-europe-debt-woes.html>; Jon Hilsenrath, *Credit Remains Scarce in Hurdle to Recovery*, WALL ST. J., Feb. 27, 2010, at A2; Neil Irwin & Lori Montgomery, *Death of New Jobs Threatens Recovery: Data Point to Sluggish Growth*, WASH. POST, July 3, 2010, at A1; Simone Meier, *Europe's Recovery Almost Stalls as Germany Stagnates (Update 2)*, BLOOMBERG (Feb. 12, 2010), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=akPchh4Ed0Vo>; Mark Deen, *European Economy Risks Decoupling from Global Growth Recovery*, BLOOMBERG BUSINESSWEEK (Feb. 25, 2010), <http://www.businessweek.com/news/2010-02-25/european-economy-risks-decoupling-from-global-growth-recovery.html>; Howard Schneider & Anthony Faiola, *Debt Is Ballooning into a Global Crisis: Developed Nations May Have to Raise Taxes and Cut Programs*, WASH. POST, Apr. 9, 2010, at A1.

²⁵ Simon Kennedy & James G. Neuger, *EU Faces Demands to Broaden Crisis Fight as G-7 Meets (Update3)*, BLOOMBERG BUSINESSWEEK (May 7, 2010), <http://www.businessweek.com/news/2010-05-07/eu-faces-demands-to-broaden-crisis-fight-as-g-7-meets-update3-.html>; Simon Kennedy et al., *Now It's a European Banking Crisis*, BLOOMBERG BUSINESSWEEK (Apr. 29, 2010), http://www.businessweek.com/magazine/content/10_19/b4177011719842.htm; Sandrine Rastello, *IMF Says Government Debt Poses Biggest Risk to Global Growth*, BLOOMBERG BUSINESSWEEK (Apr. 20, 2010), <http://www.businessweek.com/news/2010-04-20/imf-says-government-debt-poses-biggest-risk-to-global-growth.html>.

²⁶ Joe Kirwin et al., *International Economics: EU Ministers, ECB, IMF Marshal Forces to Stabilize Euro with Trillion Dollar Plan*, 94 Banking Rep. (BNA) 897 (May 11, 2010); Pierre Paulden, *When Banks Don't Trust Banks*, BLOOMBERG BUSINESSWEEK (May 27, 2010), http://www.businessweek.com/magazine/content/10_23/b4181006668043.htm; Landon Thomas, Jr. & Jack Ewing, *A Trillion for Europe, with Doubts Attached: Trying to Solve Debt Crisis with More Debt*, N.Y. TIMES, May 11, 2010, at A1.

²⁷ Gavin Finch & John Glover, *Europe's Banks Face a Funding Squeeze*, BLOOMBERG BUSINESSWEEK (June 17, 2010), http://www.businessweek.com/magazine/content/10_26/b4184051394516.htm; Carrick Mollenkamp et al., *Europe's Banks Hit by Rising Loan Costs*, WALL ST. J., May 25, 2010, at A1.

²⁸ Peter Coy, *The U.S. Economy: Stuck in Neutral*, BLOOMBERG BUSINESSWEEK (Oct. 14, 2010), http://www.businessweek.com/magazine/content/10_43/b4200013889287.htm;

The severity and duration of the financial crisis, along with rising costs of governmental support for troubled LCFIs, produced public outrage and created a strong consensus in favor of reforming financial regulation in both the United Kingdom and the United States.²⁹ Indeed, “deep public anger over the 2008 financial collapse” caused “a handful of Republicans who [faced] re-election . . . to support the [Dodd-Frank] legislation,” in spite of the unified opposition by Republican congressional leaders against the bill.³⁰

At the same time, a sputtering economic recovery and continuing public resentment against bailouts received by leading financial institutions created widespread public skepticism and distrust in the United States about the direction and likely effectiveness of financial reform. A Bloomberg national poll found that almost four-fifths of respondents had “little or no confidence” that Dodd-Frank would prevent a similar financial crisis in the future or protect their savings.³¹

Peter Coy, *Opening Remarks: Shred the Debt*, BLOOMBERG BUSINESSWEEK, Oct. 4–10, 2010, at 5; Anthony Faiola, *Debt Crisis Escalates in Europe: Fears Grow About Spain*, WASH. POST, Nov. 27, 2010, at A1; Robert J. Samuelson, *In Ireland’s Debt Crisis, an Ominous Reckoning for Europe*, WASH. POST, Nov. 29, 2010; Motoko Rich, *Jobless Rate Rises to 9.8% in Blow to Recovery Hopes*, N.Y. TIMES, Dec. 4, 2010, at A1.

²⁹ For example, the United Kingdom’s House of Commons Treasury Committee stated, in a March 2010 report, “One thing at least is now abundantly clear: the [U.K.] public will not stand for another bailout. The political case for action is as strong as the economic one.” HOUSE OF COMMONS TREASURY COMM., TOO IMPORTANT TO FAIL—TOO IMPORTANT TO IGNORE 6 (2010), available at <http://www.publications.parliament.uk/pa/cm200910/cmselect/cmtreasy/261/261i.pdf>; accord Simon Clark, ‘Lepers’ in London Defend Right to Make Money as Election Looms, BLOOMBERG (Feb. 24, 2010), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=al4xP78iSZhM> (describing public anger directed against large U.K. banks “after British taxpayers assumed liabilities of more than [\$1.23 trillion] to bail out the country’s lenders”); Phil Mattingly, *Frank Says Senate’s Stronger Rules Will Sway Financial Bill*, BLOOMBERG (May 17, 2010), <http://www.businessweek.com/news/2010-05-17/frank-says-senate-s-stronger-rules-will-sway-financial-bill.html> (describing public pressure for stronger reform measures during the Senate’s consideration of Dodd-Frank because “[t]he public has gotten a lot angrier and the game has changed due to a rise in anti-bank fever” (quoting Robert Litan)).

³⁰ David M. Herszenhorn, *Senate Republicans Call Reform Bill a ‘Takeover’ of the Banking Industry*, N.Y. TIMES, May 19, 2010, at B3; accord Brady Dennis, *Historic Financial Bill Passes Senate: Four GOP Votes for Regulation*, WASH. POST, May 21, 2010, at A1 (reporting that four Republican senators voted in favor of passing Dodd-Frank).

³¹ Rich Miller, *Wall Street Fix Seen Ineffectual by Four of Five in U.S.*, BLOOMBERG (July 13, 2010), <http://www.bloomberg.com/news/2010-07-13/wall-street-fix-from-congress-seen-ineffectual-by-four-out-of-five-in-u-s-.html>.

Almost four out of five Americans surveyed in a Bloomberg National Poll this month say they have just a little or no confidence that [Dodd-Frank] will prevent

III

LCFIS PLAYED KEY ROLES IN PRECIPITATING THE FINANCIAL CRISIS

In order to determine whether Dodd-Frank’s reforms are adequate to prevent a similar crisis in the future, it is essential to understand that (1) LCFIs were the primary private-sector catalysts for the current financial crisis and (2) the dominant position of LCFIs in the financial markets has become even more entrenched due to the TBTF subsidies they received both before and during the crisis. This Part briefly summarizes the crucial roles played by LCFIs in helping to produce the financial and economic conditions that led to the crisis, as well as governmental policies that compounded the disastrous errors of LCFIs. Part IV discusses how TBTF subsidies encouraged rapid growth and consolidation among LCFIs.

A. LCFIs Originated Huge Volumes of Risky Loans and Helped to Inflate a Massive Credit Boom That Precipitated the Crisis

During the past two decades, and especially between 2000 and 2007, LCFIs helped to generate an enormous credit boom that set the stage for the financial crisis. LCFIs used securitization techniques to earn large amounts of fee income by (1) originating high-risk loans, including nonprime residential mortgages, credit card loans, commercial mortgages, and leveraged buyout (LBO) loans; and (2) pooling those loans to create securities that could be sold to investors.³² LCFIs ostensibly followed an “originate to distribute”

or significantly soften a future crisis. More than three-quarters say they don’t have much or any confidence the proposal will make their savings and financial assets more secure.

....

Most Americans reject any new government rescues of financial institutions, such as arranged for [Citigroup and AIG] . . .

Id.; accord Brian Faler, *TARP a ‘Four-Letter Word’ for Voters Even as Bailout Cost Drops*, BLOOMBERG BUSINESSWEEK (Oct. 8, 2010), http://www.businessweek.com/bwdaily/dnflash/content/oct2010/db2010108_268416.htm (describing widespread public resentment against the government’s rescue program for large financial institutions during the financial crisis); John B. Judis, *The Unnecessary Fall: A Counter-History of the Obama Presidency*, NEW REPUBLIC, Sept. 2, 2010, at 12, 13 (“The public’s [negative] view of the bank bailout and the AIG bonuses colored its view of the auto bailout, the stimulus, and health care reform. One of the rallying cries for the populist opposition to [President] Obama was ‘where’s my bailout?’”).

³² Wilmarth, *supra* note 4, at 984–91, 1037–40 (reporting that, in 2007, residential mortgage-backed securities accounted for nearly two-thirds of all U.S. residential mortgages, while commercial mortgage-backed securities represented almost a quarter of domestic commercial mortgages, asset-backed securities accounted for more than a quarter

business strategy, which caused regulators and market analysts to assume that LCFIs were transferring the risks embedded in their securitized loans to widely dispersed investors.³³

Securitization allowed LCFIs—with the blessing of regulators—to reduce their capital requirements significantly as well as their apparent credit risks.³⁴ LCFIs created structured-finance securities that typically included senior, mezzanine, and junior (or equity) “tranches.” Those tranches represented a hierarchy of rights (along a scale from the most senior to the most subordinated) to receive cash flows produced by the pooled loans. LCFIs marketed the tranches to satisfy the demands of various types of investors for different combinations of yield and risk. Structured-finance securities included (1) asset-backed securities (ABS), which represented interests in pools of credit card loans, auto loans, student loans and other consumer loans; (2) residential mortgage-backed securities (RMBS), which represented interests in pools of residential mortgages; and (3) commercial mortgage-backed securities (CMBS), which represented interests in pools of commercial mortgages.³⁵

LCFIs created “second-level securitizations” by bundling tranches of ABS and MBS into cash flow collateralized debt obligations (CDOs), and they similarly packaged syndicated loans for corporate leveraged buyouts (LBOs) into collateralized loan obligations (CLOs).³⁶ LCFIs also created third-level securitizations by

of domestic consumer loans, and collateralized loan obligations included more than a tenth of global leveraged syndicated loans).

³³ *Id.* at 995–96, 1025–30, 1040–43 (discussing the widespread belief that the “originate to distribute” business model enabled LCFIs to transfer the risks of securitized loans to investors); James Crotty, *Structural Causes of the Global Financial Crisis: A Critical Assessment of the ‘New Financial Architecture,’* 33 CAMBRIDGE J. ECON. 563, 567–68 (2009).

³⁴ Wilmarth, *supra* note 4, at 984–85, 995–96; Viral V. Acharya et al., *Prologue: A Bird’s-Eye View: The Financial Crisis of 2007–2009: Causes and Remedies*, in RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM 1, 14–23 (Viral V. Acharya & Matthew Richardson eds., 2009) [hereinafter RESTORING FINANCIAL STABILITY]; Viral V. Acharya & Matthew Richardson, *Causes of the Financial Crisis*, 21 CRITICAL REV. 195, 198–200 (2009).

³⁵ Wilmarth, *supra* note 4, at 984–90; *see also* Joshua Coval et al., *The Economics of Structured Finance*, 23 J. ECON. PERSPECTIVES No. 1, at 3, 5–7 (2009); Efraim Benmelech & Jennifer Dlugosz, *The Credit Rating Crisis* 3–6, (Nat’l Bureau of Econ. Research, Working Paper No. 15045, 2009); Kenneth E. Scott, *The Financial Crisis: Causes and Lessons*, 22 J. APPLIED CORP. FIN. No. 3, at 22, 23–24 (2010). RMBS and CMBS are sometimes hereinafter collectively referred to as “mortgage-backed securities” (MBS).

³⁶ Wilmarth, *supra* note 4, at 990–91. The term “CDOs” is hereinafter used to refer collectively to CDOs and CLOs, as well as collateralized bond obligations (CBOs). *See*

assembling pools of tranches from cash flow CDOs to construct “CDOs-squared.”³⁷ The IMF estimated that private-sector financial institutions issued about \$15 trillion of ABS, MBS, and CDOs in global markets between 2000 and 2007, including \$9 trillion issued in the United States.³⁸ Another study determined that \$11 trillion of structured-finance securities were outstanding in the U.S. market in 2008.³⁹

LCFIs intensified the risks of securitization by writing over-the-counter (OTC) credit derivatives known as “credit default swaps” (CDS). CDS provided “the equivalent of insurance against default events” that might occur with reference to loans in securitized pools or tranches of ABS, MBS and CDOs.⁴⁰ While CDS could be used for hedging purposes, financial institutions and other investors increasingly used CDS to speculate on the default risks of securitized loans and structured-finance securities.⁴¹ LCFIs further increased the

STOWELL, *supra* note 15, at 105–06, 456. As Frank Partnoy has noted, many CDOs functioned as “‘second-level’ securitizations of ‘first-level’ mortgage-backed securities (which were securitizations of mortgages).” Frank Partnoy, *Overdependence on Credit Ratings Was a Primary Cause of the Crisis* 5 (Univ. San Diego Sch. of Law Legal Studies, Research Paper No. 09-015, 2009), available at <http://ssrn.com/abstract=1430653>. CDOs consisting of tranches of MBS are sometimes referred to as collateralized mortgage obligations (CMOs) but are referred to herein as CDOs. See Benmelech & Dlugosz, *supra* note 35, at 6.

³⁷ LCFIs frequently used mezzanine tranches of CDOs to create CDOs-squared because the mezzanine tranches were the least attractive (in terms of their risk-yield trade-off) to most investors. Wilmarth, *supra* note 4, at 990–91, 1027–30; see also Scott, *supra* note 35, at 23–24, 24 fig.3. CDOs and CDOs-squared are sometimes hereinafter collectively referred to as CDOs.

³⁸ INT’L MONETARY FUND, *supra* note 11, at 84, 84 fig.2.2 & fig.2.3 (indicating that \$15.3 trillion of “private-label” issues of ABS, MBS, CDOs, and CDOs-squared were issued in global markets between 2000 and 2007, of which \$9.4 trillion was issued in the United States). “Private-label” securitizations refer to asset-backed securities issued by private-sector financial institutions, in contrast to securitizations created by government-sponsored enterprises such as Fannie Mae and Freddie Mac. *Id.* at 77 n.1; see also Wilmarth, *supra* note 4, at 988–89.

³⁹ Benmelech & Dlugosz, *supra* note 35, at 1.

⁴⁰ Jeffrey Manns, *Rating Risk After the Subprime Mortgage Crisis: A User Fee Approach for Rating Agency Accountability*, 87 N.C. L. REV. 1011, 1036–37 (2009); see also Wilmarth, *supra* note 4, at 991–93, 1031–32; Viral V. Acharya et al., *Centralized Clearing for Credit Derivatives*, in RESTORING FINANCIAL STABILITY, *supra* note 34, at 251, 254 (explaining that “a [CDS] is like an insurance contract”).

⁴¹ Crotty, *supra* note 33, at 569 (summarizing (1) a 2007 report by Fitch Ratings, concluding that “58% of banks that buy and sell credit derivatives acknowledged that ‘trading’ or gambling is their ‘dominant’ motivation for operating in this market, whereas less than 30% said that ‘hedging/credit risk management’ was their primary motive,” and (2) a statement by New York Superintendent of Insurance Eric Dinallo, concluding that “80% of the estimated \$62 trillion in CDSs outstanding in 2008 were speculative”);

financial system's aggregate exposure to the risks of securitized loans by using pools of CDS to create synthetic CDOs. Synthetic CDOs were generally constructed to mimic the performance of cash flow CDOs, and synthetic CDOs issued yet another series of tranching, structured-finance securities to investors.⁴² By 2007, the total notional amounts of CDS and synthetic CDOs written with reference to securitized loans, ABS, MBS or cash flow CDOs may have exceeded \$15 trillion.⁴³

Thus, based on available estimates, approximately \$25 trillion of structured-finance securities and related derivatives were outstanding in the U.S. financial markets at the peak of the credit boom in 2007.⁴⁴ Eighteen giant LCFIs, including ten U.S. and eight foreign financial institutions, originated the lion's share of those complex instruments.⁴⁵ Structured-finance securities and related derivatives not only financed but also far exceeded about \$9 trillion of risky private-sector debt that was outstanding in U.S. financial markets when the credit crisis broke out.⁴⁶ The combined volume of MBS,

Manns, *supra* note 40, at 1036–37 (noting the use of CDS as “speculative instruments”); Michael Lewis, *Betting on the Blind Side*, VANITY FAIR (April 2010), <http://www.vanityfair.com/business/features/2010/04/wall-street-excerpt-201004> (“In the beginning, credit-default swaps had been a tool for hedging Very quickly, however, the new derivatives became tools for speculation”).

⁴² Wilmarth, *supra* note 4, at 993–94, 1030–32.

⁴³ *Id.* at 994 n.126, 1032 (citing estimates indicating that, at the peak of the credit boom, \$1.25 trillion to \$6 trillion of synthetic CDOs were outstanding and that about one-third of the \$45 trillion of outstanding CDS were written to protect holders of CDOs, CLOs, and other structured-finance instruments).

⁴⁴ See *supra* notes 38–39, 43 and accompanying text.

⁴⁵ During the credit boom that led to the financial crisis, the eighteen leading global LCFIs (the “big eighteen”) included the four largest U.S. banks (Bank of America, Chase, Citigroup, and Wachovia), the five largest U.S. securities firms (Bear, Goldman, Lehman Brothers (Lehman), Merrill, and Morgan Stanley), and the largest U.S. insurer (AIG), and eight foreign universal banks (Barclays, BNP Paribas, Credit Suisse, Deutsche, HSBC, RBS, Société Générale, and UBS). The big eighteen dominated global and U.S. markets for securities underwriting, securitizations, structured financial products, and OTC derivatives. See Wilmarth, *supra* note 4, at 980–84, 989–90, 994–95, 1019–20, 1031–33; Wilmarth, *supra* note 6, at 721, 721–22 n.45; see also Dwight Jaffee et al., *Mortgage Origination and Securitization in the Financial Crisis*, in RESTORING FINANCIAL STABILITY, *supra* note 34, at 61, 69 tbl.1.4 (showing that eleven of the “big eighteen” LCFIs ranked among the top twelve global underwriters of CDOs between 2004 and 2008); Anthony Saunders et al., *Enhanced Regulation of Large, Complex Financial Institutions*, in RESTORING FINANCIAL STABILITY, *supra* note 34, at 139, 142 tbl.5.2 (showing that all of the “big eighteen” LCFIs, except for AIG, ranked among the top twenty-three global providers of wholesale financial services in 2006 and 2007).

⁴⁶ About \$6.3 trillion of nonprime residential mortgage loans, credit card loans, and CRE loans were outstanding in the U.S. market in 2008. Of that amount, about \$2.8

cash flow CDOs, CDS and synthetic CDOs created an “inverted pyramid of risk,” which enabled investors to place “multiple layers of financial bets” on the performance of high-risk loans in securitized pools.⁴⁷ Consequently, when the underlying loans began to default, the leverage inherent in this “pyramid of risk” produced losses that were far larger than the face amounts of the defaulted loans.⁴⁸

B. LCFIs Used Inflated Credit Ratings to Promote the Sale of Risky Structured-Finance Securities

LCFIs made structured-finance securities attractive to investors by paying large fees to credit rating agencies (CRAs) in order to secure investment-grade ratings (BBB- and above) for most tranches of those securities.⁴⁹ CRAs charged fees for their ratings based on an “issuer pays” business model, which required an issuer of securities to pay fees to one or more CRAs in order to secure credit ratings for its securities. The “issuer pays” model created an obvious conflict of interest between a CRA’s desire to earn fees from issuers of securities and the CRA’s stake in preserving its reputation for making reliable risk assessments. Structured-finance securitizations heightened this conflict of interest because LCFIs often paid additional consulting fees to obtain advice from CRAs on how to structure securitizations to produce the maximum percentage of AAA-rated securities.⁵⁰

trillion of loans were held in securitized pools, and many of the securitized loans and other loans were referenced by CDS. See Wilmarth, *supra* note 4, at 988–94, 1024–41. In addition, about \$2.5 trillion of LBO loans and high-yield (“junk”) bonds were outstanding in the U.S. market in 2008, and a significant portion of that debt was securitized or referenced by CDS. *Id.* at 1039–43; see also CHARLES R. MORRIS, *THE TWO TRILLION DOLLAR MELTDOWN: EASY MONEY, HIGH ROLLERS, AND THE GREAT CREDIT CRASH* 123–26, 134–39 (2008).

⁴⁷ Wilmarth, *supra* note 4, at 991–94, 1027–32.

⁴⁸ See MORRIS, *supra* note 46, at 73–79, 113–14, 123–32; Michael Lewis, *The End*, PORTFOLIO.COM (Nov. 11, 2008), <http://www.portfolio.com/news-markets/national-news/portfolio/2008/11/11/The-End-of-Wall-Streets-Boom>. Hedge fund manager Steve Eisman explained that Wall Street firms built an “engine of doom” with cash flow CDOs and synthetic CDOs because those instruments created “several towers of debt” on top of “the original subprime loans,” and “that’s why the losses are so much greater than the loans.” *Id.*

⁴⁹ Manns, *supra* note 40, at 1050–52; Timothy E. Lynch, *Deeply and Persistently Conflicted: Credit Rating Agencies in the Current Regulatory Environment*, 59 CASE W. RES. L. REV. 227, 244–46 (2009); Frank Partnoy, *Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective* 4–6 (Univ. San Diego Sch. of Law Legal Studies, Research Paper No. 09-014, 2009), available at <http://ssrn.com/abstract=1430608>.

⁵⁰ See, e.g., Lynch, *supra* note 49, at 246–48, 256–61; Manns, *supra* note 40, at 1052; Partnoy, *supra* note 36, at 3–7; David Reiss, *Rating Agencies and Reputational Risk* 4–8

Moreover, a small group of LCFIs dominated the securitization markets and, therefore, were significant repeat players in those markets. Accordingly, LCFIs could strongly influence a CRA's decision on whether to assign favorable ratings to an issue of structured-finance securities by threatening to switch to other CRAs to obtain higher ratings for the same type of securities.⁵¹ Given the generous fees that CRAs received from LCFIs for rating structured-finance securities and for providing additional consulting services, it is not surprising that CRAs typically assigned AAA ratings to three-quarters or more of the tranches of ABS, RMBS, CDOs, and CDOs-squared.⁵²

Investors relied heavily on credit ratings and usually did not perform any meaningful due diligence before deciding to buy structured-finance securities. In addition, regulations issued by the Securities and Exchange Commission (SEC) allowed issuers to sell ABS, RMBS, and CDOs to investors based on limited disclosures beyond the instruments' credit ratings.⁵³ Many issuers provided descriptions of the underlying loans that were incomplete and materially misleading.⁵⁴ The complexity of structured-finance transactions made it difficult for investors to evaluate the risks of first-level securitizations and nearly impossible for investors to ascertain the risks of second- and third-level securitizations.⁵⁵

(Brooklyn Law Sch. Legal Studies, Research Paper No. 136, 2009), available at <http://ssrn.com/abstract=1358316>.

⁵¹ Benmelech & Dlugosz, *supra* note 35, at 16–21, 25; Roger Lowenstein, *Triple-A Failure*, N.Y. TIMES, Apr. 27, 2008, § MM (Magazine), at 36; Lynch, *supra* note 49, at 256–58; Wilmarth, *supra* note 4, at 988–94, 1011–12, 1017–20, 1027–42.

⁵² Benmelech & Dlugosz, *supra* note 35, at 4; Jaffee et al., *supra* note 45, at 73–74; Wilmarth, *supra* note 4, at 1028–29.

⁵³ Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2070–73 (2007) (discussing limited disclosures given to institutional investors who bought structured-finance securities in private placements under SEC Rule 144A); Richard E. Mendales, *Collateralized Explosive Devices: Why Securities Regulation Failed to Prevent the CDO Meltdown, and How to Fix It*, 2009 U. ILL. L. REV. 1359, 1360–62, 1373–87 (2009) (discussing additional reasons why SEC regulations failed to require adequate disclosures for offerings of CDOs and instead encouraged investors to rely on credit ratings).

⁵⁴ Kurt Eggert, *The Great Collapse: How Securitization Caused the Subprime Meltdown*, 41 CONN. L. REV. 1257, 1305–06 (2009); Kurt Eggert, Beyond “Skin in the Game”: The Structural Flaws in Private-Label Mortgage Securitization That Caused the Mortgage Meltdown, Testimony Before the Financial Crisis Inquiry Commission 11–13 (Sept. 23, 2010) (on file with author).

⁵⁵ Wilmarth, *supra* note 4, at 1026–28; Jaffee et al., *supra* note 45, at 73–74; Scott, *supra* note 35, at 23–24, 26; INT’L MONETARY FUND, *supra* note 11, at 81.

Investors also had strong incentives not to question the ratings assigned to structured-finance securities by CRAs. AAA-rated structured-finance securities paid yields that were significantly higher than conventional AAA-rated bonds. Structured-finance securities were therefore very attractive to investors who were seeking the highest available yields on supposedly “safe” debt securities during the low-interest, low-inflation environment of the pre-crisis period.⁵⁶ The AAA ratings issued by CRAs enabled LCFIs to transform “trillions of dollars of risky assets . . . into securities that were widely considered to be safe,” and were “eagerly bought up by investors around the world.”⁵⁷

The CRAs’ pervasive conflicts of interest encouraged them to issue credit ratings that either misperceived or misrepresented the true risks embedded in structured-finance securities. CRAs, along with the LCFIs that issued the securities, made the following crucial errors: (1) giving too much weight to the benefits of diversification from pooling large numbers of high-risk loans; (2) failing to recognize that RMBS and CDOs became more risky as mortgage lending standards deteriorated between 2004 and 2007; (3) failing to appreciate that RMBS and CDOs often contained dangerous concentrations of loans from high-risk states like California, Florida and Nevada; (4) underestimating the risk that a serious economic downturn would trigger widespread correlated defaults among risky loans of similar types; (5) relying on historical data drawn from a relatively brief period in which benign economic conditions prevailed; and (6) assuming that housing prices would never decline on a nationwide basis.⁵⁸ By mid-2009, CRAs had cut their ratings on tens of

⁵⁶ See Coval et al., *supra* note 35, at 4, 19; Wilmarth, *supra* note 4, at 1028–29; INT’L MONETARY FUND, *supra* note 11, at 81; see also Acharya & Richardson, *supra* note 34, at 205 (stating that, in June 2006, “AAA-rated tranches of subprime CDOs offered twice the premium of the typical AAA credit-default swap of a corporation”); FIN. SERVS. AUTH., THE TURNER REVIEW: A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS 12–15 (2009), available at http://www.fsa.gov.uk/pubs/other/turner_review.pdf (explaining that LCFIs created novel types of securitized credit instruments to satisfy “a ferocious search for yield” by investors in the context of “very low medium- and long-term real interest rates”); Mark Astley et al., *Global Imbalances and the Financial Crisis*, Q3 BANK ENG. Q. BULL. 178, 181 (2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1478419 (“The low interest rate environment seems to have interacted with strong competitive pressures on banks and asset managers to maintain returns, leading to a ‘search for yield’ in financial markets.”).

⁵⁷ Coval et al., *supra* note 35, at 3–4.

⁵⁸ *Id.* at 3–4, 8–21; Benmelech & Dlugosz, *supra* note 35, at 2, 13–15, 21–23, 25; Partnoy, *supra* note 36, at 6–11; Wilmarth, *supra* note 4, at 1034; Lowenstein, *supra* note 51.

thousands of investment-grade tranches of RMBS and CDOs, and securitization markets had collapsed.⁵⁹

C. LCFIs Promoted an Unsustainable Credit Boom That Set the Stage for the Financial Crisis

The LCFIs' large-scale securitizations of credit helped to create an enormous credit boom in the U.S. financial markets between 1991 and 2007. Nominal domestic private-sector debt nearly quadrupled, rising from \$10.3 trillion to \$39.9 trillion during that period, and the largest increases occurred in the financial and household sectors.⁶⁰ Total U.S. private-sector debt as a percentage of gross domestic product (GDP) rose from 150% in 1987 to almost 300% in 2007 and, by that measure, exceeded even the huge credit boom that led to the Great Depression.⁶¹ Financial sector debt as a percentage of GDP rose from 40% in 1988 to 70% in 1998 and to 120% in 2008.⁶² Meanwhile, household sector debt grew from two-thirds of GDP in the early 1990s to 100% of GDP in 2008.⁶³

The credit boom greatly increased the financial sector's importance within the broader economy. Financial sector earnings doubled from 13% of total corporate pretax profits in 1980 to 27% of such profits in 2007.⁶⁴ Stocks of financial firms included in the Standard & Poor's (S&P) 500 index held the highest aggregate market value of any

⁵⁹ INT'L MONETARY FUND, *supra* note 11, at 93 fig.2.12; Benmelech & Dlugosz, *supra* note 35, at 8–9, 31 tbl.2 (reporting that Moody's had issued 45,000 downgrades affecting 36,000 tranches of structured-finance securities during 2007 and the first nine months of 2008 and that Moody's average downgrade during that period was 5.2 rating notches).

⁶⁰ Wilmarth, *supra* note 4, at 1002, 1002 nn.174–76 (reporting that financial sector debt accounted for \$13 trillion of the rise in domestic nongovernmental debt between 1991 and 2007, while household debt grew by \$10 trillion and nonfinancial business debt increased by \$6.4 trillion).

⁶¹ FIN. SERVS. AUTH., *supra* note 56, at 18 (exhibit 1.10); *see also* STOWELL, *supra* note 15, at 456 (exhibit 3) (showing the rapid growth of total domestic nongovernmental debt as a percentage of GDP between the mid-1980s and the end of 2007); Wilmarth, *supra* note 4, at 974, 974 n.26 (referring to the credit boom of the 1920s that precipitated the Great Depression).

⁶² *A Special Report on Financial Risk: The Gods Strike Back*, ECONOMIST (Feb. 11, 2010), <http://www.economist.com/node/15474137>.

⁶³ Peter Coy, *Why the Fed Isn't Igniting Inflation*, BLOOMBERG BUSINESSWEEK (June 29, 2009), http://www.businessweek.com/magazine/content/09_26/b4137020225264.htm.

⁶⁴ Justin Lahart, *Has the Financial Industry's Heyday Come and Gone?*, WALL ST. J., Apr. 28, 2008, at A2; *see also* *Buttonwood: The Profits Puzzle*, ECONOMIST (Sept. 13, 2007), <http://www.economist.com/node/9804566> (reporting that the financial sector contributed "around 27% of the profits made by companies in the S&P 500 index [in 2007], up from 19% in 1996").

industry sector of that index from 1995 to 1998, and again from 2002 to 2007.⁶⁵

As the credit boom inflated and the financial sector grew in size and importance to the overall economy, LCFIs also became more leveraged, more fragile, and more vulnerable to a systemic crisis. At the end of 2007, the ten largest U.S. financial institutions—all of which were leading participants in structured-finance securitization—had an average leverage ratio of 27:1 when their off-balance-sheet (OBS) commitments were taken into account.⁶⁶

As I noted in a previous article, “[b]y 2007, the health of the U.S. economy relied on a massive confidence game—indeed, some might say, a Ponzi scheme—operated by its leading financial institutions.”⁶⁷ This “confidence game,” which sustained the credit boom, could continue only as long as investors were willing “to keep buying new debt instruments that would enable overstretched borrowers to expand their consumption and service their debts.”⁶⁸ In the summer of 2007, when investors lost confidence in the ability of subprime borrowers to meet their obligations, “the game collapsed and a severe financial crisis began.”⁶⁹

D. LCFIs Retained Exposures to Many of the Hazards Embedded in Their High-Risk Lending

During the credit boom, as explained above, LCFIs pursued a securitization strategy that produced highly leveraged risk taking through the use of complex structured-finance products, CDS and OBS vehicles.⁷⁰ This securitization strategy was highly attractive in the short term, because LCFIs (as well as the mortgage brokers,

⁶⁵ Elizabeth Stanton, *Bank Stocks Cede Biggest S&P Weighting to Technology (Update2)*, BLOOMBERG (May 21, 2008), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=adD4MfoIscYo>; see also Tom Lauricella, *Crumbling Profit Center: Financial Sector Showing Life, but Don't Bank on Long-Term Revival*, WALL ST. J., Mar. 24, 2008, at C1 (reporting that financial stocks accounted for 22.3% of the value of all stocks included in the S&P index at the end of 2006, “up from just 13% at the end of 1995”).

⁶⁶ Wilmarth, *supra* note 6, at 727–28, 728 n.72.

⁶⁷ Wilmarth, *supra* note 4, at 1008 (footnote omitted).

⁶⁸ *Id.*

⁶⁹ *Id.*

⁷⁰ Viral V. Acharya & Philipp Schnabl, *How Banks Played the Leverage Game*, in RESTORING FINANCIAL STABILITY, *supra* note 34, at 83–89; Blundell-Wignall et al., *supra* note 11, at 3–13; Saunders et al., *supra* note 45, at 140–45; Wilmarth, *supra* note 4, at 1027–41.

nonbank lenders and CRAs who worked with LCFIs) collected lucrative fees at each stage of originating, securitizing, rating and marketing the risky residential mortgages, commercial mortgages, credit card loans, and LBO loans.⁷¹ Based on the widespread belief that LCFIs were following an “originate to distribute” strategy, both managers and regulators of LCFIs operated under the illusion that the credit risks inherent in the securitized loans were being transferred to the ultimate purchasers of structured-finance securities.⁷² In significant ways, however, LCFIs actually pursued an “originate to *not really* distribute” program, in which they retained significant risk exposures from their securitization programs.⁷³

For example, LCFIs decided to keep large amounts of highly rated, structured-finance securities on their balance sheets because regulators allowed LCFIs to do so with a minimum of capital. In the U.S., LCFIs took advantage of a regulation issued by the federal banking agencies in November 2001, which greatly reduced the risk-based capital charge for structured-finance securities rated “AAA” or “AA” by CRAs. The 2001 regulation assigned a risk weighting of only 20% to such securities in determining the amount of risk-based capital that banks were required to hold.⁷⁴ As a practical matter, the 2001 rule cut the risk-based capital requirement for highly rated tranches of RMBS and related CDOs from 4% to only 1.6%.⁷⁵

In Europe, LCFIs similarly retained AAA-rated structured-finance securities on their balance sheets because the Basel I and Basel II capital accords assigned very low risk weights to such securities. In contrast to the United States, European nations did not require banks to maintain a minimum leverage capital ratio and instead required banks only to meet the Basel risk-weighted capital standards. As a result, European banks did not incur significant capital charges for

⁷¹ Crotty, *supra* note 33, at 565–66; Wilmarth, *supra* note 4, at 984–87, 995–96, 1017–20, 1034–42; *see also id.* at 995 (noting that “[f]ee income at the largest U.S. banks (including BofA, Chase and Citigroup) rose from 40% of total earnings in 1995 to 76% of total earnings in 2007”).

⁷² Wilmarth, *supra* note 4, at 995–96, 1025–26, 1041–42.

⁷³ *Id.* at 970–71, 1032–35, 1039–43, 1046–48; *see also* Acharya & Richardson, *supra* note 34, at 198–201; FIN. SERVS. AUTH., *supra* note 56, at 15–21.

⁷⁴ *See* Risk-Based Capital Guidelines, 66 Fed. Reg. 59,614, 59,625–27 (Nov. 29, 2001); ARNOLD KLING, NOT WHAT THEY HAD IN MIND: A HISTORY OF POLICIES THAT PRODUCED THE FINANCIAL CRISIS OF 2008, at 25–26 (2009), *available at* <http://ssrn.com/abstract=1474430>.

⁷⁵ KLING, *supra* note 74, at 25 fig.4.

holding on-balance-sheet, AAA-rated instruments, due to their low risk weights under Basel rules.⁷⁶

LCFIs also had revenue-based incentives to keep highly rated structured finance securities on their balance sheets. As the credit boom reached its peak, LCFIs found it difficult to locate investors to purchase all of the AAA-rated tranches they were producing. Managers at aggressive LCFIs decided to assume “warehouse risk” by keeping AAA-rated tranches on their balance sheets because they wanted to complete more securitization deals, earn more fees, produce higher short-term profits, and distribute larger compensation packages to executives and key employees.⁷⁷ By 2007, Citigroup, Merrill, and UBS together held more than \$175 billion of AAA-rated CDOs on their books.⁷⁸ The huge losses suffered by those institutions on retained CDO exposures were a significant reason why all three institutions needed extensive governmental assistance to avoid failure.⁷⁹

In addition, LCFIs retained risk exposures for many of the assets they ostensibly transferred to OBS entities through securitization. Regulators in the United States and Europe allowed LCFIs to sponsor structured investment vehicles (SIVs) and other OBS conduits, which were frequently used as dumping grounds for RMBS and CDOs that

⁷⁶ Acharya & Schnabl, *supra* note 70, at 94–98; ANDREW G. HALDANE, EXEC. DIR., FIN. STABILITY, BANK OF ENG., BANKING ON THE STATE 5–8 (2009), available at <http://www.bis.org/review/r091111e.pdf>. Because European banks did not have to comply with a minimum leverage capital ratio, the thirteen largest European banks operated in 2008 with an average leverage capital ratio of 2.68%, compared to an average leverage capital ratio of 5.88% for the ten largest U.S. banks (which were required by regulators to maintain a leverage capital ratio of at least 4%). Similarly, the four largest U.S. securities firms had an average leverage capital ratio of only 3.33% because the SEC did not require those firms to comply with a minimum leverage ratio. Adrian Blundell-Wignall & Paul Atkinson, *The Sub-prime Crisis: Causal Distortions and Regulatory Reform*, in LESSONS FROM THE FINANCIAL TURMOIL OF 2007 AND 2008, at 55, 93–94, 95 tbl.6 (Paul Bloxham & Christopher Kent eds., 2008), available at <http://www.rba.gov.au/publications/confs/2008/conf-vol-2008.pdf>; see also McCoy et al., *supra* note 14, at 1358–60 (explaining that the SEC allowed the five largest U.S. securities firms to determine their capital requirements based on internal risk models, with the result that leverage at the five firms increased to about 30:1 by 2008).

⁷⁷ Wilmarth, *supra* note 4, at 1032–33; see also Gian Luca Clementi et al., *Rethinking Compensation in Financial Firms*, in RESTORING FINANCIAL STABILITY, *supra* note 34, at 197, 198–200; Crotty, *supra* note 33, at 568–69; Jaffee et al., *supra* note 45, at 71–73.

⁷⁸ Clementi et al., *supra* note 77, at 198–200.

⁷⁹ GILLIAN TETT, FOOL’S GOLD: HOW THE BOLD DREAM OF A SMALL TRIBE AT J.P. MORGAN WAS CORRUPTED BY WALL STREET GREED AND UNLEASHED A CATASTROPHE 133–39 (2009); Blundell-Wignall et al., *supra* note 11, at 4, 7–11; Jaffee et al., *supra* note 45, at 68–69, 72–73.

LCFIs were unable to sell to arms-length investors. The sponsored conduits sold asset-backed commercial paper (ABCP) to investors and used the proceeds to buy structured-finance securities underwritten by the sponsoring LCFIs. The conduits faced a potentially dangerous funding mismatch between their longer-term, structured-finance assets and their shorter-term, ABCP liabilities. The sponsoring LCFIs covered that mismatch (in whole or in part) by providing explicit credit enhancements (including lines of credit) or implicit commitments to ensure the availability of liquidity if the sponsored conduits could not roll over their ABCP.⁸⁰

U.S. regulators adopted risk-based capital rules that encouraged the use of ABCP conduits. Those rules did not assess any capital charges against LCFIs for transferring securitized assets to sponsored conduits. Instead, the rules required LCFIs to post capital only if they provided explicit credit enhancements to their conduits.⁸¹ Moreover, a 2004 regulation approved a very low capital charge for sponsors' lines of credit, equal to only one-tenth of the usual capital charge of 8%, as long as the lines of credit had maturities of one year or less.⁸²

ABCP conduits sponsored by LCFIs grew rapidly during the peak years of the credit boom. As a result, the ABCP market in the United States nearly doubled after 2003 and reached \$1.2 trillion in August 2007. Three-quarters of that amount was held in 300 conduits sponsored by U.S. and European LCFIs.⁸³ Citigroup was the largest conduit sponsor, and seven of the top ten sponsors were members of the "big eighteen" club of LCFIs.⁸⁴ As a result of their risk exposures to conduits and their other OBS commitments, many of the leading LCFIs were much more highly leveraged than their balance sheets indicated.⁸⁵

⁸⁰ For discussions of the risk exposures of LCFIs to SIVs and other sponsored conduits, see TETT, *supra* note 79, at 97–98, 127–28, 136, 196–98; Acharya & Schnabl, *supra* note 70, at 88–94; Wilmarth, *supra* note 4, at 1033.

⁸¹ Acharya & Schnabl, *supra* note 70, at 89.

⁸² Risk-Based Capital Guidelines, 69 Fed. Reg. 44,908, 44,910–11 (July 28, 2004); *see also* Acharya & Schnabl, *supra* note 70, at 89 (noting that capital requirements for short-term "liquidity enhancements" were "only 0.8 percent of asset value").

⁸³ Marcin Kacperczyk & Philipp Schnabl, *When Safe Proved Risky: Commercial Paper During the Financial Crisis of 2007–2009*, 24 J. ECON. PERSPECTIVES 29, 32–34, 38 fig.1 (2010).

⁸⁴ Acharya & Schnabl, *supra* note 70, at 93 tbl.2.1 (listing Citigroup, Bank of America, Chase, HSBC, Société Générale, Deutsche, and Barclays among the top ten conduit sponsors); *supra* note 45 (listing the "big eighteen" LCFIs).

⁸⁵ TETT, *supra* note 79, at 97–98; Crotty, *supra* note 33, at 570.

After the financial crisis broke out in August 2007, conduits suffered large losses on their holdings of structured-finance securities. Many conduits were faced with imminent default because they could not roll over their ABCP. Investors refused to buy new issues of ABCP because of the presumed exposure of ABCP conduits to losses from subprime mortgages.⁸⁶ In order to avoid damage to their reputations, most LCFI sponsors went beyond their legal obligations and either brought conduit assets back onto their balance sheets or provided explicit credit enhancements that enabled conduits to remain in business.⁸⁷

Thus, notwithstanding the widely shared assumption that LCFIs were following an “originate to distribute” strategy, LCFIs did not transfer many of the credit risks created by their securitization programs. Instead, “they ‘warehoused’ nonprime mortgage-related assets . . . [and] transferred similar assets to sponsored OBS entities.”⁸⁸ One study estimated that LCFIs retained risk exposures to about half of the outstanding AAA-rated ABS in mid-2008 through their “warehoused” and OBS positions.⁸⁹ Hence, in many respects, “LCFIs pursued an ‘originate to *not really* distribute’ strategy, which prevented financial regulators and analysts from understanding the true risks created by the LCFIs’ involvement with nonprime mortgage-related assets.”⁹⁰

E. While Other Factors Contributed to the Financial Crisis, LCFIs Were the Most Important Private-Sector Catalysts for the Crisis

Excessive risk-taking by LCFIs was not the only cause of the current financial crisis. Several additional factors played an important role. First, many analysts have criticized the FRB for maintaining an excessively loose monetary policy during the second half of the 1990s and again between 2001 and 2005. Critics charge that the FRB’s monetary policy mistakes produced speculative asset booms that led

⁸⁶ Acharya & Schnabl, *supra* note 70, at 89–92.

⁸⁷ *Id.* at 91–94; *see also* Wilmarth, *supra* note 4, at 1033 (observing that the conduit rescues “showed that LCFIs felt obliged, for reasons of ‘reputation risk,’ to support OBS entities that they had sponsored, even when they did not have explicit contractual commitments to do so”). Citigroup absorbed \$84 billion of assets onto its balance sheet from seven SIVs, while HSBC and Société Générale together took back \$50 billion of assets from their SIVs. *Id.* at 1033 n.358.

⁸⁸ Wilmarth, *supra* note 4, at 1033.

⁸⁹ Acharya & Schnabl, *supra* note 70, at 97 tbl.2.2, 97–98.

⁹⁰ Wilmarth, *supra* note 4, at 1034.

to the dotcom-telecom bust in the stock market between 2000 and 2002 and the bursting of the housing bubble after 2006.⁹¹ A recent European Central Bank staff study found that lax monetary policy in the United States and the euro area produced a prolonged period of low, short-term interest rates in both regions between 2002 and 2006. The study concluded that “too low for too long monetary policy rates, by inducing a softening of lending standards and a consequent buildup of risk on banks’ assets, were a key factor leading to the financial crisis” on both continents.⁹²

Second, during the past decade several Asian nations that were large exporters of goods (including China, Japan, and South Korea) maintained artificially low exchange rates for their currencies against the dollar, the pound sterling, and the euro. Those nations preserved advantageous exchange rates for their currencies (thereby boosting exports) by purchasing Western government securities and investing in Western financial markets. In addition, many oil-exporting countries invested large amounts in Western assets. Thus, nations with significant balance-of-trade surpluses provided large amounts of credit and investment capital that boosted the value of Western currencies, supported low interest rates, and thereby promoted asset booms in the United States, the United Kingdom, and other European countries.⁹³

Third, Robert Shiller and others have argued that “bubble thinking” caused home buyers, LCFIs, CRAs, investors in structured-finance securities and regulators to believe that the housing boom would continue indefinitely and “could not end badly.”⁹⁴ According to these

⁹¹ For critiques of the FRB’s monetary policy, see Wilmarth, *supra* note 4, at 1005–06 (summarizing analysis by various critics of the FRB); JOHN B. TAYLOR, GETTING OFF TRACK: HOW GOVERNMENT ACTIONS AND INTERVENTIONS CAUSED, PROLONGED, AND WORSENE THE FINANCIAL CRISIS 1–6, 11–13 (2009) (contending that the FRB’s “extra-easy [monetary] policy accelerated the housing boom and thereby ultimately led to the housing bust”); KLING, *supra* note 74, at 38–39. For an impassioned attack on the FRB’s monetary policy between the mid-1990s and 2005, see WILLIAM A. FLECKENSTEIN & FREDERICK SHEEHAN, GREENSPAN’S BUBBLES: THE AGE OF IGNORANCE AT THE FEDERAL RESERVE (2008).

⁹² Maddloni & Peydró, *supra* note 4, at 9–10, 14–15, 25–26 (quote at 25).

⁹³ For discussion of the impact of large purchases of Western government securities and other investments in Western financial markets by Asian nations and oil-exporting countries, see MORRIS, *supra* note 46, at 88–104; Wilmarth, *supra* note 4, at 1006–07; Astley et al., *supra* note 56, at 180–82.

⁹⁴ ROBERT J. SHILLER, THE SUBPRIME SOLUTION 48–54 (2008); see also MORRIS, *supra* note 46, at 65–69; Astley et al., *supra* note 56, at 181; Wilmarth, *supra* note 4, at 1007–08.

analysts, a “*social contagion* of boom thinking” helps to explain both why the housing bubble continued to inflate for several years and why regulators failed to stop LCFIs from making high-risk loans to borrowers who had no capacity to repay or refinance their loans unless their properties continued to appreciate in value.⁹⁵

Finally, Fannie Mae (“Fannie”) and Freddie Mac (“Freddie”) contributed to the housing bubble by purchasing large quantities of nonprime mortgages and RMBS beginning in 2003. Those government-sponsored entities (GSEs) purchased nonprime mortgages and RMBS because (1) Congress pressured them to fulfill affordable housing goals, (2) large nonprime mortgage lenders (including Countrywide) threatened to sell most of their mortgages to Wall Street firms if the GSEs failed to purchase more of their nonprime loans, and (3) Fannie’s and Freddie’s senior executives feared a continuing loss of market share and profits to LCFIs that were aggressively securitizing nonprime mortgages into private-label RMBS. In 2007, the two GSEs held risk exposures connected to more than \$400 billion of nonprime mortgages, representing a fifth of the nonprime market. Heavy losses on those risk exposures contributed to the collapse of Fannie and Freddie in 2008.⁹⁶

Notwithstanding the significance of the foregoing factors, LCFIs were clearly “the primary private-sector catalysts for the destructive credit boom that led to the subprime financial crisis, and they [became] the epicenter of the current global financial mess.”⁹⁷ As indicated above, the “big eighteen” LCFIs were dominant players in global securities and derivatives markets during the credit boom.⁹⁸ Those LCFIs included most of the top underwriters for nonprime RMBS, ABS, CMBS, and LBO loans, as well as related CDOs,

⁹⁵ SHILLER, *supra* note 94, at 41–54; *see also* Wilmarth, *supra* note 4, at 1007–08.

⁹⁶ For discussions of Fannie’s and Freddie’s purchases of nonprime mortgages and RMBS and the reasons for such purchases, *see, e.g.*, Dwight Jaffee et al., *What to Do About the Government-Sponsored Enterprises*, in RESTORING FINANCIAL STABILITY, *supra* note 34, at 121, 124–30; Christopher L. Peterson, *Fannie Mae, Freddie Mac, and the Home Mortgage Foreclosure Crisis*, 10 LOY. J. PUB. INT. L. 149, 163–168 (2009); Jo Becker et al., *White House Philosophy Stoked Mortgage Bonfire*, N.Y. TIMES, Dec. 21, 2008, <http://www.nytimes.com/2008/12/21/business/worldbusiness/21iht-21admin.18841572.html>; Paul Davidson, *Lawmakers Blast Former Freddie, Fannie CEOs: Execs Say Competition Played Role in Decisions*, USA TODAY, Dec. 10, 2008, at 3B; Charles Duhigg, *Pressured to Take More Risk, Fannie Reached Tipping Point*, N.Y. TIMES, Oct. 4, 2008, <http://www.nytimes.com/2008/10/05/business/05fannie.html>.

⁹⁷ Wilmarth, *supra* note 4, at 1046.

⁹⁸ *See supra* note 45 and accompanying text.

CLOs, and CDS.⁹⁹ While Fannie and Freddie funded about a fifth of the nonprime mortgage market between 2003 and 2007, they did so primarily by purchasing nonprime mortgages and private-label RMBS that were originated or underwritten by LCFIs.¹⁰⁰ LCFIs provided most of the rest of the funding for nonprime mortgages, as well as much of the financing for risky credit card loans, CRE loans, and LBO loans.¹⁰¹

The central role of LCFIs in the financial crisis is confirmed by the enormous losses they suffered and the huge bailouts they received. The “big eighteen” LCFIs accounted for three-fifths of the \$1.5 trillion of total worldwide losses recorded by banks, securities firms, and insurers between the outbreak of the financial crisis in mid-2007 and the spring of 2010.¹⁰² The list of leading LCFIs is “a who’s who of the current financial crisis,” which includes “[m]any of the firms [that] either went bust . . . or suffered huge write-downs that led to significant government intervention.”¹⁰³ Lehman failed, while two other members of the “big eighteen” LCFIs (AIG and RBS) were nationalized, and three others (Bear, Merrill, and Wachovia) were acquired by other LCFIs with substantial governmental assistance.¹⁰⁴ Three additional members of the group (Citigroup, Bank of America, and UBS) survived only because they received costly government bailouts.¹⁰⁵ Chase, Goldman, and Morgan Stanley received substantial infusions of capital under the federal government’s Troubled Asset Relief Program (TARP), and Goldman and Morgan

⁹⁹ Wilmarth, *supra* note 4, at 982–84, 989–91, 1019–20, 1031–35, 1039–42; *see also* Jaffee et al., *supra* note 45, at 69 tbl.1.4 (showing that the “big eighteen” LCFIs included eleven of the twelve top global underwriters of CDOs during 2006 and 2007).

¹⁰⁰ *See* Peterson, *supra* note 96, at 167–69; *supra* note 96 and accompanying text.

¹⁰¹ *See* Jaffee et al., *supra* note 45, at 68–73; Saunders et al., *supra* note 45, at 143–45; *supra* notes 33–48 and accompanying text.

¹⁰² Yap & Pierson, *supra* note 19 (showing that the “big eighteen” LCFIs accounted for \$892 billion of the \$1.51 trillion of losses suffered by banks, securities firms, and insurers during that period); *see also* Saunders et al., *supra* note 45, at 144–45 tbl.5.3.

¹⁰³ Jaffee et al., *supra* note 45, at 69.

¹⁰⁴ STOWELL, *supra* note 15, at 182–84, 398–405, 408–17; Wilmarth, *supra* note 4, at 1044–45; Wilmarth, *supra* note 15, at 28–30.

¹⁰⁵ Wilmarth, *supra* note 4, at 1044–45 (explaining that Citigroup and Bank of America “received huge bailout packages from the U.S. government that included \$90 billion of capital infusions and more than \$400 billion of asset price guarantees,” while UBS “received a \$60 billion bailout package from the Swiss government”); *see also* WESSEL, *supra* note 14, at 239–41, 259–63 (discussing bailouts of Citigroup and Bank of America); SIGTARP BANK OF AMERICA REPORT, *supra* note 14, at 19–21, 28–29; SIGTARP CITIGROUP REPORT, *supra* note 14, at 5–7, 19–32.

Stanley quickly converted to BHCs to secure permanent access to the FRB's discount window as well as "the Fed's public promise of protection."¹⁰⁶

Thus, of the "big eighteen" LCFIs, only Lehman failed, but the United States, the United Kingdom, and European nations provided extensive assistance to ensure the survival of at least twelve other members of the group.¹⁰⁷ In the United States, the federal government guaranteed the viability of the nineteen largest BHCs as well as AIG.¹⁰⁸ Those institutions received \$290 billion of capital infusions from the federal government, and they also issued \$235 billion of debt that was guaranteed (and thereby subsidized) by the Federal Deposit Insurance Corporation (FDIC). In contrast, smaller banks received only \$41 billion of capital assistance and issued only \$11 billion of FDIC-guaranteed debt.¹⁰⁹ A senior Federal Reserve official observed in 2009 that LCFIs "were central to this crisis as it expanded and became a global recession. . . . [S]tockholders and creditors of these firms enjoyed special protection funded by the American taxpayer."¹¹⁰ He further remarked, "It is no longer conjecture that the largest institutions in the United States have been determined to be too big to fail. They have been bailed out"¹¹¹

¹⁰⁶ WESSEL, *supra* note 14, at 217–18, 227, 236–40 (noting that Chase received \$25 billion of TARP capital while Goldman and Morgan Stanley each received \$10 billion).

¹⁰⁷ See Fabio Benedetti-Valentini, *SocGen Predicts 'Challenging' 2009, Posts Profit (Update 2)*, BLOOMBERG (Feb. 18, 2009), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a7hahfcNNpPE&refer=Europe>; *supra* notes 104–06 and accompanying text. After Lehman's collapse severely disrupted global financial markets, federal authorities decided to take all necessary measures to prevent any additional failures by major LCFIs. That decision led to the federal government's bailouts of AIG, Citigroup, and Bank of America; the infusions of TARP capital into other LCFIs; and other extraordinary measures of support for the financial markets. See SORKIN, *supra* note 14, at 373–537; WESSEL, *supra* note 14, at 189–241.

¹⁰⁸ See Robert Schmidt, *Geithner Slams Bonuses, Says Banks Would Have Failed (Update 2)*, BLOOMBERG (Dec. 4, 2009), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aCUCZcFhssuY> (quoting statement by Treasury Secretary Timothy Geithner that "none" of the biggest U.S. banks would have survived if the federal government had not intervened to support the financial system); *supra* notes 14–17 and accompanying text.

¹⁰⁹ Wilmarth, *supra* note 6, at 737–38, 738 n.122.

¹¹⁰ Thomas M. Hoenig, President, Fed. Reserve Bank of Kansas City, *Regulatory Reform and the Economy: We Can Do Better*, Speech at the 2009 Colorado Economic Forums 8 (Oct. 6, 2009), *available at* <http://www.kansascityfed.org/SpeechBio/HoenigPDF/Denver.Forums.10.06.09.pdf>.

¹¹¹ Thomas M. Hoenig, President, Fed. Reserve Bank of Kansas City, *Leverage and Debt: The Impact of Today's Choices on Tomorrow*, Speech at the 2009 Annual Meeting of the Kansas Bankers Ass'n (Aug. 6, 2009), *available at* <http://www.kansascityfed.org>

IV

GOVERNMENT BAILOUTS DEMONSTRATED THAT LCFIS BENEFIT FROM HUGE TBTF SUBSIDIES

As shown above, LCFIs pursued aggressive and speculative business strategies that exposed them to huge losses and potential failures when asset bubbles in U.S. and European housing markets, CRE markets, and LBO markets burst in the second half of 2007.¹¹² The systemic risk created by LCFIs during the credit boom caused the United States and other nations to implement massive bailouts of LCFIs, including leading securities firms and insurance companies as well as banks.¹¹³

At the height of the financial crisis in March 2009, FRB Chairman Bernanke declared that the federal government was committed to ensure the survival of “systemically important financial institutions” (SIFIs) in order to prevent a systemic collapse of the financial markets and an economic depression.¹¹⁴ Chairman Bernanke defended the federal government’s decision to ensure “the continued viability” of SIFIs in the following terms:

In the midst of this crisis, given the highly fragile state of financial markets and the global economy, government assistance to avoid the failures of major financial institutions has been necessary to avoid a further serious destabilization of the financial system, and our commitment to avoiding such a failure remains firm.¹¹⁵

Chairman Bernanke acknowledged that “the too-big-to-fail issue has emerged as an enormous problem” because “it reduces market discipline and encourages excessive risk-taking” by TBTF firms.¹¹⁶

/SpeechBio/HoenigPDF/hoenigKBA.08.06.09.pdf; *accord* Charles I. Plosser, President and CEO, Fed. Reserve Bank of Phila., Some Observations About Policy Lessons from the Crisis, Speech at the Philadelphia Fed Policy Forum 3 (Dec. 4, 2009), *available at* http://www.philadelphiafed.org/publications/speeches/plosser/2009/12-04-09_fed-policy-forum.pdf (“During this crisis and through the implementation of the stress tests, we have effectively declared at least 19 institutions as too big to fail . . .”).

¹¹² Wilmarth, *supra* note 4, at 1032–43; Saunders et al., *supra* note 45, at 143–45.

¹¹³ See Liam Plevin & Dan Fitzpatrick, *Struggling Hartford Taps McGee as New CEO*, WALL ST. J., Sept. 30, 2009, at C1 (reporting that Hartford, a large insurance company, received a capital infusion of \$3.4 billion from the Treasury Department under the TARP program); *supra* notes 14–18, 103–11 and accompanying text.

¹¹⁴ Ben S. Bernanke, Chairman, Fed. Reserve Bd., Financial Reform to Address Systemic Risk, Speech at the Council on Foreign Relations (Mar. 10, 2009), *available at* <http://www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm>.

¹¹⁵ *Id.*

¹¹⁶ *Id.*

In subsequent testimony delivered in September 2010, Chairman Bernanke confirmed that “[m]any of the vulnerabilities that amplified the crisis are linked with the problem of so-called too-big-to-fail firms,” and he declared, “[i]f the crisis has a single lesson, it is that the too-big-to-fail problem must be solved.”¹¹⁷

In an October 2009 speech, Governor Mervyn King of the Bank of England condemned the perverse incentives created by TBTF subsidies in even stronger terms. Governor King maintained that “[t]he massive support extended to the banking sector around the world, while necessary to avert economic disaster, has created possibly the biggest moral hazard in history.”¹¹⁸ He further argued that TBTF subsidies provided a partial explanation for decisions by LCFIs to engage in high-risk strategies during the credit boom:

Why were banks willing to take risks that proved so damaging to themselves and the rest of the economy? One of the key reasons—mentioned by market participants in conversations before the crisis hit—is that incentives to manage risk and to increase leverage were distorted by the implicit support or guarantee provided by government to creditors of banks that were seen as “too important to fail.” . . . Banks and their creditors knew that if they were sufficiently important to the economy or the rest of the financial system, and things went wrong, the government would always stand behind them. And they were right.¹¹⁹

Industry studies and anecdotal evidence confirm that TBTF subsidies create significant economic distortions and promote moral hazard. During the past three decades, and particularly during the financial crisis, LCFIs that were perceived as TBTF received benefits that extended well beyond customary access to federal deposit insurance and the Fed’s discount window. Both before and during the crisis, LCFIs operated with much lower capital ratios and benefited from significantly higher stock prices (adjusted for risk) and much lower funding costs compared to smaller banks.¹²⁰ CRAs and bond

¹¹⁷ Bernanke, *supra* note 1.

¹¹⁸ Mervyn King, Governor of the Bank of Eng., Speech to Scottish Business Organizations in Edinburgh 4 (Oct. 20, 2009), *available at* <http://www.bankofengland.co.uk/publications/speeches/2009/speech406.pdf>; *see also* RICHARD S. CARNELL ET AL., THE LAW OF BANKING AND FINANCIAL INSTITUTIONS 326 (4th ed. 2009) (explaining that “moral hazard” results from the fact that “[i]nsurance changes the incentives of the person insured [I]f you no longer fear a harm [due to insurance], you no longer have an incentive to take precautions against it.”).

¹¹⁹ King, *supra* note 118, at 3.

¹²⁰ *See* Allen N. Berger et al., *How Do Large Banking Organizations Manage Their Capital Ratios?*, 34 J. FIN. SERVS. RESEARCH 123, 138–39, 145 (2008) (finding that banks

investors gave preferential treatment to TBTF institutions because of the explicit and implicit government backing they received.¹²¹

For example, Bertrand Rime found evidence of TBTF benefits based on an analysis of credit ratings given by Moody's and Fitch to banks in twenty-one industrialized nations between 1999 and 2003. During that period, Moody's and Fitch gave each bank an "individual" rating based on its "intrinsic" resources and an "issuer" rating that also considered the bank's ability to draw support from third parties, including governmental agencies. The rated banks ranged in size from \$1 billion to \$1 trillion. The study found that Moody's and Fitch gave banks with assets of \$100 to \$400 billion a significant ratings upgrade compared to smaller banks with similar financial characteristics. Moody's and Fitch also gave banks with assets of \$400 billion to \$1 trillion an even larger ratings upgrade. The study concluded that "proxies of the TBTF status of a bank (total assets and market share) have a positive and significant effect on large banks' issuer ratings, and . . . the rating bonus also implies a substantial reduction of the refinancing costs of those banks that are regarded as TBTF by rating agencies."¹²²

with more than \$50 billion of assets maintained significantly lower capital ratios, compared to smaller banks, between 1992 and 2006); Hoenig, *supra* note 111 (observing that the ten largest U.S. banks operated with a Tier 1 common stock capital ratio of 3.2% during the first quarter of 2009, compared to a ratio of 6.0% for banks smaller than the top-twenty banks); Priyank Gandhi & Hanno Lustig, *Size Anomalies in U.S. Bank Stock Returns: A Fiscal Explanation* 1–13, 30–34 (Nat'l Bureau of Econ. Research, Working Paper No. 16553, 2010) (determining, based on risk-adjusted stock prices of U.S. banks from 1970 to 2008, that (1) the largest banks received an implicit cost of capital "subsidy" of 3.1%, due to the financial markets' belief that the federal government would protect those banks from "disaster risk" during financial crises, and (2) smaller banks paid an implicit cost of capital "tax" of 3.25% because they did not receive comparable protection from the government); Gretchen Morgenson, *The Cost of Saving These Whales*, N.Y. TIMES, Oct. 3, 2009, <http://www.nytimes.com/2009/10/04/business/economy/04gret.html>; Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 295, 301–02 (2002).

¹²¹ See, e.g., GARY H. STERN & RON J. FELDMAN, TOO BIG TO FAIL: POLICIES AND PRACTICES IN GOVERNMENT BAILOUTS 30–37, 60–79 (2004) (describing the preferential treatment given to TBTF banks by CRAs and other participants in the financial markets); Wilmarth, *supra* note 120, at 301, 301 n.359 (same).

¹²² FIN. CRISIS INQUIRY COMM'N, PRELIMINARY STAFF REPORT, GOVERNMENTAL RESCUES OF "TOO-BIG-TO-FAIL" FINANCIAL INSTITUTIONS 12 (2010) (alteration in original) (on file with author) (summarizing and quoting a 2005 study by Bertrand Rime). I was the principal drafter of this staff report while I worked as a consultant to the FCIC during the summer of 2010.

The preferential status of TBTF institutions was confirmed by the fact that major financial institutions received by far the largest share of governmental assistance in the form of TARP capital assistance, FDIC debt guarantees, and the FRB's emergency lending programs.¹²³ As noted above, federal regulators publicly announced in early 2009, before they began the "stress tests" on the nineteen largest BHCs, that the federal government would provide any capital needed to ensure the survival of those institutions. As a practical matter, regulators certified the TBTF status of all nineteen BHCs.¹²⁴

After the stress tests were completed, Moody's gave the following ratings upgrades for deposits and senior debt issued by the six largest U.S. banks, based on Moody's expectation of "a very high probability of systemic support" for such banks from the U.S. government:

- Bank of America—a five-notch upgrade for the bank's deposits above its "unsupported" or "stand-alone" rating;
- Citibank—a four-notch upgrade for the bank's deposits and senior debt above its unsupported rating;
- Goldman Sachs—a one-notch upgrade for the bank's deposits and senior debt above its unsupported rating;
- JP Morgan Chase—a two-notch upgrade for the bank's deposits above its unsupported rating;
- Morgan Stanley—a two-notch upgrade for the bank's deposits and senior debt above its unsupported rating; and
- Wells Fargo—a four-notch upgrade for the bank's deposits above its unsupported rating.¹²⁵

Similarly, a newspaper article published in November 2009 stated that S&P, the other leading CRA, "gave Bank of America, Citigroup, Goldman Sachs and Morgan Stanley ratings upgrades of three notches, four notches, two notches and three notches, respectively,

¹²³ See *supra* notes 106, 108–09 and accompanying text (discussing TARP assistance and FDIC debt guarantees provided to the largest banks); Gretchen Morgenson, *So That's Where the Money Went*, N.Y. TIMES, Dec. 5, 2010, § BU, at 1 (reporting that Citigroup, Morgan Stanley, Merrill, and Bank of America were the "biggest recipients," and Goldman was a "large beneficiary," among institutions that received \$3.3 trillion of liquidity assistance from the FRB during the financial crisis).

¹²⁴ See *supra* notes 16–17, 108–11 and accompanying text.

¹²⁵ FIN. CRISIS INQUIRY COMM'N, *supra* note 122, at 33–34 (citations omitted) (summarizing and quoting Moody's investor reports issued between May and December 2009).

because of their presumed access to governmental assistance.”¹²⁶ Thus, the largest banks benefited significantly during the financial crisis from their status as TBTF institutions, because they received explicit and implicit public support that was far more generous than the assistance given to smaller banks.¹²⁷

Given the major advantages conferred by TBTF status, it is not surprising that LCFIs have pursued aggressive growth strategies during the past two decades to reach a size at which they would be presumptively TBTF.¹²⁸ All of today’s four largest U.S. banks (Bank of America, Chase, Citigroup, and Wells Fargo) are the products of serial acquisitions and explosive growth since 1990.¹²⁹ Bank of America’s and Citigroup’s rapid expansions led them to brink of failure, from which they were saved by huge federal bailouts.¹³⁰ Wachovia (the fourth-largest U.S. bank at the beginning of the crisis) pursued a similar path of frenetic growth until it collapsed in 2008

¹²⁶ *Id.* at 34; accord Peter Eavis, *Banks’ Safety Net Fraying*, WALL ST. J., Nov. 16, 2009, at C6 (reporting that “S&P gives Citigroup a single-A rating, but adds that it would be rated triple-B-minus, four notches lower, with no [governmental] assistance,” while “Morgan Stanley and Bank of America get a three-notch lift,” and “Goldman Sachs Group enjoys a two-notch benefit”).

¹²⁷ See Cheryl D. Block, *Measuring the True Cost of Government Bailout*, 88 WASH. U. L. REV. 149, 174–78, 183–85, 201–06, 218–19, 224–25 (2010); Nadezhda Malysheva & John R. Walter, *How Large Has the Federal Financial Safety Net Become?*, 96 FED. RES. BANK RICHMOND ECON. Q. No. 3, at 273, 273–81 (2010), available at http://www.richmondfed.org/publications/research/economic_quarterly/2010/q3/pdf/walter.pdf.

¹²⁸ See, e.g., Robert De Young et al., *Mergers and Acquisitions of Financial Institutions: A Review of the Post-2000 Literature*, 36 J. FIN. SERVS. RES. 87, 96–97, 104 (2009) (reviewing studies and finding that “subsidies associated with becoming ‘too big to fail’ are important incentives for large bank acquisitions”); Elijah Brewer, III & Julapa Jagtiani, *How Much Did Banks Pay to Become Too-Big-to-Fail and to Become Systemically Important?*, 20–22, 33–35 (Fed. Reserve Bank of Phila., Working Paper, 2009) (determining that large banks paid significantly higher premiums to acquire smaller banks when (1) the acquisition produced an institution that crossed a presumptive TBTF threshold, such as \$100 billion in assets or \$20 billion in market capitalization, or (2) a bank that was already TBTF acquired another bank and thereby enhanced its TBTF status), available at <http://ssrn.com/abstract=1548105>; Todd Davenport, *Understanding the Endgame: Scale Will Matter, but How Much?*, AM. BANKER, Aug. 30, 2006, at 1 (describing the widespread belief among banking industry executives that “size is the best guarantor of survival” and that “[t]he best way—and certainly the quickest way—to achieve scale is to buy it”); Wilmarth, *supra* note 120, at 300–08 (citing additional evidence for the conclusion that “TBTF status allows megabanks to operate with virtual ‘fail-safe’ insulation from both market and regulatory discipline”).

¹²⁹ Wilmarth, *supra* note 6, at 745, 745–46 n.150.

¹³⁰ See *supra* notes 14, 105 and accompanying text.

and was rescued by Wells Fargo in a federally assisted merger.¹³¹ A comparable pattern of rapid expansion, collapse, and bailout occurred among several European LCFIs.¹³²

Unfortunately, the emergency acquisitions of LCFIs arranged by U.S. regulators have produced domestic financial markets in which the largest institutions hold even greater dominance.¹³³ In 2009, the four largest U.S. banks (Bank of America, Chase, Citigroup, and Wells Fargo) controlled 56% of domestic banking assets, up from 35% in 2000, while the top ten U.S. banks controlled 75% of domestic banking assets, up from 54% in 2000.¹³⁴ The four largest banks also controlled a majority of the product markets for home mortgages, home equity loans, and credit card loans.¹³⁵ The same four banks and Goldman Sachs accounted for 97% of the aggregate notional values of OTC derivatives contracts written by U.S. banks.¹³⁶

The combined assets of the six largest banks—the foregoing five institutions plus Morgan Stanley—were equal to 63% of the U.S. GDP in 2009, compared to only 17% of the GDP in 1995.¹³⁷ Nomi Prins has observed that, as a result of the financial crisis, “we have larger players who are more powerful, who are more dependent on government capital and who are harder to regulate than they were to

¹³¹ Wilmarth, *supra* note 6, at 746, 746 n.152; *see also* Block, *supra* note 127, at 216–19 (discussing a controversial tax ruling issued by the Treasury Department, which facilitated Wells Fargo’s acquisition of Wachovia by allowing Wells Fargo to offset Wachovia’s pre-acquisition losses against Wells Fargo’s future earnings).

¹³² Wilmarth, *supra* note 6, at 746, 746 n.153.

¹³³ *See supra* notes 15, 104 and accompanying text (discussing acquisitions of Countrywide and Merrill by Bank of America, of Bear and WaMu by Chase, and of Wachovia by Wells Fargo).

¹³⁴ Peter Eavis, *Finance Fixers Still Living in Denial*, WALL ST. J., Dec. 16, 2009, at C18 (discussing assets held by the four largest banks); Heather Landy, *What’s Lost, Gained if Giants Get Downsized*, AM. BANKER, Nov. 5, 2009, at 1 (reviewing assets held by the top ten banks).

¹³⁵ Wilmarth, *supra* note 6, at 747, 747 n.157.

¹³⁶ *Id.* at 747, 747 n.158.

¹³⁷ SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN 202–04, 217 (2010); Peter Boone & Simon Johnson, *Shooting Banks*, NEW REPUBLIC, Mar. 11, 2010, at 20; *see also* Thomas M. Hoenig, President, Fed. Reserve Bank of Kansas City, *It’s Not Over ‘Til It’s Over: Leadership and Financial Regulation* (Oct. 10, 2010) (noting that “the largest five [U.S. BHCs] control \$8.4 trillion of assets, nearly 60 percent of GDP, and the largest 20 control \$12.8 trillion of assets or almost 90 percent of GDP”), *available at* <http://www.kansascityfed.org/speechbio/hoenigpdf/william-taylor-hoenig-10-10-10.pdf>.

begin with.”¹³⁸ Similarly, Simon Johnson and James Kwak contend that “the problem at the heart of the financial system [is] the enormous growth of top-tier financial institutions and the corresponding increase in their economic and political power.”¹³⁹

V

THE DODD-FRANK ACT DOES NOT SOLVE THE TBTF PROBLEM

In 2002, I warned that “the TBTF policy is the great unresolved problem of bank supervision” because it “undermines the effectiveness of both supervisory and market discipline, and it creates moral hazard incentives for managers, depositors, and other uninsured creditors of [LCFIs].”¹⁴⁰ During the current financial crisis, as noted above, the U.S. and European nations followed a TBTF policy that provided more than \$10 trillion of support to the entire financial sector.¹⁴¹ Three studies concluded that the TARP capital infusions and FDIC debt guarantees announced in October 2008 represented very large transfers of wealth from taxpayers to the shareholders and creditors of the largest U.S. LCFIs.¹⁴²

¹³⁸ Alison Fitzgerald & Christine Harper, *Lehman Monday Morning Lesson Lost with Obama Regulator-in-Chief*, BLOOMBERG (Sept. 11, 2009), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aUth4YMml6QE> (quoting Nomi Prins).

¹³⁹ JOHNSON & KWAK, *supra* note 137, at 191.

¹⁴⁰ Wilmarth, *supra* note 120, at 475.

¹⁴¹ See *supra* notes 11–12 and accompanying text.

¹⁴² Elijah Brewer, III & Anne Marie Klingenhagen, *Be Careful What You Wish for: The Stock Market Reactions to Bailing Out Large Financial Institutions*, 18 J. FIN. REG. & COMPLIANCE 56, 57–59, 64–66 (2010) (finding significant increases in stock market valuations for the twenty-five largest U.S. banks as a result of Treasury Secretary Paulson’s announcement, on Oct. 14, 2008, of \$250 billion of TARP capital infusions into the banking system, including \$125 billion for the nine largest banks); Pietro Veronesi & Luigi Zingales, *Paulson’s Gift 2–3*, 11–31 (Chicago Booth Research Paper No. 09-42, 2009), available at <http://ssrn.com/abstract=1498548> (concluding that the TARP capital infusions and FDIC debt guarantees produced \$130 billion of gains for holders of equity and debt securities of the nine largest U.S. banks at an estimated cost to taxpayers of \$21 to \$44 billion); see also CONG. OVERSIGHT PANEL, FEBRUARY OVERSIGHT REPORT: VALUING TREASURY’S ACQUISITIONS 4–8, 26–29, 36–38 (2009), available at <http://cop.senate.gov/documents/cop-020609-report.pdf> (presenting a valuation study concluding (1) that capital infusions into eight major banks (Bank of America, Citigroup, Chase, Goldman, Morgan Stanley, US Bancorp, and Wells Fargo) that were made under TARP’s Capital Purchase Program provided an average subsidy to those banks equal to 22% of the Treasury’s investment and (2) that additional capital infusions into AIG and Citigroup under TARP provided an average subsidy to those institutions equal to 59% of the Treasury’s investment).

The enormous competitive advantages enjoyed by TBTF institutions must be eliminated (or at least significantly reduced) in order to restore a more level playing field for smaller financial institutions and to encourage the voluntary breakup of inefficient and risky financial conglomerates.¹⁴³ The financial crisis has proven, beyond any reasonable doubt, that large universal banks operate based on a dangerous business model that is riddled with conflicts of interest and prone to speculative risk taking.¹⁴⁴

Accordingly, U.S. and European governments must rapidly adopt reforms that will (1) greatly reduce the scope of governmental safety nets and thereby significantly diminish the subsidies currently provided to LCFIs and (2) facilitate the orderly failure and liquidation of LCFIs under governmental supervision, with consequential losses to managers, shareholders, and creditors of LCFIs. A few months before Dodd-Frank was enacted, I wrote an article proposing five key reforms to accomplish these objectives. My proposed reforms would have (1) strengthened existing statutory restrictions on the growth of LCFIs, (2) created a special resolution process to manage the orderly liquidation or restructuring of systemically important financial institutions (SIFIs), (3) established a consolidated supervisory regime and enhanced capital requirements for SIFIs, (4) created a special insurance fund to cover the costs of resolving failed SIFIs, and (5) rigorously insulated FDIC-insured banks that are owned by LCFIs from the activities and risks of their nonbank affiliates.¹⁴⁵

The following sections of Part V of this Article discusses my proposed reforms and compare those proposals to relevant provisions of Dodd-Frank. As shown below, Dodd-Frank includes a portion of my first proposal as well as the major components of my second and third proposals. However, Dodd-Frank omits most of my last two proposals. In my opinion, Dodd-Frank's omissions are highly significant and raise serious doubts about the statute's ability to prevent TBTF bailouts in the future. As explained below, a careful reading of Dodd-Frank indicates that Congress has left the door open

¹⁴³ Wilmarth, *supra* note 6, at 740–44. As I argued in a previous article, large financial conglomerates have never proven their ability to achieve superior performance without the extensive TBTF subsidies they currently receive. *Id.* at 748–49.

¹⁴⁴ Saunders et al., *supra* note 45, at 143–47; Wilmarth, *supra* note 4, at 970–72, 994–1002, 1024–50; JOHNSON & KWAK, *supra* note 137, at 74–87, 120–41, 193, 202–05; John Kay, *Narrow Banking: The Reform of Banking Regulation* 12–16, 41–44, 86–88 (unpublished manuscript), available at <http://www.johnkay.com/wp-content/uploads/2009/12/JK-Narrow-Banking.pdf>.

¹⁴⁵ Wilmarth, *supra* note 6, at 747–79.

for taxpayer-funded protection of creditors of SIFIs during future financial crises.

A. Dodd-Frank Modestly Strengthened Existing Statutory Limits on the Growth of LCFIs but Did Not Close Significant Loopholes

Congress authorized nationwide banking—via interstate branching and interstate acquisitions of banks by BHCs—when it passed the Riegle-Neal Interstate Banking and Branching Act of 1994.¹⁴⁶ To prevent the emergence of dominant megabanks, the Riegle-Neal Act imposed nationwide and statewide deposit concentration limits (“deposit caps”) on interstate expansion by large banking organizations.¹⁴⁷ Under the Riegle-Neal Act, a BHC may not acquire a bank in another state, and a bank may not merge with another bank across state lines, if the resulting banking organization (together with all affiliated FDIC-insured depository institutions) would hold (1) 10% or more of the total deposits of all depository institutions in the United States or (2) 30% or more of the total deposits of all depository institutions in a single state.¹⁴⁸

Unfortunately, the Riegle-Neal Act’s nationwide and statewide deposit caps contained three major loopholes. First, the deposit caps applied only to interstate bank acquisitions and interstate bank mergers, and the deposit caps therefore did not restrict combinations between banking organizations headquartered in the same state. Second, the deposit caps did not apply to acquisitions of, or mergers with, thrift institutions and industrial banks because those institutions were not treated as “banks” under the Riegle-Neal Act.¹⁴⁹ Third, the deposit caps did not apply to acquisitions of, or mergers with, banks

¹⁴⁶ Riegle-Neal Interstate Banking and Branching (Riegle-Neal) Act of 1994, Pub. L. No. 103-328, 108 Stat. 2338.

¹⁴⁷ See H.R. REP. NO. 103-448, at 65–66 (1994) (explaining that the Riegle-Neal Act “adds two new concentration limits to address concerns about potential concentration of financial power at the state and national levels”), reprinted in 1994 U.S.C.C.A.N. 2039, 2065–66.

¹⁴⁸ Riegle-Neal Act §§ 101, 102, 108 Stat. at 2340, 2345 (codified as amended in 12 U.S.C. §§ 1831u(b)(2), 1842(d)(2)). The Riegle-Neal Act permits a state to waive or relax, by statute, regulation, or order, the 30% statewide concentration limit with respect to interstate mergers or acquisitions involving banks located in that state. See 12 U.S.C. §§ 1831u(b)(2)(D), 1842(d)(2)(D).

¹⁴⁹ See Order Approving the Acquisition of a Savings Association and an Industrial Loan Company, 95 Fed. Res. Bull. B13, B14 n.6 (Mar. 2009) [hereinafter FRB Bank of America and Merrill Order] (noting that thrifts and industrial banks “are not ‘banks’ for purposes of the [Riegle-Neal] Act and its nationwide deposit cap”).

that are “in default or in danger of default” (the “failing bank” exception).¹⁵⁰

The emergency acquisitions of Countrywide, Merrill, Washington Mutual (WaMu), and Wachovia in 2008 demonstrated the significance of the Riegle-Neal Act’s loopholes and the necessity of closing them. Based on the “non-bank” loophole, the FRB approved Bank of America’s acquisitions of Countrywide and Merrill even though (1) both firms controlled FDIC-insured depository institutions (a thrift, in the case of Countrywide, and a thrift and industrial bank, in the case of Merrill) and (2) both transactions allowed Bank of America to exceed the 10% nationwide deposit cap.¹⁵¹ Similarly, after the FDIC seized control of WaMu as a failed depository institution, the “non-bank” loophole enabled the FDIC to sell the giant thrift to Chase even though the transaction enabled Chase to exceed the 10% nationwide deposit cap.¹⁵² Finally, although the FRB determined that Wells Fargo’s acquisition of Wachovia gave Wells Fargo control of just under 10% of nationwide deposits, the FRB probably could have approved the acquisition in any case by designating Wachovia as a bank in danger of default.¹⁵³

As a result of the foregoing acquisitions, Bank of America, Chase, and Wells Fargo each surpassed the 10% nationwide deposit cap in October 2008.¹⁵⁴ To prevent further breaches of the Riegle-Neal Act’s concentration limits, I proposed that Congress should extend the

¹⁵⁰ 12 U.S.C. §§ 1831u(e), 1842(d)(5).

¹⁵¹ See Order Approving the Acquisition of a Savings Association and Other Nonbanking Activities, 94 Fed. Res. Bull. C81–C82, C83 n.13 (Aug. 2008) (approving Bank of America’s acquisition of Countrywide and Countrywide’s thrift subsidiary, even though the transaction resulted in Bank of America’s ownership of 10.9% of nationwide deposits); FRB Bank of America and Merrill Order, *supra* note 149, at B13–B14, B14 n.6 (approving Bank of America’s acquisition of Merrill and Merrill’s thrift and industrial bank subsidiaries, even though the transaction resulted in Bank of America’s ownership of 11.9% of nationwide deposits).

¹⁵² Joe Adler, *Thrift M&A Could Suffer as Frank Slams ‘Loophole,’* AM. BANKER, Dec. 10, 2009, at 1.

¹⁵³ See Statement by the Board of Governors of the Federal Reserve System Regarding the Application and Notices by Wells Fargo & Company to Acquire Wachovia Corporation and Wachovia’s Subsidiary Banks and Nonbanking Companies, 95 Fed. Res. Bull. B40, B41–42 (Mar. 2009) (determining that “the combined organization would not control an amount of deposits that would exceed the nationwide deposit cap on consummation of the proposal”); *id.* at B48 (concluding that “expeditious approval of the proposal was warranted in light of the weakened condition of Wachovia”).

¹⁵⁴ See Matt Ackerman, *Big 3 Deposit Share Approaches 33%*, AM. BANKER, Oct. 28, 2008, at 16 (reporting the nationwide deposit shares for Bank of America, Chase, and Wells Fargo as 11.31%, 10.20%, and 11.18%, respectively).

nationwide and statewide deposit caps to cover all intrastate and interstate transactions involving any type of FDIC-insured depository institution, including thrifts and industrial banks. In addition, I proposed that Congress should significantly narrow the failing bank exception by requiring federal regulators to make a “systemic risk determination” (SRD) in order to approve any acquisition involving a failing depository institution that would exceed either the nationwide or statewide deposit caps.¹⁵⁵

Under my proposed standard for an SRD, the FRB and the FDIC could not invoke the failing bank exception unless they determined jointly, with the concurrence of the Treasury Secretary, that the proposed acquisition was necessary “to avoid a substantial threat of severe systemic injury to the banking system, the financial markets or the national economy.”¹⁵⁶ In addition, each invocation of an SRD would be subject to post-transaction review in the form of (1) an audit by the Government Accountability Office (GAO) to determine whether regulators satisfied the criteria for an SRD and (2) a joint hearing held by the House and Senate committees with oversight of the financial markets (the “SRD Review Procedure”). My proposed SRD requirements would have ensured much greater public transparency of, and scrutiny for, any federal agency order that invoked the failing bank exception to the Riegle-Neal Act’s deposit caps.¹⁵⁷

Section 623 of Dodd-Frank does extend the Riegle-Neal Act’s 10% nationwide deposit cap to reach all interstate acquisitions and mergers involving any type of FDIC-insured depository institution. Thus, interstate acquisitions and mergers involving thrift institutions and industrial banks are now subject to the nationwide deposit cap to the same extent as interstate acquisitions and mergers involving commercial banks.¹⁵⁸ However, section 623 leaves open the other Riegle-Neal Act loopholes because (1) it does not apply the nationwide deposit cap to intrastate acquisitions or mergers, (2) it does not apply the statewide deposit cap to interstate transactions

¹⁵⁵ Wilmarth, *supra* note 6, at 752.

¹⁵⁶ *Id.*

¹⁵⁷ *Id.* As discussed below, section 203 of Dodd-Frank establishes a similar “Systemic Risk Determination” requirement and procedure for authorizing the FDIC to act as receiver for a failing SIFI. *See infra* notes 185–86 and accompanying text.

¹⁵⁸ Dodd-Frank Act § 623 (applying the nationwide deposit cap to interstate mergers involving any type of FDIC-insured depository institutions and interstate acquisitions of such depository institutions by either BHCs or savings and loan holding companies).

involving thrifts or industrial banks or to any type of intrastate transaction, and (3) it does not impose any enhanced substantive or procedural requirements for invoking the failing bank exception. Thus, section 623 of Dodd-Frank closes one important loophole but fails to close other significant exemptions that continue to undermine the effectiveness of the Riegle-Neal Act's deposit caps.¹⁵⁹

Section 622 of Dodd-Frank authorizes federal regulators to impose a separate concentration limit on mergers and acquisitions involving "financial companies." As defined in section 622, the term "financial companies" includes insured depository institutions and their holding companies, nonbank SIFIs and foreign banks operating in the U.S.¹⁶⁰ Subject to two significant exceptions described below, section 622 potentially bars any acquisition or merger that would give a "financial company" control of more than 10% of the total "liabilities" of all financial companies.¹⁶¹ This limitation on control of nationwide liabilities ("liabilities cap") was originally proposed by former FRB Chairman Paul Volcker.¹⁶²

The liabilities cap in section 622 provides an additional method for restricting the growth of very large financial companies (e.g., Citigroup, Goldman, and Morgan Stanley) that rely mainly on

¹⁵⁹ The absence of any deposit cap limiting intrastate transactions is somewhat mitigated by the fact that any proposal by a large bank to acquire an in-state rival would be subject to antitrust scrutiny, especially if they were direct competitors in the same local markets. However, federal regulators substantially relaxed their standards for reviewing bank mergers after 1980, with the result that very few bank mergers have been denied during the past two decades. Bernard Shull & Gerald A. Hanweck, *Bank Merger Policy: Proposals for Change*, 119 *BANKING L.J.* 214, 215–24 (2002). For example, the FRB denied only five bank acquisition proposals on competitive grounds between 1987 and 1997, and the FRB evidently did not deny any bank merger applications based on competitive factors between 1997 and 2007. See Bernard Shull & Gerald A. Hanweck, *A New Merger Policy for Banks*, 45 *ANTITRUST BULL.* 679, 694 (2000) (providing data for 1987–1997); Edward Pekarek & Michela Huth, *Bank Merger Reform Takes an Extended Philadelphia National Bank Holiday*, 13 *FORDHAM J. CORP. & FIN. L.* 595, 609 (2008) (providing information for 1997–2007).

¹⁶⁰ Dodd-Frank Act § 622 (enacting section 14(a)(2) of the Bank Holding Company (BHC) Act).

¹⁶¹ Under section 622, the term "liabilities" is defined as the risk-weighted assets of a financial company minus its regulatory capital as determined under the applicable risk-based capital rules. *Id.* § 622 (enacting a new section 14(a)(3) of the BHC Act).

¹⁶² See Rebecca Christie & Phil Mattingly, 'Volcker Rule' Draft Signals Obama Wants to Ease Market Impact, *BLOOMBERG* (Mar. 4, 2010), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aHT_LKrSCQ1c.

funding from the capital markets instead of deposits.¹⁶³ I supported the Volcker liabilities cap in my previous article.¹⁶⁴

However, the liabilities cap in section 622 has two significant exceptions. First, it is subject to a “failing bank” exception (similar to the “failing bank” loophole in Riegel-Neal), which regulators can invoke without making any SRD.¹⁶⁵

Second, and more importantly, the liabilities cap is not self-executing. Section 622 requires the Financial Stability Oversight Council (FSOC) to conduct a study of the potential costs and benefits of the liabilities cap, including any negative effects on (1) “the efficiency and competitiveness of U.S. financial firms and financial markets” and (2) “the cost and availability of credit and other financial services to [U.S.] households and businesses.”¹⁶⁶ Based on the results of that study, section 622 directs the FSOC to “make recommendations regarding any modifications” to the liabilities cap.¹⁶⁷ Section 622 further requires the FRB to adopt regulations for the purpose of “implementing” the liabilities cap in accordance with any “recommendations” by the FSOC for “modifications” of the cap.¹⁶⁸ Thus, section 622 allows the FRB to weaken (and perhaps even eliminate) the liabilities cap if the FSOC determines that the cap would have adverse effects that would outweigh its potential benefits.

LCFIs will almost certainly urge the FSOC and the FRB to weaken or remove the liabilities cap under section 622. Consequently, it is questionable whether Dodd-Frank will impose any meaningful new limit on the growth of LCFIs beyond the statute’s beneficial extension of the nationwide deposit cap to reach all interstate acquisitions and mergers involving FDIC-insured institutions.

¹⁶³ See JOHNSON & KWAK, *supra* note 137, at 213 (noting that Goldman and Morgan Stanley each had more than \$1 trillion of assets at the end of 2007); Wilmarth, *supra* note 6, at 749 n.166, 753 n.183 (stating that Goldman and Morgan Stanley relied primarily on the capital markets for funding, as each firm had less than \$70 billion of deposits in 2009, while Citigroup had \$1.8 trillion of assets but only \$200 billion of domestic deposits).

¹⁶⁴ Wilmarth, *supra* note 6, at 753.

¹⁶⁵ Dodd-Frank Act § 622 (enacting section 14(b) of the BHC Act).

¹⁶⁶ *Id.* (enacting section 14(e) of the BHC Act). The FSOC’s study is also directed to take account of “financial stability [and] moral hazard in the financial system” in evaluating the costs and benefits of the liabilities cap. *Id.*

¹⁶⁷ *Id.* (enacting section 14(e)(1) of the BHC Act).

¹⁶⁸ *Id.* (enacting section 14(d) and (e)(2) of the BHC Act).

B. Dodd-Frank Establishes a Special Resolution Regime for Systemically Important Financial Institutions but Allows the FDIC to Provide Full Protection for Favored Creditors of Those Institutions

1. Dodd-Frank's Orderly Liquidation Authority Does Not Preclude Full Protection of Favored Creditors of SIFIs

During the financial crisis—as shown by the FRB's emergency assistance for Chase's acquisition of Bear, the traumatic bankruptcy of Lehman, and the federal government's massive bailout of AIG—federal regulators confronted a “Hobson's choice of bailout or disorderly bankruptcy” when they decided how to respond to a SIFI's potential failure.¹⁶⁹ Dodd-Frank establishes an “orderly liquidation authority” (OLA) for SIFIs. The OLA seeks to provide a “viable alternative to the undesirable choice... between bankruptcy of a large, complex financial company that would disrupt markets and damage the economy, and bailout of such financial company that would expose taxpayers to losses and undermine market discipline.”¹⁷⁰ In some respects, Dodd-Frank's OLA for SIFIs—which is similar to the FDIC's existing resolution regime for failed depository institutions¹⁷¹—resembles my proposal for a special resolution regime for SIFIs.¹⁷² However, contrary to the statute's stated purpose of ending bailouts,¹⁷³ Dodd-Frank's OLA does not preclude future rescues of favored creditors of TBTF institutions.

Dodd-Frank establishes the FSOC as an umbrella organization with systemic risk oversight authority. The FSOC's voting members include the leaders of nine major federal banking agencies and an independent member with insurance experience.¹⁷⁴ By a two-thirds

¹⁶⁹ Daniel K. Tarullo, Governor, U.S. Fed. Reserve Bd., Financial Regulatory Reform, Speech at the U.S. Monetary Policy Forum (Feb. 26, 2010), *available at* <http://www.federalreserve.gov/newsevents/speech/tarullo20100226a.htm>.

¹⁷⁰ S. REP. NO. 111-176, at 4 (2010).

¹⁷¹ See CARNELL ET. AL., *supra* note 118, ch. 13 (describing the FDIC's resolution regime for failed banks); Fed. Deposit Ins. Corp., Notice of Proposed Rulemaking Implementing Certain Orderly Liquidation Authority Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 75 Fed. Reg. 64,173, 64,175 (Oct. 19, 2010) [hereinafter FDIC Proposed OLA Rule] (stating that “[p]arties who are familiar with the liquidation of insured depository institutions . . . will recognize many parallel provisions in Title II” of Dodd-Frank).

¹⁷² See Wilmarth, *supra* note 6, at 754–57.

¹⁷³ See Dodd-Frank Act pmb. (stating that the statute is designed “to end ‘too big to fail’ [and] to protect the American taxpayer by ending bailouts”).

¹⁷⁴ The FSOC is chaired by the Secretary of the Treasury and includes the following additional voting members: the chairmen of the FRB and the FDIC, the Comptroller of the

vote, the FSOC may determine that a domestic or foreign nonbank financial company should be subject to Dodd-Frank's systemic risk regime, which includes prudential supervision by the FRB and potential liquidation by the FDIC under the OLA.¹⁷⁵ In deciding whether to impose Dodd-Frank's systemic risk regime on a nonbank financial company, the crucial question to be decided by the FSOC is whether "material financial distress at the . . . nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the . . . nonbank financial company, could pose a threat to the financial stability of the United States."¹⁷⁶

Dodd-Frank does not use the term "systemically important financial institution" to describe a nonbank financial company that is subject to the statute's systemic risk regime, but I will generally refer to such companies as SIFIs. Dodd-Frank generally treats BHCs with assets of more than \$50 billion as SIFIs, and those BHCs are also subject to enhanced supervision by the FRB and potential liquidation by the FDIC under the OLA.¹⁷⁷

Dodd-Frank contemplates the public identification of SIFIs, as I have previously advocated.¹⁷⁸ Some commentators have opposed any

Currency, the chairmen of the Commodity Futures Trading Commission and the SEC, the director of the National Credit Union Administration, the chairman of the Federal Housing Finance Agency, the director of the Bureau of Consumer Financial Protection (created by Title X of Dodd-Frank), and an independent member with insurance experience appointed by the President. Dodd-Frank Act § 111(b). In addition, the FSOC includes the following five non-voting advisory members: the director of the Office of Financial Research (created by Title I of Dodd-Frank), the director of the Federal Insurance Office (created by Title V of Dodd-Frank), a state banking supervisor, a state insurance commissioner, and a state securities regulator. *Id.*

¹⁷⁵ *Id.* §§ 113(a), (b), 201(a)(11)(B)(ii), 204(a); S. REP. NO. 111-176, at 48–49, 57 (2010). A "nonbank financial company" is a U.S. or foreign company that is "predominantly engaged" in financial activities in the United States. Dodd-Frank Act § 102(a)(4). A nonbank company is deemed to be "predominantly engaged" in financial activities if at least 85% of its consolidated annual gross revenues or at least 85% of its consolidated assets are derived from or related to activities that are "financial in nature" as defined in 12 U.S.C. § 1843(k). Dodd-Frank Act § 102(a)(6).

¹⁷⁶ Dodd-Frank Act § 113(a)(1), (b)(1). For a complete list of the factors to be considered by the FSOC in determining whether to impose Dodd-Frank's systemic risk regime on a nonbank financial company, see *id.* § 113(a)(2), (b)(2).

¹⁷⁷ *Id.* §§ 115, 165. The FRB may decide, pursuant to a recommendation from the FSOC, that Dodd-Frank's systemic risk regime should be applied only to BHCs with an asset size threshold that is higher than \$50 billion. See *id.* §§ 115(a)(2), 165(a)(2)(B).

¹⁷⁸ See Dodd-Frank Act § 114 (requiring each nonbank SIFI to register with the FRB); *id.* § 165(f) (authorizing the FRB to prescribe enhanced public disclosure requirements for

identification of SIFIs, due to concerns that firms designated as SIFIs would be treated as TBTF by the financial markets and would create additional moral hazard.¹⁷⁹ However, moral hazard already exists in abundance because the financial markets currently treat major LCFIs as presumptively TBTF. The financial markets' preferential treatment for major LCFIs is a rational response to the extraordinary support that federal regulators provided during the financial crisis to LCFIs, including Bear, AIG and the nineteen largest BHCs.¹⁸⁰ Based on regulators' past actions, depositors, bondholders, and CRAs clearly expect that leading LCFIs will receive TBTF treatment in the future.¹⁸¹

Accordingly, federal regulators can no longer credibly retreat to their former policy of "constructive ambiguity" by asserting their willingness to allow major LCFIs to collapse into disorderly bankruptcies similar to the Lehman debacle.¹⁸² Neither the public nor the financial markets would believe such claims.¹⁸³ Dodd-Frank properly recognizes that—absent mandatory breakups of LCFIs—the best way to impose effective discipline on SIFIs, and to reduce the federal subsidies they receive, is to designate them publicly as SIFIs and to impose stringent regulatory requirements that force them to internalize the potential costs of their TBTF status.

nonbank SIFIs and BHCs with assets of \$50 billion or more); *see also* Wilmarth, *supra* note 6, at 755–56 (arguing for public identification of SIFIs).

¹⁷⁹ *See* Malini Manickavasagam & Mike Ferullo, *Regulatory Reform: Witnesses Warn Against Identifying Institutions as Systemically Significant*, 41 *Sec. Reg. & L. Rep.* (BNA) 502 (Mar. 23, 2009).

¹⁸⁰ *See supra* notes 11–14, 102–26 and accompanying text (discussing the Fed's rescues of Bear and AIG and federal regulators' treatment of the nineteen largest BHCs as TBTF).

¹⁸¹ *See* JOHNSON & KWAK, *supra* note 137, at 200–05; *supra* notes 120–26 and accompanying text.

¹⁸² *See* James B. Thomson, *On Systemically Important Financial Institutions and Progressive Systemic Mitigation* 8–10 (Fed. Reserve Bank of Cleveland, Policy Discussion Paper No. 27, 2009) (agreeing that "constructive ambiguity" is not a credible regulatory policy and that SIFIs should be publicly identified).

¹⁸³ *See* JOHNSON & KWAK, *supra* note 137, at 204. In March 2010, Herbert Allison, a senior Treasury Department official, asserted before the Congressional Oversight Panel (COP) that "[t]here is no 'too big to fail' guarantee on the part of the U.S. government." Cheyenne Hopkins, *Pandit Sees a New Citigroup, but Others Aren't Convinced*, *AM. BANKER*, Mar. 5, 2010, at 1 (quoting Mr. Allison). Members of the COP responded to Mr. Allison's claim with derision and disbelief. COP member Damon Silvers declared, "I do not understand why it is that the United States government cannot admit what everyone in the world knows." *Id.* (quoting Mr. Silver and noting that Mr. Allison's claim "angered and baffled the panelists").

As I and many others have proposed, Dodd-Frank establishes a systemic resolution process—the OLA—to handle the failures of SIFIs.¹⁸⁴ In order to invoke the OLA for a “covered financial company,” the Treasury Secretary must issue an SRD, based on the recommendation of the FRB together with either the FDIC or the SEC (if the failing company’s largest subsidiary is a securities broker or dealer) or the Federal Insurance Office (if the failing company’s largest subsidiary is an insurance company).¹⁸⁵ The Treasury Secretary’s SRD must find that (1) the covered financial company’s failure and resolution under otherwise applicable insolvency rules (e.g., the federal bankruptcy laws) would have “serious adverse effects on financial stability,” (2) application of the OLA would “avoid or mitigate such adverse effects,” and (3) “no viable private sector alternative is available to prevent” the company’s failure.¹⁸⁶

In my previous article, I argued that the systemic resolution process for SIFIs should embody three core principles in order to create a close similarity between that process and Chapter 11 of the federal Bankruptcy Code. Those core principles are: (1) requiring equity owners in a failed SIFI to lose their entire investment if the SIFI’s assets are insufficient to pay all valid creditor claims, (2) removing senior managers and other employees who were responsible for the SIFI’s failure, and (3) requiring unsecured creditors to accept meaningful “haircuts” in the form of significant reductions of their

¹⁸⁴ S. REP. NO. 111-176, at 4–6, 57–65 (2010); Wilmarth, *supra* note 6, at 756–57.

¹⁸⁵ Dodd-Frank Act § 203(a). “Covered financial companies” include nonbank financial companies that have been designated as SIFIs under section 113 of the Dodd-Frank Act, large BHCs, and any other financial company as to which the Treasury Secretary has issued an SRD in order to invoke the OLA. *Id.* § 201(a)(8), (11).

¹⁸⁶ *Id.* § 203(b). If the board of directors of a covered financial company does not agree to the appointment of the FDIC as receiver under the OLA, the Treasury Secretary’s SRD will be subject to expedited judicial review in an emergency confidential proceeding in the U.S. District Court for the District of Columbia. *Id.* § 202(a). The district court must issue its order within twenty-four hours after the Treasury Secretary files a petition to initiate the proceeding. *Id.* § 202(a)(1)(A). If the district court fails to issue its order within that time period, the Treasury Secretary’s petition will be deemed approved as a matter of law. *Id.* § 202(a)(1)(A)(v). The district court’s scope of review is limited to two issues: (1) whether the company in question is a “financial company” as defined in section 201(11) of the Dodd-Frank Act and (2) whether the company is “in default or danger of default.” *Id.* § 202(a)(1)(A)(iv). After the SRD becomes final, the Treasury Secretary must provide reports of the SRD to Congress and the public, and the SRD must be audited by the GAO in a manner similar to my proposed SRD Review Procedure. *Id.* § 203(b), (c); see also Wilmarth, *supra* note 6, at 752, 752 n.178. In contrast to my proposal, congressional review of an SRD is discretionary rather than mandatory. See Dodd-Frank Act § 203(c)(3)(C) (providing that the FDIC and the primary financial regulator—if any—for a failed SIFI must appear before Congress to testify on the SRD “if requested”).

debt claims or an exchange of substantial portions of their debt claims for equity in a successor institution. I would have required the FDIC to prepare an SRD and to comply with the SRD Review Procedure if the FDIC proposed to depart from any of those principles based on systemic risk considerations.¹⁸⁷

Dodd-Frank incorporates the first two of my core principles. It requires the FDIC to ensure that equity owners of a failed SIFI do not receive any payment until all creditor claims are paid and that the managers responsible for the failure are removed.¹⁸⁸ At first glance, Dodd-Frank seems to embody the third principle by directing the FDIC to impose losses on unsecured creditors if the assets of the SIFI are insufficient to pay all secured and unsecured debts.¹⁸⁹ However, a careful reading of the statute reveals that Dodd-Frank authorizes the FDIC to provide full protection to favored classes of unsecured creditors of failed SIFIs.

In its capacity as receiver for a failed SIFI, the FDIC may provide funds for the payment or transfer of creditors' claims in at least two ways. First, the FDIC may provide funding directly to the SIFI's receivership estate by making loans, purchasing or guaranteeing assets, or assuming or guaranteeing liabilities.¹⁹⁰ Second, the FDIC may provide funding to establish a "bridge financial company" (BFC), and the FDIC may then approve a transfer of designated assets and liabilities from the failed SIFI to the BFC.¹⁹¹ In either case, the FDIC may (1) take steps to "mitigate[] the potential for serious adverse effects to the financial system"¹⁹² and (2) provide preferential treatment to certain creditors if the FDIC determines that such treatment is necessary to "maximize" the value of a failed SIFI's assets or to preserve "essential" operations of the SIFI or a successor

¹⁸⁷ Wilmarth, *supra* note 6, at 756–57, 752 (arguing that the FDIC should be required to show that a departure from the core principles was "necessary in order to avoid a substantial threat of severe systemic injury to the banking system, the financial markets, or the national economy" in order to satisfy the prerequisites for an SRD).

¹⁸⁸ Dodd-Frank Act §§ 204(a)(1), (2), 206(2), (4).

¹⁸⁹ §§ 204(a)(1), 206(3).

¹⁹⁰ § 204(d). The FDIC may not acquire any equity interest in a failed SIFI or any subsidiary thereof. § 206(6).

¹⁹¹ *Id.* § 210(h)(1), (3), (5). A BFC may not accept a transfer of any claims that are based on equity ownership interests in a failed SIFI. § 210(h)(3)(B).

¹⁹² *Id.* § 210(a)(9)(E)(iii); *see also id.* § 206(1) (requiring the FDIC to determine that its actions as receiver are "necessary for purposes of the financial stability of the United States, and not for the purpose of preserving the [failed SIFI]").

BFC.¹⁹³ Subject to the foregoing conditions, the FDIC may give preferential treatment to certain creditors as long as every creditor receives at least the amount she would have recovered in a liquidation proceeding under Chapter 7 of the federal Bankruptcy Code.¹⁹⁴

In October 2010, the FDIC issued a proposed rule to implement the OLA under Dodd-Frank. The proposed rule states that the FDIC may provide preferential treatment to certain creditors in order “to continue key operations, services, and transactions that will maximize the value of the [failed SIFI’s] assets and avoid a disorderly collapse in the marketplace.”¹⁹⁵ The proposed rule also declares that the FDIC’s powers under the OLA “parallel authority the FDIC has long had under the Federal Deposit Insurance Act to continue operations after the closing of failed insured banks if necessary to maximize the value of the assets... or to prevent ‘serious adverse effects on economic conditions or financial stability.’”¹⁹⁶ The proposed rule would exclude the following classes of creditors from any possibility of preferential treatment: (1) holders of unsecured senior debt with a term of more than 360 days and (2) holders of subordinated debt. Accordingly, the proposed rule would allow the FDIC to provide full protection to short-term, unsecured creditors of a failed SIFI whenever the FDIC determines that such protection is “essential for [the SIFI’s] continued operation and orderly liquidation.”¹⁹⁷

Under the proposed rule, the FDIC is likely to give full protection to short-term liabilities of SIFIs, including commercial paper and securities repurchase agreements, because those liabilities proved to be highly volatile and prone to creditor “runs” during the financial crisis.¹⁹⁸ The proposed rule’s statement that the FDIC reserves the right to provide preferential treatment to short-term creditors of failed SIFIs, but will *never* provide such treatment to holders of long-term debt or subordinated debt, will likely have at least two perverse results. If adopted, the proposed rule will (1) provide an implicit subsidy to short-term creditors of SIFIs and (2) encourage SIFIs to

¹⁹³ § 210(b)(4), (h)(5)(E).

¹⁹⁴ *Id.*; see also FDIC Proposed OLA Rule, *supra* note 171, at 64,175, 64,177 (explaining Dodd-Frank’s minimum guarantee for creditors of a failed SIFI).

¹⁹⁵ FDIC Proposed OLA Rule, *supra* note 171, at 64,175.

¹⁹⁶ *Id.* at 64177 (quoting 12 U.S.C. § 1823(c)).

¹⁹⁷ *Id.* at 64177–78.

¹⁹⁸ See Zoltan Pozsar et al., *Shadow Banking* 2–6, 46–59 (Fed. Reserve Bank of N.Y., Staff Report No. 458, 2010), available at http://www.newyorkfed.org/research/staff_reports/sr458.pdf.

rely even *more* heavily on vulnerable, short-term funding strategies that led to repeated disasters during the financial crisis. The proposed rule will make short-term liabilities more attractive to SIFIs because short-term creditors are likely to demand much lower yields, in light of their implicit subsidy under the proposed rule, compared to long-term bondholders (who will charge higher yields to protect themselves against the significant risk of suffering haircuts in any future OLA receivership).

As indicated by the proposed rule, Dodd-Frank gives the FDIC considerable leeway to provide de facto bailouts for favored creditors of failed SIFIs. Dodd-Frank also provides a funding source for such bailouts. Section 201(n) of Dodd-Frank establishes an Orderly Liquidation Fund (OLF) to finance liquidations of SIFIs. As discussed below in Part V.D., Dodd-Frank does not establish a pre-funding mechanism for the OLF. However, the FDIC may obtain funds for the OLF by borrowing from the Treasury. Under section 201(n)(5) of Dodd-Frank, the FDIC may borrow up to (1) 10% of a failed SIFI's assets within thirty days after the FDIC's appointment as receiver plus (2) 90% of the "fair value" of the SIFI's assets that are "available for repayment" thereafter.¹⁹⁹ The FDIC's authority to borrow from the Treasury provides an immediate source of funding to protect unsecured creditors that are deemed to have systemic significance. In addition, the "fair value" standard potentially gives the FDIC considerable discretion in appraising the assets of a failed SIFI because the standard does not require the FDIC to rely on current market values in measuring the worth of a failed SIFI's assets.²⁰⁰

¹⁹⁹ Dodd-Frank Act § 210(n)(5), (6). In order to borrow funds from the Treasury to finance an orderly liquidation, the FDIC must enter into a repayment agreement with the Treasury after consulting with the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services. *Id.* § 210(n)(9).

²⁰⁰ Jeffrey Gordon and Christopher Muller have criticized Dodd-Frank on somewhat different grounds. In contrast to my concern that Dodd-Frank will allow the FDIC to finance future bailouts of favored creditors of failed SIFIs, Gordon and Muller believe that (1) the OLA provides "inadequate funding for the orderly resolution of individual firms," and (2) Dodd-Frank's "stringent constraints on government financial support of firms not in FDIC receivership will drive firms into receivership," resulting in a "nationalization of much of the financial sector" during a serious financial crisis. Jeffrey N. Gordon & Christopher Muller, *Confronting Financial Crisis: Dodd-Frank's Dangers and the Case for a Systemic Emergency Insurance Fund* 38–48 (Columbia Law & Econ., Working Paper No. 374, Draft 3.0, Sept. 2010), available at <http://ssrn.com/abstract=1636456>. Gordon and Muller identify the FDIC's authority to provide loan guarantees to SIFIs placed in receivership as the only source of financial assistance that Dodd-Frank allows for specific troubled firms, apart from the FDIC's limited (and in their view inadequate) authority to borrow from the Treasury based on the value of a failed SIFI's assets. *Id.* As

Dodd-Frank generally requires the FDIC to impose a “claw-back” on creditors who receive preferential treatment if the proceeds of liquidating a failed SIFI are insufficient to repay the full amount that the FDIC borrows from the Treasury to conduct the liquidation.²⁰¹ However, as noted above, Dodd-Frank authorizes the FDIC to exercise its powers under the OLA (including its authority to provide preferential treatment to favored creditors of a failed SIFI) for the purpose of preserving “the financial stability of the United States” and preventing “serious adverse effects to the financial system.”²⁰² Therefore, the FDIC could conceivably assert the power to waive its right of “claw-back” against a failed SIFI’s creditors who received preferential treatment if the FDIC determined that such a waiver were necessary to maintain the stability of the financial markets.

2. *Dodd-Frank Does Not Prevent Federal Regulators from Using Other Sources of Funding to Protect Creditors of SIFIs*

Dodd-Frank could potentially be interpreted as allowing the FDIC to borrow an additional \$100 billion from the Treasury for use in accomplishing the orderly liquidation of a SIFI. Dodd-Frank states that the FDIC’s borrowing authority for the OLF does not “affect” the FDIC’s authority to borrow from the Treasury Department under 12 U.S.C. § 1824(a).²⁰³ Under § 1824(a), the FDIC may exercise its “judgment” to borrow up to \$100 billion from the Treasury “for insurance purposes,” and the term “insurance purposes” appears to include functions beyond the FDIC’s responsibility to administer the Deposit Insurance Fund (DIF) for banks and thrifts.²⁰⁴ Dodd-Frank

discussed below in Part V.B.2., I believe that the FDIC and the FRB can use additional sources of funding to support failing or failed SIFIs and their subsidiary banks. However, I agree with Gordon and Muller that Dodd-Frank contains serious flaws, including its lack of a pre-funded systemic risk insurance fund. *See infra* Part V.D.

²⁰¹ Dodd-Frank Act § 210(o)(1)(B), (D); *see also* FDIC Proposed OLA Rule, *supra* note 171, at 64,178 (stating that Dodd-Frank “includes the power to ‘claw-back’ or recoup some or all of any additional payments made to creditors if the proceeds of the sale of the [failed SIFI’s] assets are insufficient to repay any monies drawn from the Treasury during the liquidation”).

²⁰² Dodd-Frank Act § 206(1); *see also* § 210(a)(9)(E)(iii).

²⁰³ *Id.* § 201(n)(8)(A).

²⁰⁴ Under § 1824(a), the FDIC may exercise its “judgment” to borrow up to \$100 billion “for insurance purposes,” and such borrowed funds “shall be used by the [FDIC] solely in carrying out its functions with respect to such insurance.” 12 U.S.C. § 1824(a). Section 1824(a) further provides that the FDIC “*may* employ any funds obtained under this section for purposes of the [DIF] and the borrowing shall become a liability of the [DIF] to the extent funds are employed therefor.” *Id.* (emphasis added). The foregoing language

bars the FDIC from using the DIF to assist the OLF or from using the OLF to assist the DIF.²⁰⁵ However, the FDIC could conceivably assert authority to borrow up to \$100 billion from the Treasury under § 1824(a) for the “insurance purpose” of financing an orderly liquidation of a SIFI *outside* the funding parameters of the OLF. Assuming that such supplemental borrowing authority is available to the FDIC, the FDIC could use that authority to protect a SIFI’s uninsured and unsecured creditors as long as such protection “maximizes” the value of the SIFI’s assets or “mitigates the potential for serious adverse effects to the financial system.”²⁰⁶

The “systemic risk exception” (SRE) to the Federal Deposit Insurance Act (FDIA) provides a further potential source of funding to protect creditors of failed SIFIs.²⁰⁷ Under the SRE, the Treasury Secretary can authorize the FDIC to provide full protection to uninsured creditors of a bank in order to avoid or mitigate “serious effects on economic conditions or financial stability.”²⁰⁸ Dodd-Frank amended and narrowed the SRE by requiring that a bank must be placed in receivership in order for the bank’s creditors to receive extraordinary protection under the SRE.²⁰⁹ Thus, if a failing SIFI owned a bank that was placed in receivership, the SRE would permit the FDIC (with the Treasury Secretary’s approval) to provide full protection to creditors of that bank in order to avoid or mitigate systemic risk. By protecting a SIFI-owned bank’s creditors (which could include the SIFI itself), the FDIC could use the SRE to extend indirect support to the SIFI’s creditors.

Two provisions of Dodd-Frank seek to prevent the FRB and the FDIC from providing financial support to failing SIFIs or their subsidiary banks outside the OLA or the SRE. First, section 1101 of

strongly indicates that funds borrowed by the FDIC under § 1824(a) do not have to be used exclusively for the DIF and can be used for other “insurance purposes” in accordance with the “judgment” of the Board of Directors of the FDIC. It could be argued that borrowing for the purpose of funding the OLF would fall within such “insurance purposes.”

²⁰⁵ Dodd-Frank Act § 210(n)(8)(A).

²⁰⁶ § 210(a)(9)(E)(i), (iii).

²⁰⁷ See FIN. CRISIS INQUIRY COMM’N, *supra* note 122, at 10–11, 29–32 (discussing the SRE under 12 U.S.C. § 1823(c)(4)(G), as originally enacted in 1991 and as invoked by federal regulators during the financial crisis).

²⁰⁸ In order to invoke the SRE, the Treasury Secretary must receive a favorable recommendation from the FDIC and the FRB and consult with the President. 12 U.S.C. § 1823(c)(4)(G)(i).

²⁰⁹ See Dodd-Frank Act § 1106(b) (amending 12 U.S.C. § 1823(c)(4)(G)).

Dodd-Frank provides that the FRB may not extend emergency secured loans under section 13(3) of the Federal Reserve Act²¹⁰ except to solvent firms that are “participant[s] in any program or facility with broad-based eligibility” that has been approved by the Treasury Secretary and reported to Congress.²¹¹ Second, section 1105 of Dodd-Frank provides that the FDIC may not guarantee debt obligations of depository institutions or their holding companies or other affiliates except pursuant to a “widely available program” for “solvent” institutions that has been approved by the Treasury Secretary and endorsed by a joint resolution of Congress.²¹²

In light of the foregoing constraints, it is difficult to envision how the FRB or the FDIC could provide loans or debt guarantees to *individual* failing SIFIs or their subsidiary banks under sections 1101 or 1105 of Dodd-Frank.²¹³ However, the FRB arguably could use its remaining authority under section 13(3) to create a “broad-based” program similar to the Primary Dealer Credit Facility (PDCF) in order to provide emergency liquidity assistance to a selected *group* of LCFIs that the FRB deemed to be “solvent.”²¹⁴ As the events of 2008

²¹⁰ 12 U.S.C. § 343; *see also* FIN. CRISIS INQUIRY COMM’N, *supra* note 122, at 19, 21–22, 25–26 (discussing section 13(3) as amended in 1991 and as applied by the FRB to provide emergency secured credit to particular firms and segments of the financial markets during the financial crisis).

²¹¹ Dodd-Frank Act § 1101(a) (requiring the Fed to use its section 13(3) authority solely for the purpose of establishing a lending “program or facility with broad-based eligibility” that is open only to solvent firms and is designed “for the purpose of providing liquidity to the financial system, and not to aid a failing financial company”); *see* S. REP. NO. 111-176, at 6, 182–83 (2010) (discussing Dodd-Frank’s restrictions on the FRB’s lending authority under section 13(3)).

²¹² Dodd-Frank Act § 1105. In addition, Dodd-Frank bars the FDIC from establishing any “widely available debt guarantee program” based on the SRE under the FDI Act. *Id.* § 1106(a). In October 2008, federal regulators invoked the SRE in order to authorize the FDIC to establish the Debt Guarantee Program (DGP). The DGP enabled depository institutions and their affiliates to issue more than \$300 billion of FDIC-guaranteed debt securities between October 2008 and the end of 2009. *See* FIN. CRISIS INQUIRY COMM’N, *supra* note 122, at 29–32. However, Dodd-Frank prohibits regulators from using the SRE to establish any program similar to the DGP. Dodd-Frank Act § 1106(a); *see also* S. REP. NO. 111-176, at 6–7, 183–84 (discussing Dodd-Frank’s limitations on the FDIC’s authority to guarantee debt obligations of depository institutions and their holding companies).

²¹³ *See* Gordon & Muller, *supra* note 200, at 40, 44–47.

²¹⁴ The FRB established the PDCF in March 2008 (at the time of its rescue of Bear) and expanded that facility in September 2008 (at the time of Lehman’s failure). The PDCF allowed the nineteen primary dealers in government securities to make secured borrowings from the FRB on a basis similar to the FRB’s discount window for banks. The nineteen primary dealers eligible for participation in the PDCF were securities broker-dealers; however, all but four of those dealers were affiliated with banks. As of March 1, 2008, the

demonstrated, it is extremely difficult for outsiders (including members of Congress) to second-guess a regulator's determination of solvency during the midst of a systemic crisis. Moreover, regulators are strongly inclined during a crisis to make generous assessments of solvency in order to justify their decision to provide emergency assistance to troubled LCFIs.²¹⁵ Thus, during a financial crisis, the FRB could potentially assert its authority under amended section 13(3) to provide emergency loans to a targeted group of LCFIs that it claimed to be "solvent," such as the primary dealers, with the goal of helping one or more troubled members of that group.

Moreover, Dodd-Frank does not limit the ability of banks owned by LCFIs to receive liquidity support from the FRB's discount window or from Federal Home Loan Banks (FHLBs). The FRB's discount window (often referred to as the FRB's "lender of last resort" facility) provides short-term loans to depository institutions secured by qualifying collateral.²¹⁶ Similarly, FHLBs—described in one study as "lender[s] of next-to-last resort"²¹⁷—make collateralized

FRB's list of primary dealers included all of the "big eighteen" LCFIs except for AIG, Société Générale, and Wachovia. See Tobias Adrian et al., *The Federal Reserve's Primary Dealer Credit Facility*, 15 CURRENT ISSUES ECON. & FIN. No. 4, Aug. 2009; Adam Ashcraft et al., *The Federal Home Loan Bank System: The Lender of Next-to-Last Resort?*, 42 J. MONEY, CREDIT & BANKING 551, 574–75 (2010); *Primary Dealers List*, FED. RESERVE BANK OF N.Y. (Nov. 30, 2007), <http://www.newyorkfed.org/newsevents/news/markets/2007/an071130.html>.

²¹⁵ For example, on October 14, 2008, the Treasury Department announced that it would provide \$125 billion of capital to Bank of America, Citigroup, and seven other major banks pursuant to the Troubled Asset Relief Program. In its announcement, the Treasury Department declared that all nine banks were "healthy." Several weeks later, following public disclosures of serious problems at Bank of America and Citigroup, the Treasury Department made \$40 billion of additional capital infusions into Bank of America and Citigroup, and federal regulators provided asset guarantees covering more than \$400 billion of Bank of America's and Citigroup's assets. The extraordinary assistance provided to Bank of America and Citigroup raised serious questions about the validity (and even the sincerity) of the Treasury Department's declaration that both institutions were "healthy" in October 2008. See CONG. OVERSIGHT PANEL, NOVEMBER OVERSIGHT REPORT: GUARANTEES AND CONTINGENT PAYMENTS IN TARP AND RELATED PROGRAMS 13–27 (2009), available at <http://cop.senate.gov/documents/cop-110609-report.pdf>; SIGTARP BANK OF AMERICA REPORT, *supra* note 14, at 14–31; SIGTARP CITIGROUP REPORT, *supra* note 14, at 4–32, 41–44.

²¹⁶ See 12 U.S.C. § 347b; Ashcraft et al., *supra* note 214, at 552–53, 568–69 (describing the FRB's discount window); Stephen G. Cecchetti, *Crisis and Responses: The Federal Reserve in the Early Stages of the Financial Crisis*, 23 J. ECON. PERSPECTIVES No. 1, at 51, 56–57, 64–66 (2009) (same).

²¹⁷ Ashcraft et al., *supra* note 214, at 554.

“advances” to member institutions, including banks and insurance companies.²¹⁸

During the financial crisis, most banks did not borrow significant amounts from the discount window due to (1) the perceived “stigma” of doing so and (2) the availability of alternative sources of credit through FHLBs and several emergency liquidity facilities that the FRB established under its section 13(3) authority.²¹⁹ In contrast, the FHLBs provided \$235 billion of advances to member institutions during the second half of 2007, following the outbreak of the financial crisis. During that period, FHLBs extended almost \$150 billion of advances to ten major LCFIs. Six of those LCFIs incurred large losses during the crisis, and they either failed, were acquired in emergency transactions, or received “exceptional assistance” from the federal government.²²⁰ Accordingly, FHLB advances provided a significant source of support for troubled LCFIs, especially during the early phase of the financial crisis.²²¹ During future crises, it seems likely that individual LCFIs will use the FRB’s discount window more frequently, along with FHLB advances, because Dodd-Frank prevents the FRB from providing emergency credit to individual institutions under section 13(3).²²²

Discount window loans and FHLB advances cannot be made to banks in receivership, but they do provide a potential source of funding for troubled SIFIs or SIFI-owned banks, as long as that funding is extended prior to the appointment of a receiver for either the bank or the SIFI.²²³ To the extent that the FRB or FHLBs provide

²¹⁸ *Id.* at 555–62, 577–59 (describing collateralized advances provided by FHLBs to member institutions, including banks); FED. HOUSING FIN. AGENCY, REPORT TO CONGRESS 2009, at 65 (2010), available at <http://www.fhfa.gov/webfiles/15784/FHFAReportToCongress52510.pdf> (stating that 210 insurance companies were members of FHLBs and had received almost \$50 billion of advances at the end of 2009).

²¹⁹ Ashcraft et al., *supra* note 214, at 567–79; Cecchetti, *supra* note 216, at 64–72.

²²⁰ Ashcraft et al., *supra* note 214, at 553, 579–80. Of the ten largest recipients of FHLB advances during the second half of 2007, WaMu and Wachovia failed, Countrywide and Merrill were acquired by Bank of America in emergency transactions, and Citigroup and Bank of America received “exceptional assistance” from the federal government. *See id.* at 580, 580 tbl.3; *supra* notes 14–15, 104–07 and accompanying text.

²²¹ Arthur E. Wilmarth, Jr., *Subprime Crisis Confirms Wisdom of Separating Banking and Commerce*, 27 BANKING & FIN. SERVICES POL’Y REP. 1, 6 (2008), available at <http://ssrn.com/abstract=1263453>.

²²² *See supra* notes 210–11, 216–18 and accompanying text.

²²³ *See* 12 U.S.C. § 347b(b) (allowing the FRB to make discount window loans to “undercapitalized” banks subject to specified limitations); *supra* notes 220–21 and

such funding, at least some short-term creditors of troubled SIFIs or SIFI-owned banks are likely to benefit by obtaining full payment of their claims before any receivership is created.

Thus, notwithstanding Dodd-Frank's explicit promise to end bailouts of TBTF institutions,²²⁴ federal agencies retain several powers that will permit them to protect creditors of weakened SIFIs. A more fundamental problem is that Dodd-Frank's "no bailout" pledge will not bind future Congresses. When a future Congress confronts the next systemic financial crisis, that Congress is likely to abandon Dodd-Frank's "no bailout" position either explicitly (by amending or repealing the statute) or implicitly (by looking the other way while regulators expansively construe their authority to protect creditors of SIFIs). For example, Congress and President George H.W. Bush made "never again" statements when they rescued the thrift industry with taxpayer funds in 1989,²²⁵ but those statements did not prevent Congress and President George W. Bush from using public funds to bail out major financial institutions in 2008. As Adam Levitin has observed,

It is impossible . . . to create a standardized resolution system that will be rigidly adhered to in a crisis. . . . Any prefixed resolution regime will be abandoned whenever it cannot provide an acceptable distributional outcome. In such cases, bailouts are inevitable.

This reality cannot be escaped by banning bailouts. Law is an insufficient commitment device for avoiding bailouts altogether. It is impossible to produce binding commitment to a preset resolution process, irrespective of the results. The financial Ulysses cannot be bound to the mast. . . . Once the ship is foundering, we do not want Ulysses to be bound to the mast, lest [we] go down with the ship

accompanying text (noting that FHLBs made large advances during 2007 to troubled LCFIs).

²²⁴ See Dodd-Frank Act pmb.; S. REP. NO. 111-176, at 1 (2010); Kaper, *supra* note 2.

²²⁵ See H.R. REP. NO. 101-54(I), at 310 (1989) (declaring that "Never Again" was "the theme of the Committee's deliberations" on legislation to rescue the thrift industry), reprinted in 1989 U.S.C.C.A.N. 86, 106; George Bush, Remarks on Signing the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (Aug. 9, 1989), available at <http://www.presidency.ucsb.edu/ws/index.php?pid=17414#axzzIIMYLF09> (statement by President George H.W. Bush that the 1989 thrift rescue statute would "safeguard and stabilize America's financial system and put in place permanent reforms so these problems will never happen again" and that "[n]ever again will America allow any insured institution to operate normally if owners lack sufficient tangible capital to protect depositors and taxpayers alike").

and drown. Instead, we want to be sure his hands are free—too bail.²²⁶

Similarly, Cheryl Block has concluded that “despite all the . . . ‘no more taxpayer-funded bailout’ clamor included in recent financial reform legislation, bailouts in the future are likely if circumstances become sufficiently severe.”²²⁷ Accordingly, it seems probable that future Congresses will loosen or remove Dodd-Frank’s constraints on TBTF bailouts, or will permit federal regulators to evade those limitations, whenever such actions are deemed necessary to prevent failures of SIFIs that could destabilize our financial system.²²⁸

C. Dodd-Frank Subjects SIFIs to Consolidated Supervision and Enhanced Prudential Standards, but Those Provisions Are Not Likely to Prevent Future Bailouts of SIFIs

Dodd-Frank authorizes the FRB to obtain reports from and examine nonbank SIFIs and their subsidiaries.²²⁹ Dodd-Frank also provides the FRB with authority to take enforcement actions (including cease-and-desist orders, civil money penalty orders, and orders removing directors and officers) against nonbank SIFIs and their subsidiaries.²³⁰ Thus, Dodd-Frank provides the FRB with consolidated supervision and enforcement authority over nonbank SIFIs comparable to the FRB’s umbrella supervisory and enforcement

²²⁶ Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L.J. 435, 439 (2011).

²²⁷ Block, *supra* note 127, at 224; *see also id.* at 227 (“pretending that there will never be another bailout simply leaves us less prepared when the next severe crisis hits”).

²²⁸ *See* Levitin, *supra* note 226, at 489 (“If an OLA proceeding would result in socially unacceptable loss allocations, it is likely to be abandoned either for improvised resolution or for the statutory framework to be stretched . . . to permit outcomes not intended to be allowed.”).

²²⁹ In obtaining reports from and making examinations of a nonbank SIFI and its subsidiaries, the FRB is required (1) to use “to the fullest extent possible” reports and supervisory information provided by the primary financial regulator of any subsidiary depository institution or other functionally regulated subsidiary (e.g., a securities broker-dealer or an insurance company) and (2) to coordinate with the primary regulator of any such subsidiary. Dodd-Frank Act § 161.

²³⁰ In order to take an enforcement action against any depository institution subsidiary or functionally regulated subsidiary of a nonbank SIFI, the FRB must first recommend that the primary financial regulator should bring an enforcement proceeding against the designated subsidiary. The FRB may initiate an enforcement action if the primary regulator does not take action with sixty days after receiving the FRB’s recommendation. Dodd-Frank Act § 162(b).

powers with respect to BHCs and financial holding companies (FHCs).²³¹

Dodd-Frank requires the FRB (either on its own motion or on the FSOC's recommendation) to adopt enhanced prudential standards for nonbank SIFIs and large BHCs "[i]n order to prevent or mitigate risks to the financial stability of the United States."²³² The enhanced standards must be "more stringent" than the ordinary supervisory rules that apply to nonbank financial companies and BHCs that are not SIFIs.²³³

At a minimum, Dodd-Frank requires the FRB to adopt enhanced risk-based capital requirements, leverage limits, liquidity requirements, overall risk management rules, risk concentration limits, and requirements for resolution plans ("living wills") and credit exposure reports.²³⁴ In addition, the FRB may, in its discretion, require SIFIs to satisfy contingent capital requirements, enhanced public disclosures, short-term debt limits, and additional prudential standards.²³⁵

Dodd-Frank's requirements for consolidated supervision and stronger prudential standards for SIFIs are generally consistent with proposals contained in my previous article on financial regulatory reform.²³⁶ In that article, I gave particular attention to the idea of requiring SIFIs to issue contingent capital in the form of convertible subordinated debt. The contingent capital concept would require such debt to convert automatically into common stock upon the occurrence of a designated event of financial stress, such as (1) a decline in a SIFI's capital below a specified level that would "trigger" an automatic conversion or (2) the initiation of the special resolution process for a SIFI. One advantage of contingent capital is that the SIFI's common equity would be increased (due to the mandatory conversion of subordinated debt) at a time when the SIFI was under

²³¹ See S. REP. NO. 111-176, at 53-54, 83-85 (2010); see also CARNELL ET AL., *supra* note 118, at 437-74 (discussing the FRB's authority to regulate BHCs and FHCs under the BHC Act).

²³² Dodd-Frank Act § 165(a); see also *id.* § 115 (authorizing the FSOC to recommend that the FRB should adopt various types of enhanced prudential standards for nonbank SIFIs and large BHCs).

²³³ *Id.* § 161(a)(1)(A), (d).

²³⁴ *Id.* § 165(b)(1)(A).

²³⁵ § 165(b)(1)(B). The FRB may not impose a contingent capital requirement on nonbank SIFIs or large BHCs until the FSOC completes a study of the potential costs and benefits of such a requirement. *Id.* §§ 115(c), 165(c)(1).

²³⁶ Wilmarth, *supra* note 6, at 757-61.

severe stress and probably could not sell stock in the market. Additionally, mandatory conversion would give holders of convertible subordinated debt a strong incentive to exercise greater discipline over the SIFI's management because those holders would risk losing their entire investment if mandatory conversion occurred.²³⁷

As I explained, it may be very difficult for LCFIs to reach agreement with outside investors on terms for contingent capital that are mutually satisfactory. Institutional investors are not likely to purchase mandatory convertible debt securities unless those securities offer a comparatively high yield and other investor-friendly features that may not be acceptable to LCFIs. Despite widespread support among regulators for mandatory convertible debt, only two foreign banks (and no U.S. banks) sold such debt between 2007 and the end of 2010.²³⁸ However, John Coffee has recently suggested that mandatory convertible debt would be more attractive to investors, managers, and regulators of LCFIs if the debt were converted into voting preferred stock instead of common stock.²³⁹ Coffee explains that "voting, non-convertible senior preferred stock, with a fixed return and cumulative dividends" would "create a constituency with voting rights that would naturally be resistant to increased leverage and higher risk."²⁴⁰ He believes that mandatory conversion of debt securities into voting preferred stock would "reduce shareholder pressure on management" by providing a "counterweight" to common shareholders, who typically favor greater risk taking.²⁴¹

Whether or not contingent capital proves to be a feasible option for outside investors, I previously argued that contingent capital should become a significant component of compensation packages for senior managers and other key employees (e.g., risk managers and traders) of LCFIs. In contrast to outside investors, senior managers and key employees are "captive investors" who can be required, as a condition

²³⁷ *Id.* at 760.

²³⁸ *Id.* at 760–61; John Glover, *UBS, Credit Suisse Need New Investor Base for CoCo Bonds*, BLOOMBERG (Oct. 6, 2010), <http://www.bloomberg.com/news/2010-10-06/ubs-credit-suisse-may-need-new-investor-base-for-coco-bonds.html>; Sara Schaefer Muñoz, *A Hard Road for 'Coco' Debt: Bonds That Convert to Equity Get a Cautious Reception from Potential Issuers*, WALL ST. J., Oct. 15, 2010, at C3.

²³⁹ John C. Coffee, Jr., *Bail-Ins Versus Bail-Outs: Using Contingent Capital to Mitigate Systemic Risk* (Columbia Law Sch. Ctr. for Law & Econ. Studies, Working Paper No. 380, 2010), at 6–9, 25–41.

²⁴⁰ *Id.* at 9.

²⁴¹ *Id.* at 8.

of their continued employment, to accept convertible subordinated debentures in payment of a significant portion (e.g., one-third) of their total annual compensation, including incentive-based compensation. Managers and key employees should not be allowed to make voluntary conversions of their subordinated debentures into common stock until the expiration of a minimum holding period (e.g., three years) after the termination date of their employment. Such a minimum post-employment holding period would discourage managers and key employees from taking excessive risks to boost the value of the conversion option during the term of their employment. At the same time, their debentures should be subject to mandatory conversion into common stock upon the occurrence of a designated “triggering” event of financial distress.²⁴²

Requiring managers and key employees to hold significant amounts of contingent capital during their employment, and for a lengthy period thereafter, should give them positive incentives to manage their institution prudently and with appropriate regard for the interests of creditors as well as longer-term shareholders. Such a requirement would cause managers and key employees to realize that (1) they will not be able to “cash out” a significant percentage of their accrued compensation unless their organization achieves long-term success and viability, and (2) they will lose a significant portion of their accrued compensation if their institution is threatened with failure.²⁴³

Dodd-Frank’s provisions requiring consolidated FRB supervision and enhanced prudential standards for SIFIs represent valuable improvements. For at least five reasons, however, those provisions are unlikely to prevent future failures of SIFIs with the attendant risk of governmental bailouts for systemically significant creditors. First, like previous regulatory reforms, Dodd-Frank relies heavily on the concept of stronger capital requirements. Unfortunately, capital-

²⁴² Wilmarth, *supra* note 6, at 761.

²⁴³ *Id.* For other recent proposals that call for managers and key employees to receive part of their compensation in debt securities in order to encourage them to avoid excessive risk taking, see Lucian Bebchuk & Holger Spamann, *Regulating Bankers’ Pay*, 98 GEO. L.J. 247, 283–86 (2010); Jeffrey N. Gordon, *Executive Compensation and Corporate Governance in Financial Firms: The Case for Convertible Equity Based Pay* 11–14 (Columbia Law & Econ., Working Paper No. 373, 2010), available at <http://ssrn.com/abstract=1633906>; Frederick Tung, *Pay for Banker Performance: Structuring Executive Compensation and Risk Regulation* 31–51 (Emory Law & Econ., Research Paper No. 10-60, 2010), available at <http://ssrn.com/abstract=1546229>. Professor Gordon’s proposal is most similar to my own.

based regulation has repeatedly failed in the past.²⁴⁴ As regulators learned during the banking and thrift crises of the 1980s and early 1990s, capital levels are “lagging indicators” of bank problems²⁴⁵ because (1) “many assets held by banks... are not traded on any organized market and, therefore, are very difficult for regulators and outside investors to value,” and (2) bank managers “have strong incentives to postpone any recognition of asset depreciation and capital losses” until their banks have already suffered serious damage.²⁴⁶

Second, LCFIs have repeatedly demonstrated their ability to engage in “regulatory capital arbitrage” in order to weaken the effectiveness of capital requirements.²⁴⁷ For example, the Basel II international capital accord was designed to prevent the arbitrage techniques (including securitization) that banks used to undermine the effectiveness of the Basel I accord.²⁴⁸ However, many analysts concluded that the Basel II accord (including its heavy reliance on internal risk-based models developed by LCFIs) was seriously flawed and allowed LCFIs to operate with capital levels that were “very, very low... unacceptably low” during the period leading up to the financial crisis.²⁴⁹ In September 2010, the Basel Committee on Bank Supervision (BCBS) gave tentative approval to a new set of proposals known as “Basel III,” which seeks to strengthen the Basel II capital standards significantly.²⁵⁰ BCBS’ adoption of Basel III was widely

²⁴⁴ See *Reforming Banking: Base Camp Basel*, ECONOMIST (Jan. 21, 2010), <http://www.economist.com/node/15328883> (stating that “the record of bank-capital rules is crushingly bad”).

²⁴⁵ 1 FED. DEPOSIT INS. CORP., HISTORY OF THE EIGHTIES: LESSONS FOR THE FUTURE 39–40, 55–56 (1997).

²⁴⁶ Wilmarth, *supra* note 120, at 459; see also DANIEL K. TARULLO, BANKING ON BASEL: THE FUTURE OF INTERNATIONAL FINANCIAL REGULATION 171–72 (2008).

²⁴⁷ JOHNSON & KWAK, *supra* note 137, at 137–41; Wilmarth, *supra* note 120, at 457–61.

²⁴⁸ TARULLO, *supra* note 246, at 79–83.

²⁴⁹ *Reforming Banking: Base Camp Basel*, *supra* note 244 (quoting unnamed regulator); see also *supra* note 76 and accompanying text (noting that European banks and U.S. securities firms that followed Basel II rules operated with very high leverage during the pre-crisis period); TARULLO, *supra* note 246, at 139–214 (identifying numerous shortcomings in the Basel II accord).

²⁵⁰ Daniel Pruzin, *Capital: Financial Sector Gives Cautious Welcome to Agreement on Bank Capital Standards*, 95 Banking Rep. (BNA) 385 (Sept. 14, 2010); see *infra* note 261 and accompanying text (discussing adoption of the Basel III accord and criticisms of its apparent shortcomings).

viewed as an implicit admission of Basel II's inadequacy.²⁵¹ After reviewing a preliminary version of the Basel III proposals, a prominent U.K. financial commentator observed, "We can say with conviction now that Basel II failed."²⁵²

Third, the past shortcomings of capital-based rules are part of a broader phenomenon of supervisory failure. Regulators did not stop large banks from pursuing hazardous (and in many cases fatal) strategies during the 1980s, including rapid growth with heavy concentrations in high-risk assets and excessive reliance on volatile, short-term liabilities. During the 1980s, regulators proved to be unwilling or unable to stop risky behavior as long as banks continued to report profits.²⁵³ Similarly, although the full story is yet to be told, there is wide agreement that federal banking and securities regulators repeatedly failed to restrain excessive risk taking by LCFIs during the decade leading up to the financial crisis.²⁵⁴

Fourth, repeated regulatory failures during past financial crises reflect a "political economy of regulation"²⁵⁵ in which regulators face significant political and practical challenges that undermine their efforts to discipline LCFIs. A full discussion of those challenges is beyond the scope of this Article. For present purposes, it is sufficient to note that analysts have pointed to strong evidence of "capture" of financial regulatory agencies by LCFIs during the two decades leading up to the financial crisis, due to factors such as (1) large political contributions made by LCFIs, (2) an intellectual and policy environment favoring deregulation, and (3) a continuous interchange of senior personnel between the largest financial institutions and the top echelons of the financial regulatory agencies.²⁵⁶ Commentators

²⁵¹ See, e.g., *Reforming Banking: Base Camp Basel*, *supra* note 244; Yalman Onaran et al., *The Global Battle over New Rules for Banks*, BLOOMBERG BUSINESSWEEK, May 31–June 6, 2010, at 41.

²⁵² Onaran et al., *supra* note 251, at 42 (quoting Charles Goodhart).

²⁵³ FED. DEPOSIT INS. CORP., *supra* note 245, at 39–46, 245–47, 373–78.

²⁵⁴ See JOHNSON & KWAK, *supra* note 137, at 120–50; McCoy et al., *supra* note 14, at 1343–66; see also Coffee, *supra* note 239, at 17–18 (stating that "[a]greement is virtually universal that lax regulation by all the financial regulators played a significant role in the 2008 financial crisis").

²⁵⁵ Gordon & Muller, *supra* note 200, at 26.

²⁵⁶ JOHNSON & KWAK, *supra* note 137, at 82–109, 118–21, 133–50; see also Deniz Igan et al., *A Fistful of Dollars: Lobbying and the Financial Crisis* (Int'l Monetary Fund, Working Paper 09/287, 2009), available at <http://ssrn.com/abstract=1531520>; ROBERT WEISSMAN & JAMES DONAHUE, ESSENTIAL INFO. & CONSUMER EDUC. FOUND., SOLD OUT: HOW WALL STREET AND WASHINGTON BETRAYED AMERICA (2009), available at http://www.wallstreetwatch.org/reports/sold_out.pdf.

have also noted that LCFIs skillfully engaged in global regulatory arbitrage by threatening to move operations from the United States to London or to other foreign financial centers if U.S. regulators did not make regulatory concessions.²⁵⁷

Fifth, Dodd-Frank does not provide specific instructions about the higher capital requirements and other enhanced prudential standards that the FRB must adopt. Instead, Dodd-Frank sets forth general categories of supervisory requirements that the FRB either must or may address.²⁵⁸ Thus, the actual achievement of stronger prudential standards will depend upon implementation by the FRB through rule making, and LCFIs have marshaled an imposing array of lobbying resources to persuade the FRB to adopt more lenient rules.²⁵⁹ When Congress passed Dodd-Frank, the head of a leading Wall Street trade association declared that “[t]he bottom line is that this saga will continue,” and he noted that there are “more than 200 items in [Dodd-Frank] where final details will be left up to regulators.”²⁶⁰

²⁵⁷ Coffee, *supra* note 239, at 18–21; Gordon & Muller, *supra* note 200, at 27.

²⁵⁸ See *supra* notes 232–35 and accompanying text; see also Stacy Kaper, *Now for the Hard Part: Writing All the Rules*, AM. BANKER, July 22, 2010, at 1 (stating that although Dodd-Frank will “require the Fed to impose tougher risk-based capital and leverage requirements, it is unspecific about how this should be done”).

²⁵⁹ See Binyamin Appelbaum, *On Finance Bill, Lobbying Shifts to Regulations*, N.Y. TIMES, June 27, 2010, at A1 (noting that “[r]egulators are charged with deciding how much money banks have to set aside against unexpected losses, so the Financial Services Roundtable, which represents large financial companies, and other banking groups have been making a case to the regulators that squeezing too hard would hurt the economy”); see also Kaper, *supra* note 258; *Congress’s Approval of Finance Bill Shifts Focus to Regulators*, BLOOMBERG BUSINESSWEEK (July 16, 2010), <http://www.businessweek.com/news/2010-07-16/congress-s-approval-of-finance-bill-shifts-focus-to-regulators.html>.

²⁶⁰ Randall Smith & Aaron Lucchetti, *The Financial Regulatory Overhaul: Biggest Banks Manage to Dodge Some Bullets*, WALL ST. J., June 26, 2010, at A5 (quoting, in part, Timothy Ryan, chief executive of the Securities and Financial Markets Ass’n); see also Edward J. Kane, *Missing Elements in U.S. Financial Reform: A Kubler-Ross Interpretation of the Inadequacy of the Dodd-Frank Act 7* (Nat’l Bureau of Econ. Research, Working Paper 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1654051 (“During and after what will be an extended post-Act rulemaking process, decisionmakers will be opportunistically lobbied to scale back taxpayer and consumer protections to sustain opportunities for extracting safety-net subsidies. . . . Financial-sector lobbyists’ ability to influence regulatory and supervisory decisions remains strong because the legislative framework Congress has asked regulators to implement gives a free pass to the dysfunctional ethical culture of lobbying that helped both to generate the crisis and to dictate the extravagant cost of the diverse ways that the financial sector was bailed out.”); Kaper, *supra* note 258 (reporting that, “[b]y some estimates, federal regulators must complete 243 rules, . . . along with 67 one-time reports or studies and 22 periodic reports” in order to implement Dodd-Frank’s mandates).

During the summer of 2010, domestic and foreign LCFIs succeeded in weakening and delaying the imposition of enhanced capital standards under the Basel III proposal, and they expressed their determination to prevent U.S. regulators from adopting stronger capital requirements that would go beyond Basel III.²⁶¹ During the 2010 midterm congressional elections, LCFIs and their trade associations made large contributions to Republican candidates, which helped Republicans to take control of the House of Representatives and significantly reduce the Democrats' majority in the Senate.²⁶² The financial services industry strongly backed President Obama and Democratic congressional candidates in 2008, but the passage of Dodd-Frank caused big financial institutions and their trade associations to shift their support to Republicans in 2010.²⁶³ The new Republican House leaders quickly announced their

²⁶¹ As discussed above, the BCBS agreed in September 2010 on a proposal to strengthen international capital standards. Under the proposal, banks would be required to maintain common equity equal to 7% of their risk-weighted assets, including a 2.5% "buffer" for extra protection against future losses. See *supra* note 250 and accompanying text. However, the BCBS significantly weakened many of the terms of the proposal in comparison with its original recommendation in December 2009, and the BCBS also extended the time for full compliance with Basel III until the end of 2018. The BCBS made those concessions in response to extensive lobbying by U.S. and foreign LCFIs as well as the governments of France, Germany, and Japan. See Pruzin, *supra* note 250; Yalman Onaran, *Basel Means Higher Capital Ratios, Time to Comply*, BLOOMBERG BUSINESSWEEK (Sept. 13, 2010), <http://www.businessweek.com/news/2010-09-13/basel-means-higher-capital-ratios-time-to-comply.html>. Stock prices of major LCFIs rose significantly in response to the BCBS's compromise proposal, indicating that the compromise was more favorable to leading banks than analysts had expected. Michael J. Moore & Yalman Onaran, *Banks Stocks Climb as Basel Gives Firms Eight Years to Comply*, BLOOMBERG (Sept. 13 2010), <http://www.bloomberg.com/news/2010-09-13/banks-climb-as-regulators-allow-eight-years-to-meet-capital-requirements.html>. In addition, LCFIs declared that they strongly opposed efforts by individual nations, including the United States, the United Kingdom, and Switzerland, to impose capital requirements that are stronger than the Basel III proposal. Yalman Onaran, *Banks Resist as Regulators Say Basel Is Just a Start*, BLOOMBERG BUSINESSWEEK (Oct. 11, 2010), <http://www.businessweek.com/news/2010-10-11/banks-resist-as-regulators-say-basel-is-just-a-start.html>.

²⁶² Clea Benson & Phil Mattingly, *Firms That Fought Dodd-Frank May Gain Under New House*, BLOOMBERG BUSINESSWEEK (Nov. 3, 2010), <http://www.businessweek.com/news/2010-11-03/firms-that-fought-dodd-frank-may-gain-under-new-house.html>; Stacy Kaper, *Banks Use Election as Payback for Reg Reform*, AM. BANKER, Sept. 7, 2010, at 1; Robert Schmidt, *Wall Street Banking on Republicans to Push Legislative Goals*, BLOOMBERG (Sept. 14, 2010), <http://www.bloomberg.com/news/2010-09-14/wall-street-banking-on-republicans-to-push-legislative-goals.html>.

²⁶³ Kaper, *supra* note 262; Brody Mullins & Alicia Mundy, *Corporate Political Giving Swings Toward the GOP*, WALL ST. J., Sept. 21, 2010, at A5; Editorial, *Troubled*

intention to oversee and influence the implementation of Dodd-Frank by federal agencies in order to secure outcomes that were more favorable to the financial services industry.²⁶⁴ Thus, notwithstanding the widespread public outrage created by bailouts of major banks and Wall Street firms, the continued political clout of LCFIs is undeniable.²⁶⁵

For all of the foregoing reasons, as John Coffee has noted, “the intensity of regulatory supervision” is likely to weaken over time as the economy improves and “the crisis fades in the public’s memory” as well as in the memories of regulators.²⁶⁶ When the next economic boom occurs, regulators will face escalating political pressures to reduce the regulatory burden on LCFIs as long as those institutions continue to finance the boom and also continue to report profits.²⁶⁷ Accordingly, while Dodd-Frank’s provisions for stronger supervision and enhanced prudential standards represent improvements over prior

Marriage: Feeling Scorned by the President, Big Business Is Turning to the GOP: How Fair Is That?, WASH. POST, Sept. 4, 2010, at A16.

²⁶⁴ Benson & Mattingly, *supra* note 262; Cheyenne Hopkins, *Oversight by House GOP to Shape Rules*, AM. BANKER, Nov. 8, 2010, at 1; Stacy Kaper, *REVIEW 2010/PREVIEW 2011: Redrawing the Battle Lines on Reform*, AM. BANKER, Jan. 3, 2011, at 1; Phil Mattingly, *Derivatives, ‘Volcker’ Rules May Be House Republican Targets*, BLOOMBERG (Nov. 14, 2010), <http://www.bloomberg.com/news/2010-11-19/derivatives-volcker-rules-may-be-house-republican-targets.html>.

²⁶⁵ John Cassidy, *What Good Is Wall Street?*, NEW YORKER (Nov. 29, 2010), http://www.newyorker.com/reporting/2010/11/29/101129fa_fact_cassidy; Catherine Dodge, *Banning Big Wall Street Bonus Favored by 70% of Americans in National Poll*, BLOOMBERG (Dec. 12, 2010), <http://www.bloomberg.com/news/2010-12-13/banning-big-wall-street-bonus-favored-by-70-of-americans-in-national-poll.html>; Michael J. Moore, *Wall Street Sees Record Revenue in ‘09-10 Recovery from Bailout*, BLOOMBERG (Dec. 12, 2010), <http://www.bloomberg.com/news/2010-12-13/wall-street-sees-record-revenue-in-09-10-recovery-from-government-bailout.html>; Paul Starobin, *Too Big To Like?*, NAT’L J., Sept. 4, 2010, at 17.

²⁶⁶ Coffee, *supra* note 239, at 21, 20; *see also* Kane, *supra* note 260, at 7 (arguing that, due to the financial sector’s skill in “mixing . . . innovation with well-placed political pressure,” the strength and effectiveness of Dodd-Frank’s regulatory reforms “are unlikely to hold up over time . . . [a]s memory of the crisis recedes”).

²⁶⁷ In this regard, Jeffrey Gordon and Christopher Muller observe:

[G]rowing [financial sector] profits seem to attest to the skill and sagacity of industry participants and increase normative deference to their views. . . . [T]he added profits generate additional resources for lobbying, campaign contributions, and media campaigns that not only enhance the industry’s ability to block new legislation but also to enlist legislative and executive [branch] pressure against regulatory intervention under existing authorities [T]he enhanced profitability of the financial sector typically produces economic spillovers that add to overall economic growth, which is highly desired by political actors.

Gordon & Muller, *supra* note 200, at 27.

law, they are unlikely to prevent future failures of SIFIs and their accompanying pressures for governmental protection of systemically important creditors.²⁶⁸

D. Dodd-Frank Does Not Require SIFIs to Pay Insurance Premiums to Pre-Fund the Orderly Liquidation Fund

As noted above, Dodd-Frank establishes an Orderly Liquidation Fund (OLF) to provide financing for the FDIC's liquidation of failed SIFIs. However, Dodd-Frank does not require LCFIs to pay assessments for the purpose of pre-funding the OLF.²⁶⁹ Instead, Dodd-Frank authorizes the FDIC borrow from the Treasury to provide the necessary funding for the OLF after a SIFI is placed in receivership.²⁷⁰

The FDIC must repay any borrowings from the Treasury within five years, unless the Treasury determines that an extension of the repayment period is "necessary to avoid a serious adverse effect on the financial system of the United States."²⁷¹ Dodd-Frank authorizes the FDIC to repay borrowings from the Treasury by making ex post assessments on (1) creditors who received preferential payments (to the extent of such preferences), (2) nonbank SIFIs supervised by the FRB under Dodd-Frank, (3) BHCs with assets of \$50 billion or more, and (4) other financial companies with assets of \$50 billion or more.²⁷² Dodd-Frank requires the FDIC to determine the appropriate assessment levels for nonbank SIFIs, large BHCs and other large financial companies by (1) setting a "graduated basis" for assessments that requires larger and riskier financial companies to pay higher rates and (2) establishing a "risk matrix" that incorporates recommendations from the FSOC.²⁷³

Thus, Dodd-Frank relies on an ex post funding system for financing liquidations of SIFIs. That was not the case with early versions of the legislation. The bill passed by the House of Representatives would have authorized the FDIC to pre-fund the OLF by collecting up to \$150 billion in risk-based assessments from

²⁶⁸ *Id.* at 22–23; JOHNSON & KWAK, *supra* note 137, at 205–08.

²⁶⁹ *See supra* notes 199–200 and accompanying text.

²⁷⁰ Dodd-Frank Act § 210(n)(5), (6); *see also supra* note 199 and accompanying text (discussing the FDIC's authority to borrow from the Treasury).

²⁷¹ Dodd-Frank Act § 210(n)(9)(B), (o)(1)(B), (C) (quote).

²⁷² § 210(o)(1).

²⁷³ § 210(o)(4).

nonbank SIFIs and large BHCs.²⁷⁴ The bill reported by the Senate Committee on Banking, Housing, and Urban Affairs would also have established a pre-funded OLF, albeit with a smaller “target size” of \$50 billion.²⁷⁵ FDIC Chairman Sheila Bair strongly championed the concept of a pre-funded OLF.²⁷⁶

However, Senate Republicans repeatedly blocked consideration of the bill on the Senate floor until Senate Democrats agreed to remove the pre-funding provision.²⁷⁷ Republican legislators denounced the pre-funding provision as a “permanent taxpayer bailout” fund, even though the fund would have been paid for by LCFIs and would therefore have provided at least partial protection to taxpayers. The Obama Administration never supported the pre-funding mechanism and eventually urged Senate leaders to remove it from the bill.²⁷⁸ During the House-Senate conference committee’s deliberations on

²⁷⁴ See Mike Ferrulo et al., *Regulatory Reform: House Clears Regulatory Reform Package Calling for New Controls on Financial Sector*, 93 *Banking Rep.* (BNA) 1167 (Dec. 15, 2009).

²⁷⁵ S. REP. NO. 111-176, at 4, 5, 63–64 (2010).

²⁷⁶ *Id.* at 5, 5 n.10; see also Sheila C. Bair, Chairman, Fed. Deposit Ins. Corp., Statement on the Causes and Current State of the Financial Crisis Before the Financial Crisis Inquiry Commission 38–39 (Jan. 14, 2010) [hereinafter Bair FCIC Testimony], available at <http://fcic.law.stanford.edu/documents/view/2144> (supporting establishment of a pre-funded OLF).

²⁷⁷ Alison Vekshin & James Rowley, *Senate Republicans Vow to Amend Finance Bill on Floor (Update 1)*, BLOOMBERG BUSINESSWEEK (Apr. 29, 2010), <http://www.businessweek.com/news/2010-04-29/senate-republicans-vow-to-amend-finance-bill-on-floor-update1-.html> (reporting that “[o]n three previous votes this week, the [Senate’s] 41 Republicans united to block consideration of the bill” until Republicans “got assurances that Democrats would remove from the bill a \$50 billion industry-supported fund that would be used to wind down failing firms”).

²⁷⁸ *Finance-Overhaul Bill Would Reshape Wall Street, Washington*, BLOOMBERG BUSINESSWEEK (May 21, 2010), <http://www.businessweek.com/news/2010-05-21/finance-overhaul-bill-would-reshape-wall-street-washington.html> (reporting that the Senate committee’s proposal for “a \$50 billion [resolution] fund, paid for by the financial industry,” was removed from the Senate bill in order “to allow debate on the bill to begin” after “[b]ank lobbyists opposed the fund, and Republicans argued that the provision would create a permanent taxpayer bailout of Wall Street banks”); Stacy Kaper, *Democrats Soften Stand on \$50B Resolution Fund*, AM. BANKER, April 20, 2010, at 3 (noting the claim of Republican Senate leader Mitch McConnell that his opposition to the \$50 billion fund was “vindicated by President Obama’s request to remove it”); David M. Herszenhorn & Sheryl Gay Stolberg, *White House and Democrats Join to Press Case on Financial Controls*, N.Y. TIMES, April 15, 2010, at B1 (reporting that “[t]he Obama administration has not supported the creation of the \$50 billion fund” and citing Senator McConnell’s claim that the fund would “encourage bailouts”); see also *infra* note 284 and accompanying text (explaining that removal of the pre-funded OLF from Dodd-Frank was widely viewed as a significant victory for LCFIs).

Dodd-Frank, House Democratic conferees tried to revive the pre-funding mechanism, but their efforts failed.²⁷⁹

It is contrary to customary insurance principles to establish an OLF that is funded only after a SIFI fails and must be liquidated.²⁸⁰ When commentators have considered analogous insurance issues created by the DIF, they have recognized that moral hazard is reduced when banks pay risk-based premiums that compel “each bank [to] bear the cost of its own risk-taking.”²⁸¹ In stark contrast to the FDI Act (which requires banks to pre-fund the DIF), Dodd-Frank does not require SIFIs to pay risk-based premiums to pre-fund the OLF. As a result, SIFIs will derive implicit subsidies from the protection their creditors expect to receive from the OLF, and SIFIs will pay nothing for those subsidies until the first SIFI fails.²⁸²

When reporters asked Republican Senate leader Mitch McConnell why big banks were opposing a pre-funded OLF if the fund actually benefited them by “guarantee[ing] future bailouts,” he had no response.²⁸³ The true answer, of course, was that SIFIs did not wish to pay for the implicit benefits they expected to receive from a post-funded OLF. SIFIs had good reason to anticipate that a post-funded OLF, backed by the Treasury and ultimately by the taxpayers, would be viewed by creditors as an implicit subsidy for SIFIs and would

²⁷⁹ R. Christian Bruce & Mike Ferullo, *Regulatory Reform: Oversight Council Still a Sticking Point as Bank Reform Conference Plows Ahead*, 94 Banking Rep. (BNA) 1227 (June 22, 2010); Alison Vekshin, *House Backs Off Reserve Fund for Unwinding Failed Companies*, BLOOMBERG BUSINESSWEEK (June 23, 2010), <http://www.businessweek.com/news/2010-06-23/house-backs-off-reserve-fund-for-unwinding-failed-companies.html>; see also *House-Senate Conference Committee Holds a Meeting on the Wall Street Reform and Consumer Protection Act*, FIN. MARKETS REG. WIRE, June 17, 2010 [hereinafter *Conference Committee Transcript*] (transcript of deliberations of House-Senate conference committee on Dodd-Frank on June 17, 2010, during which House Democratic conferees voted to propose a restoration of a pre-funded OLF with \$150 billion of assessments to be paid by LCFIs).

²⁸⁰ See CARNELL ET AL., *supra* note 118, at 535 (noting that ordinarily “an insurer collects, pools, and invests policyholders’ premiums and draws on that pool to pay policyholders’ claims”).

²⁸¹ *Id.* at 328.

²⁸² See Wilmarth, *supra* note 6, at 763 (contending that “a post-funded SRIF would not be successful in eliminating many of the implicit subsidies (and associated moral hazard) that our current TBTF policy has created”); *Conference Committee Transcript*, *supra* note 279 (remarks of Rep. Guttierrez, arguing that a post-funded OLF would create “moral hazard” by “allowing [large financial institutions] to act and not be responsible for their actions by contributing to a fund which dissolves the riskiest of them”).

²⁸³ Herszenhorn & Stolberg, *supra* note 278 (reporting on a press conference with Sen. McConnell).

therefore reduce their funding costs. The elimination of pre-funding for the OLF was a significant “victory” for LCFIs because it relieved them of the burden of paying an “upfront fee” to cover the potential costs of that implicit subsidy.²⁸⁴

The Congressional Budget Office estimated that Dodd-Frank would produce a ten-year net budget deficit of \$19 billion, due primarily to “potential net outlays for the orderly liquidation of [SIFIs], measured on an expected value basis.”²⁸⁵ To offset that deficit, the House-Senate conferees proposed a \$19 billion tax on financial companies with assets of \$50 billion or more and on hedge funds with assets of \$10 billion or more. LCFIs strongly objected to the tax, and Republicans who had voted for the Senate bill threatened to block final passage of the legislation unless the tax was removed. To ensure Dodd-Frank’s passage, the House-Senate conference committee reconvened and removed the \$19 billion tax.²⁸⁶

In place of the discarded tax, the conferees approved two other measures—a capture of the savings from ending the Troubled Asset Relief Program (TARP) and an assessment of higher deposit insurance premiums on banks. Those measures effectively shifted to taxpayers and midsize banks most of Dodd-Frank’s estimated ten-year cost impact on the federal budget.²⁸⁷ Thus, LCFIs and their

²⁸⁴ Mike Ferrulo, *Regulatory Reform: Democrats Set to Begin Final Push to Enact Dodd-Frank Financial Overhaul*, 94 *Banking Rep. (BNA)* 1277 (June 29, 2010) (reporting that the elimination of a pre-funded OLF “is seen as a victory for large financial institutions” and quoting analyst Jaret Seiberg’s comment that “[t]he key for [the financial services] industry was to avoid the upfront fee”); Joe Adler & Cheyenne Hopkins, *Assessing the Final Reg Reform Bill: Some Win, Some Lose, Many Glad It’s Not Worse*, *AM. BANKER*, June 28, 2010, at 1 (quoting my view that “[t]he elimination of a prefunded systemic resolution fund . . . is a huge win for the ‘too big to fail’ players and a huge loss for the FDIC and taxpayers”).

²⁸⁵ CONG. BUDGET OFFICE, *COST ESTIMATE, H.R. 4173: RESTORING FINANCIAL STABILITY ACT OF 2010: AS PASSED BY THE SENATE ON MAY 20, 2010*, at 6 (2010).

²⁸⁶ Rob Blackwell & Stacy Kaper, *Lawmakers Try FDIC Premiums to Save Bill*, *AM. BANKER*, June 30, 2010, at 1; Ferrulo, *supra* note 284.

²⁸⁷ In order to pay for Dodd-Frank’s estimated ten-year budgetary cost of \$19 billion, the conferees voted to cap TARP at \$475 billion (in lieu of the originally authorized \$700 billion) and to prohibit any additional spending under TARP, thereby saving an estimated \$11 billion. To cover the remaining \$8 billion of Dodd-Frank’s estimated ten-year cost, the conferees required banks with assets of \$10 billion or more to pay increased deposit insurance premiums to the FDIC. David M. Herszenhorn, *Bank Tax Is Dropped in Overhaul of Industry*, *N.Y. TIMES*, June 30, 2010, at 1; Jim Puzzanghera & Lisa Mascaro, *Plan Would Cut Off TARP: House-Senate Panel Votes to End Bailout Fund Early to Help Pay for Financial Reform*, *L.A. TIMES*, June 30, 2010, at B1. The practical results of those changes were (1) to shift the \$11 billion benefit from ending TARP from taxpayers to LCFIs and (2) to require banks with assets between \$10 and \$50 billion to help larger

allies were successful in defeating both the \$19 billion tax and the pre-funded OLF. As I observed in a contemporaneous blog post, “[t]he biggest banks have once again proven their political clout . . . [and] have also avoided any significant payment for the subsidies they continue to receive.”²⁸⁸

I have previously argued that a pre-funded “systemic risk insurance fund” (SRIF) is essential to shrink TBTF subsidies for LCFIs. I proposed that the FDIC should assess risk-adjusted premiums over a period of several years to establish a SRIF with financial resources that would provide reasonable protection to taxpayers against the cost of resolving failures of SIFIs during a future systemic financial crisis.²⁸⁹ As explained above, federal regulators provided \$290 billion of capital assistance to the nineteen largest BHCs (each with assets of more than \$100 billion) and to AIG during the current crisis.²⁹⁰ I therefore proposed (1) that \$300 billion (appropriately adjusted for inflation) would be the minimum acceptable size for the SRIF and (2) that SRIF premiums should be paid by all BHCs with assets of more than \$100 billion (also adjusted for inflation) and by all other designated SIFIs.²⁹¹ I also recommended that the FDIC should

banks in covering the remaining \$8 billion of Dodd-Frank’s estimated ten-year cost, even though midsize banks were not responsible for originating the unsound home mortgage loans that triggered the financial crisis. Joe Adler, *Plenty of Reservation on Hiking Reserves*, AM. BANKER, July 1, 2010, at 1; Herszenhorn, *supra*.

²⁸⁸ Art Wilmarth, *Too Big to Fail=Too Powerful to Pay*, CREDIT SLIPS (July 7, 2010), <http://www.creditslips.org/creditslips/2010/07/too-big-to-fail-too-powerful-to-pay.html#more>.

²⁸⁹ Wilmarth, *supra* note 6, at 761–64; *see also* Arthur E. Wilmarth, Jr., *Viewpoint: Prefund a Systemic Resolution Fund*, AM. BANKER, June 11, 2010, at 8. Representative Luis Guttierrez, who was the leading congressional proponent of a pre-funded OLF, quoted my *Viewpoint* article during the House-Senate conference committee’s consideration of a pre-funded OLF. *See Conference Committee Transcript, supra* note 279 (remarks of Rep. Guttierrez).

²⁹⁰ *See supra* notes 14–17, 108–09 and accompanying text.

²⁹¹ Wilmarth, *supra* note 6, at 762. Jeffrey Gordon and Christopher Muller have proposed a similar “Systemic Risk Emergency Fund” with a pre-funded base of \$250 billion to be financed by risk-adjusted assessments paid by large financial firms. They would also provide their proposed fund with a supplemental borrowing authority of up to \$750 billion from the Treasury. Gordon & Muller, *supra* note 200, at 51–53. Thus, Gordon and Muller’s proposal is consistent with my recommendation for a pre-funded SRIF financed by \$300 billion of assessments paid by SIFIs. *Cf.* Xin Huang et al., *A Framework for Assessing the Systemic Risk of Major Financial Institutions*, 33 J. BANKING & FIN. 2036 (2009) (proposing a stress-testing methodology for calculating an insurance premium sufficient to protect a hypothetical fund against losses of more than 15% of the total liabilities of twelve major U.S. banks during the period from 2001 to 2008, and concluding that the hypothetical aggregate insurance premium would have had an “upper bound” of \$250 billion in July 2008).

impose additional assessments on SIFIs in order to replenish the SRIF within three years after the SRIF incurs any loss due to the failure of a SIFI.²⁹²

For four additional reasons, Congress should amend Dodd-Frank to require SIFIs to pay risk-based insurance premiums to prefund the OLF. First, it is unlikely that most SIFIs would have adequate financial resources to pay large OLF assessments after one or more of their peers failed during a financial crisis. SIFIs are frequently exposed to highly correlated risk exposures during a serious financial disruption because they followed similar high-risk business strategies (e.g., “herding”) during the credit boom that led to the crisis.²⁹³ Many SIFIs are therefore likely to suffer severe losses and to face a substantial risk of failure during a major disturbance in the financial markets.²⁹⁴ Consequently, the FDIC (1) probably will not be able in the short term to collect enough premiums from surviving SIFIs to cover the costs of resolving one or more failed SIFIs and (2) therefore will have to borrow large sums from the Treasury to cover short-term

²⁹² Wilmarth, *supra* note 6, at 762.

²⁹³ A recent study concluded that market returns of the hundred largest banks, securities firms, insurers, and hedge funds became “highly interconnected,” and their risk exposures became “highly interrelated,” during the current financial crisis as well as during (1) the dotcom-telecom bust of 2000–2002 and (2) the 1998 crisis resulting from Russia’s debt default and the threatened failure of Long-Term Capital Management, a major hedge fund. Monica Billio et al., *Measuring Systemic Risk in the Finance and Insurance Sectors* 16–17, 40–47 (MIT Sloan School of Mgmt., Working Paper 4774-10, 2010), available at <http://ssrn.com/abstract=1571277>; see also JIAN YANG & YINGGANG ZHOU, FINDING SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS AROUND THE GLOBAL CREDIT CRISIS: EVIDENCE FROM CREDIT DEFAULT SWAPS 20–24, 38 tbl.2, 51–52 fig.3, fig.4 (2010) (concluding, based on a study of CDS spreads, that the four largest U.S. banks and five largest U.S. securities firms were “intensively connected” from 2007 to 2009, with credit shocks being rapidly transmitted among members of that group and also between members of that group and leading U.S. insurance companies, including AIG and MetLife), available at <http://ssrn.com/abstract=1691111>. For additional evidence indicating that banks and other financial institutions engage in herding behavior that can trigger systemic financial crises, see Viral V. Acharya & Tanju Yorulmazer, *Information Contagion and Bank Herding*, 40 J. MONEY, CREDIT & BANKING 215, 215–17, 227–29 (2008); Raghuram G. Rajan, *Has Finance Made the World Riskier?*, 12 EUROPEAN FIN. MANAGEMENT 499, 500–02, 513–22 (2006). As described above in Part III, LCFIs engaged in parallel behavior that resembled herding during the credit boom that precipitated the recent crisis, particularly with regard to high-risk securitized lending in the residential and commercial mortgage markets and the corporate LBO market.

²⁹⁴ See *supra* notes 102–11 and accompanying text (explaining that (1) the “big eighteen” LCFIs accounted for three-fifths of the \$1.5 trillion of losses that were incurred by global banks, securities firms, and insurers during the financial crisis, and (2) Lehman failed during the crisis, while twelve of the other “big eighteen” institutions were bailed out or received substantial governmental assistance).

resolution costs. Even if the FDIC ultimately repays the borrowed funds by imposing ex post assessments on surviving SIFIs, the public and the financial markets will correctly infer that the federal government (and, ultimately, the taxpayers) provided bridge loans to pay the creditors of failed SIFIs.²⁹⁵

Second, under Dodd-Frank's post-funded OLF, the most reckless SIFIs will effectively shift the potential costs of their risk taking to the most prudent SIFIs because the latter will be more likely to survive and bear the ex post costs of resolving their failed peers. Thus, a post-funded OLF is undesirable because "firms that fail never pay and the costs are borne by surviving firms."²⁹⁶

Third, a pre-funded OLF would create beneficial incentives that would encourage each SIFI to monitor other SIFIs and to inform regulators about excessive risk taking by those institutions. Every SIFI would know that the failure of another SIFI would deplete the SRIF and would also trigger future assessments that it and other surviving SIFIs would have to pay. Thus, each SIFI would have good reason to complain to regulators if it became aware of unsound practices or conditions at another SIFI.²⁹⁷

Fourth, the payment of risk-based assessments to pre-fund the OLF would reduce TBTF subsidies for SIFIs by forcing them to internalize more of the "negative externality" (i.e., the potential public bailout

²⁹⁵ Bair FCIC Testimony, *supra* note 276, at 38–39; *see also* Cheyenne Hopkins, *Resolution Fund New Reg Reform Headache*, AM. BANKER, Nov. 12, 2009, at 1 (quoting observation by Doug Elliott, a fellow at the Brookings Institution, that pre-funding a systemic resolution fund would be advantageous "because you can start funding while the institutions are still strong . . . [while] if you do it after the fact you are almost certain to do it when institutions are weak and less funds are available"); Gordon & Muller, *supra* note 200, at 41 (observing that, under Dodd-Frank, "[r]esolution funds will be borrowed from Treasury and ultimately, the taxpayers. Politically, this will likely register as a taxpayer 'bailout,' notwithstanding the [statute's] strong repayment mandate").

²⁹⁶ Bair FCIC Testimony, *supra* note 276, at 38–39. During the conference committee's deliberations on Dodd-Frank, House Democratic conferees unsuccessfully pushed for a pre-funded OLF. *See supra* note 279 and accompanying text. In warning against the dangers of a post-funded OLF, Representative Gregory Meeks observed:

What kind of system are we promoting if the biggest risk takers now know that they won't have to pitch in for the cleanup because they will be out of business and [will] have run off with the accrued . . . profits from the good days, while those who are more prudent and survive the crises are left holding the tab for . . . their wild neighbors.

Conference Committee Transcript, supra note 279 (remarks of Rep. Meeks).

²⁹⁷ Wilmarth, *supra* note 6, at 763.

cost) of their activities.²⁹⁸ To accomplish the goal of internalizing risk, the marginal rates for OLF assessments should become progressively higher for SIFIs that create a greater potential for systemic risk, based on factors such as size, complexity, opacity and interconnectedness with other SIFIs. A pre-funded OLF with appropriately calibrated risk-based assessments would reduce moral hazard among SIFIs and would shield governments and taxpayers from at least “first loss” exposure for the cost of resolving future failures of SIFIs.²⁹⁹

Gordon and Muller point out that a pre-funded OLF would also reduce TBTF subsidies by making Dodd-Frank’s “liquidation threat more credible.”³⁰⁰ In their view, a pre-funded OLF would encourage regulators to “impos[e] an FDIC receivership” on a failing SIFI.³⁰¹ In contrast, Dodd-Frank’s post-funded OLF creates a strong incentive for regulators to grant forbearance in order to avoid or postpone the politically unpopular step of borrowing from the Treasury to finance a failed SIFI’s liquidation.³⁰²

To further reduce the potential TBTF subsidy for SIFIs, Congress should prevent the DIF, which insures bank deposits, from being used to protect nondeposit creditors of SIFIs. As discussed above, the “systemic-risk exception” (SRE) in the FDI Act is a potential source of bailout funds for SIFI-owned banks, and those funds could indirectly support creditors of SIFIs.³⁰³ The FDIC relied on the SRE when it jointly agreed with the Treasury Department and the FRB to provide more than \$400 billion of asset guarantees to Citigroup and Bank of America.³⁰⁴ Dodd-Frank now requires the SRE to be

²⁹⁸ Viral V. Acharya et al., *Regulating Systemic Risk*, in RESTORING FINANCIAL STABILITY, *supra* note 34, at 283, 293–95.

²⁹⁹ Wilmarth, *supra* note 6, at 762–3; *see also* Acharya et al., *supra* note 298, at 293–95.

³⁰⁰ Gordon & Muller, *supra* note 200, at 55.

³⁰¹ *Id.*

³⁰² *Id.* at 55–56; *see also id.* at 41 (contending that Dodd-Frank’s post-funded OLF will encourage regulators to “delay putting a troubled financial firm into receivership”).

³⁰³ *See supra* notes 207–09 and accompanying text.

³⁰⁴ *See* Press Release, Joint Statement by Treasury, Federal Reserve and the FDIC on Citigroup (Nov. 23, 2008), *available at* <http://www.fdic.gov/news/news/pres/2008/pr08125.html>; FDIC Chairman Sheila C. Bair, Statement on Bank of America Acquisition of Merrill Lynch before the House Comm. on Oversight and Government Reform and the Subcomm. on Domestic Policy (Dec. 11, 2009), *available at* <http://www.fdic.gov/news/news/speeches/archives/2009/spdec1109.html>. Although the terms of the asset guarantee for Bank of America were agreed to in principle, they were never finalized, and the

invoked solely in the context of a failed bank receivership. However, the FDIC could still use the SRE in that context to protect the creditors of SIFI-owned banks (including, potentially, the parent companies of such banks).³⁰⁵

The DIF should be strictly separated from the systemic resolution process to ensure that the DIF cannot be used as a potential source of protection for creditors of SIFIs (except for bank depositors). To accomplish that goal, Congress should repeal the SRE and should designate the OLF as the exclusive source of future funding for all resolutions of failed SIFIs. By repealing the SRE, Congress would ensure that (1) the FDIC must apply the least-cost test in resolving all future bank failures,³⁰⁶ (2) the DIF must be used solely to pay the claims of bank depositors, and (3) non-deposit creditors of SIFIs could no longer view the DIF as a potential source of financial support. By making those changes, Congress would significantly reduce the implicit TBTF subsidies currently enjoyed by SIFIs.³⁰⁷

E. The Dodd-Frank Act Does Not Prevent Financial Holding Companies from Using Federal Safety Net Subsidies to Support Risky Nonbanking Activities

1. Dodd-Frank Does Not Prevent the Exploitation of Federal Safety Net Subsidies

Dodd-Frank contains three sections that are intended to prevent the federal “safety net” for banks³⁰⁸ from being used to support speculative nonbanking activities connected to the capital markets. As discussed below, none of the three sections adequately insulates the federal safety net from potential exposure to significant losses arising out of risky nonbanking activities conducted by LCFIs. The

Treasury Secretary did not formally invoke the SRE for Bank of America. See FIN. CRISIS INQUIRY COMM’N, *supra* note 122, at 32.

³⁰⁵ See *supra* note 209 and accompanying text.

³⁰⁶ The least-cost test requires the FDIC to “meet the obligation of the [FDIC] to provide insurance coverage for the insured deposits” in a failed bank by using the approach that is “least costly to the [DIF].” 12 U.S.C. § 1823(c)(4)(A)(i), (ii) (2006); see also CARNELL ET AL., *supra* note 118, at 303, 331, 731–32 (discussing the FDIC’s “least-cost” requirement for resolving bank failures, and noting that the SRE represents the only exception to the “least-cost” requirement).

³⁰⁷ Wilmarth, *supra* note 6, at 764.

³⁰⁸ The federal “safety net” for banks includes (1) federal deposit insurance, (2) protection of uninsured depositors and other uninsured creditors in TBTF banks under the SRE, and (3) discount window advances and other liquidity assistance provided by the FRB as lender of last resort. See Wilmarth, *supra* note 221, at 16 n.39.

first provision (the Kanjorski Amendment) is unwieldy and constrained by stringent procedural requirements. The other two provisions (the Volcker Rule and the Lincoln Amendment) are riddled with loopholes and have long phase-in periods. In addition, the implementation of all three provisions is subject to broad regulatory discretion and is therefore likely to be influenced by aggressive industry lobbying.

a. The Kanjorski Amendment

Section 121 of Dodd-Frank, the “Kanjorski Amendment,” was originally sponsored by Representative Paul Kanjorski (D-PA).³⁰⁹ Section 121 provides the FRB with potential authority to require large BHCs or nonbank SIFIs to divest high-risk operations. However, the FRB may exercise its divestiture authority under section 121 only if (1) the BHC or nonbank SIFI “poses a grave threat to the financial stability of the United States” and (2) the FRB’s proposed action is approved by at least two-thirds of the FSOC’s voting members.³¹⁰ Moreover, the FRB may not exercise its divestiture authority unless it has previously attempted to “mitigate” the threat posed by the BHC or nonbank SIFI by taking several, less drastic remedial measures.³¹¹ If, and only if, the FRB determines that all of those remedial measures are “inadequate to mitigate [the] threat,” the FRB may then exercise its residual authority to “require the company to sell or otherwise transfer assets or off-balance-sheet items to unaffiliated parties.”³¹²

The FRB’s divestiture authority under section 121 is thus a last resort, and it is restricted by numerous procedural requirements

³⁰⁹ Simon Johnson, *Flawed Financial Bill Contains Huge Surprise*, BLOOMBERG BUSINESSWEEK (July 8, 2010), <http://www.businessweek.com/news/2010-07-08/flawed-financial-bill-contains-huge-surprise-simon-johnson.html>. Representative Kanjorski was the second-ranking Democrat on the House Financial Services Committee. He lost his bid for reelection in November 2010, along with ten other Democratic members of that committee. Donna Borak & Joe Adler, *Voters Shake Up the House Financial Services Roster*, AM. BANKER, Nov. 4, 2010, at 4.

³¹⁰ Dodd-Frank Act § 121(a). The FRB must provide a large BHC (i.e., a BHC with assets of \$50 billion or more) or a nonbank SIFI with notice and an opportunity for hearing before the FRB takes any action under section 121. *Id.* § 121(b).

³¹¹ Before the FRB may require a breakup of a large BHC or nonbank SIFI under section 121, the FRB must first take all of the following actions with regard to that company: (1) imposing limitations on mergers or affiliations, (2) placing restrictions on financial products, (3) requiring termination of activities, and (4) imposing conditions on the manner of conducting activities. Dodd-Frank Act § 121(a).

³¹² *Id.* § 121(a)(5); *see also* S. REP. NO. 111-176, at 51–52 (2010) (explaining section 121).

(including, most notably, a two-thirds vote by the FSOC). The Bank Holding Company Act (BHC Act)³¹³ contains a similar provision, under which the FRB can force a BHC to divest a nonbank subsidiary that “constitutes a serious risk to the financial safety, soundness or stability” of any of the BHC’s banking subsidiaries.³¹⁴ The FRB may exercise its divestiture authority under the BHC Act without the concurrence of any other federal agency, and the FRB is not required to take any intermediate remedial steps before requiring the divestiture. However, according to a senior Federal Reserve official, the FRB’s divestiture authority under the BHC Act “has never been successfully used for a major banking organization.”³¹⁵ In view of the much more stringent procedural and substantive constraints on the FRB’s authority under the Kanjorski Amendment, the prospects for an FRB-ordered breakup of a SIFI seem remote at best.

b. The Volcker Rule

Section 619 of Dodd-Frank, the “Volcker Rule,” was originally proposed by former FRB Chairman Paul Volcker, who wanted to stop banking organizations from continuing to engage in speculative trading activities in the capital markets.³¹⁶ In January 2010, President Obama publicly endorsed the Volcker Rule as a means of rallying support for financial regulatory reform after Republican Scott Brown won a special election to fill the Massachusetts Senate seat formerly held by the late Edward Kennedy.³¹⁷ As approved by the Senate Banking Committee, the Volcker Rule prohibited banks and BHCs from (1) sponsoring or investing in hedge funds or private equity funds and (2) engaging in proprietary trading (i.e., buying and selling securities, derivatives, and other tradable assets for their own account).³¹⁸

³¹³ 12 U.S.C. §§ 1841–50 (2006).

³¹⁴ *Id.* § 1844(e)(1).

³¹⁵ Hoenig, *supra* note 137, at 4.

³¹⁶ Uchitelle, *supra* note 3 (describing the genesis of the Volcker Rule).

³¹⁷ Senator Brown’s surprise election was a major political development because it gave the Republicans forty-one seats in the Senate, thereby depriving the Democrats of their previous filibuster-proof majority. R. Christian Bruce, *Outlook 2010: Three Days of Political Upheaval Jolt Outlook for Financial Regulatory Reform*, 94 *Banking Rep. (BNA)* 167 (Jan. 26, 2010); Cheyenne Hopkins, *In Shift, Obama Decides Big Is Bad*, *AM. BANKER*, Jan. 22, 2010, at 1; Jonathan Weisman, *Obama’s Bank Proposal: Policy Pivot Followed Months of Wrangling*, *WALL ST. J.*, Jan. 22, 2010, at A4.

³¹⁸ The Senate committee bill required the FSOC to conduct a study and to make recommendations for implementation of the Volcker Rule through regulations to be

The Senate committee report explained that the Volcker Rule would prevent banks “protected by the federal safety net, which have a lower cost of funds, from directing those funds to high-risk uses.”³¹⁹ The report endorsed Mr. Volcker’s view that public policy does not favor having “public funds—taxpayer funds—protecting and supporting essentially proprietary and speculative activities.”³²⁰ The report further declared that the Volcker Rule was directed at “limiting the inappropriate transfer of economic subsidies” by banks and “reducing inappropriate conflicts of interest between [banks] and their affiliates.”³²¹ Thus, the Senate report argued that deposit insurance and other elements of the federal safety net should be used to protect depositors and to support traditional banking activities but should not be allowed to subsidize speculative capital markets activities.³²²

LCFIs strongly opposed the Volcker Rule as approved by the Senate committee.³²³ However, the Volcker Rule—and the Senate’s reform bill as a whole—gained significant political momentum from two events related to Goldman. First, the SEC filed a lawsuit on April 16, 2010, alleging that Goldman defrauded two institutional purchasers of interests in a CDO, designated as “Abacus 2007-AC1,” which Goldman structured and marketed in early 2007. The SEC charged that Goldman did not disclose to the CDO’s investors that a large hedge fund, Paulson & Co., had helped to select the CDO’s

adopted by the federal banking agencies. S. REP. NO. 111-176, at 8–9, 90–92; Chris Dieterich, *Volcker Rule Is Showing Some Staying Power*, AM. BANKER, April 13, 2010, at 1; Alison Vekshin, *Dodd’s Financial Overhaul Bill Approved by Senate Banking Panel*, BLOOMBERG BUSINESSWEEK (Mar. 23, 2010) (article removed from Web site); Mike Ferullo, *Regulatory Reform: Proprietary Trading Language from Treasury Targets All Financial Firms for Restrictions*, 94 Banking Rep. (BNA) 459 (Mar. 9, 2010).

³¹⁹ S. REP. NO. 111-176, at 8–9.

³²⁰ *Id.* at 91 (quoting testimony by Mr. Volcker). The report also quoted Mr. Volcker’s contention that

conflicts of interest [are] inherent in the participation of commercial banking organizations in proprietary or private investment activity. . . . When the bank itself is a “customer,” i.e., it is trading for its own account, it will almost inevitably find itself, consciously or inadvertently, acting at cross purposes to the interests of an unrelated commercial customer of a bank.

Id.

³²¹ *Id.* at 90.

³²² *Id.* (explaining that the Volcker Rule was intended to “eliminate any economic subsidy to high-risk activities that is provided by access to lower-cost capital because of participation in the regulatory safety net”).

³²³ See Eamon Javers & Victoria McGrane, *Chris Dodd Proposal Hits Wall Street Hard*, POLITICO.COM (Mar. 16, 2010), <http://www.politico.com/news/stories/0310/34463.html> (noting that the Volcker Rule was “hated on Wall Street”).

portfolio of RMBS while intending to short the CDO by purchasing CDS from Goldman. The SEC alleged that Goldman knew, and did not disclose, that Paulson & Co. had an “economic incentive” to select RMBS that it expected to default within the near-term future. CRAs downgraded almost all of the RMBS in the CDO’s portfolio within nine months after the CDO’s securities were sold to investors. The institutional investors in the CDO lost more than \$1 billion, while Paulson & Co. reaped a corresponding gain.³²⁴ Goldman subsequently settled the SEC’s lawsuit by paying restitution and penalties of \$550 million.³²⁵

Second, on April 27, 2010, the Senate Permanent Subcommittee on Oversight interrogated Goldman’s chairman and several of Goldman’s other current and former officers during a highly adversarial eleven-hour hearing. The Subcommittee also released a report charging, based on internal Goldman documents, that Goldman aggressively sold nonprime, mortgage-backed investments to clients in late 2006 and 2007 while Goldman was “making huge and profitable bets against the housing market and acting against the interest of its clients.”³²⁶ The allegations against Goldman presented in the SEC’s lawsuit and at the Senate hearing provoked widespread public outrage and gave a major political boost to the Volcker Rule and the Dodd-Frank legislation as a whole.³²⁷

³²⁴ Securities and Exchange Comm’n, Litigation Release No. 21,489 (April 16, 2010), available at <http://www.sec.gov/litigation/litreleases/2010/lr21489.htm>.

³²⁵ Goldman did not admit or deny the SEC’s allegations in settling the lawsuit. However, Goldman did acknowledge that “the marketing materials for the [CDO] contained incomplete information” and that it was a “mistake” to sell the CDO “without disclosing the role of Paulson & Co. in the portfolio selection process and that Paulson’s economic interests were adverse to CDO investors.” *Litigation Release No. 21592*, SEC. EXCH. COMM’N (July 15, 2010), <http://sec.gov/litigation/litreleases/2010/lr21592.htm>. The SEC and Goldman entered into the settlement “just hours after the U.S. Senate passed . . . Dodd-Frank,” but SEC Enforcement Director Robert Khuzami “claimed that ‘absolutely no consideration’ had been given to the political timing of the settlement’s announcement.” R.J. Lehmann, *SEC Will Have Goldman’s Help in Other Wall Street Investigations*, SNL Financial Services Daily, July 16, 2010.

³²⁶ Zachary A. Goldfarb, *Goldman Sachs Executives Face Senators Investigating Role in Financial Crisis*, WASH. POST, Apr. 28, 2010, at A01; see also Joshua Gallu & Jesse Westbrook, *Goldman Armed Salespeople to Dump Bonds, E-mails Show (Update 1)*, BLOOMBERG BUSINESSWEEK (Apr. 27, 2010), <http://www.businessweek.com/news/2010-04-27/goldman-armed-salespeople-to-dump-bonds-e-mails-show-update1-.html>.

³²⁷ Donna Borak & Cheyenne Hopkins, *Volcker Ban Bolstered by Goldman Allegations*, AM. BANKER, Apr. 28, 2010, at 1; Michael J. Moore & Joshua Gallu, *Goldman Sachs E-mails Spur Democrats to Push Wall Street Rules*, BLOOMBERG BUSINESSWEEK (Apr. 25, 2010), <http://www.businessweek.com/news/2010-04-25>

Nevertheless, large financial institutions continued their campaign of “lobbying vigorously to weaken the Volcker rule” during the conference committee’s deliberations on the final terms of Dodd-Frank.³²⁸ House and Senate Democratic leaders agreed (with the Obama Administration’s concurrence) on a last-minute compromise that significantly weakened the Volcker Rule and “disappointed” Mr. Volcker.³²⁹ The compromise inserted exemptions in the Volcker Rule that allow banks and BHCs (1) to invest up to three percent of their Tier 1 capital in hedge funds or private equity funds (as long as a bank’s investments do not exceed three percent of the total ownership interests in any single fund), (2) to purchase and sell government securities, (3) to engage in “risk-mitigating hedging activities,” (4) to make investments through insurance company affiliates, and (5) to make small business investment company investments.³³⁰ The compromise also delayed the Volcker Rule’s effective date so that banks and BHCs will have (1) up to seven years after Dodd-Frank’s enactment date to bring most of their equity-investing and proprietary-trading activities into compliance with the Volcker Rule and (2) up to twelve years to bring “illiquid” investments that were already in existence on May 1, 2010, into compliance with the Rule.³³¹

Probably the most troublesome aspect of the final Volcker Rule is that the Rule fails to establish a clear demarcation between prohibited “proprietary trading” and permissible “market making.” The rule

/goldman-sachs-e-mails-spur-democrats-to-push-wall-street-rules.html; Stacy Kaper, *Goldman Suit, Wamu Mess Rev Reg Reform*, AM. BANKER, Apr. 19, 2010, at 1.

³²⁸ John Cassidy, *The Volcker Rule: Obama’s Economic Adviser and His Battles over the Financial-Reform Bill*, NEW YORKER (July 26, 2010), http://www.newyorker.com/reporting/2010/07/26/100726fa_fact_cassidy; see also Yalman Onaran, *Volcker Rule Attacked as Lawmakers Seek Fund Loophole*, BLOOMBERG (June 23, 2010), <http://www.bloomberg.com/news/2010-06-23/volcker-rule-under-attack-as-lawmakers-seek-hedge-fund-loophole.html>; Eric Dash & Nelson D. Schwartz, *In a Final Push, Banking Lobbyists Make a Run at Reform Measures*, N.Y. TIMES, June 21, 2010, at B1.

³²⁹ Cassidy, *supra* note 328. After reviewing the final terms of the Volcker Rule, Mr. Volcker remarked, “I’m a little pained that it doesn’t have the purity I was searching for.” *Id.*

³³⁰ *Id.*; Christine Harper & Bradley Keoun, *Financial Reform: The New Rules Won’t Stop the Next Crisis*, BLOOMBERG BUSINESSWEEK, July 6–11, 2010, at 42, 43; Stacy Kaper & Cheyenne Hopkins, *Key Issues Unresolved as Reform Finishes Up: Fate of derivatives, Volcker Rule Still in Limbo in Final Hours*, AM. BANKER, June 25, 2010, at 1; see also Dodd-Frank Act § 619 (enacting §§ 13(d)(1)(A), (B), (C), (E), (F), (G), & (d)(4) of the BHC Act).

³³¹ Harper & Keoun, *supra* note 330; see also new § 13(d) of the BHC Act, added by Dodd-Frank Act § 619.

defines “proprietary trading” as “engaging as a principal for the trading account of the banking entity,” while “market making” is defined as “[t]he purchase, sale, acquisition, or disposition of securities and other instruments . . . on behalf of customers.”³³² Distinguishing between proprietary trading and market making is notoriously difficult,³³³ and analysts expect large Wall Street banks to seek to evade the Volcker Rule by shifting their trading operations into so-called “client-related businesses.”³³⁴ Moreover, the parameters of “proprietary trading,” “market making” and other ambiguous terms in the Volcker Rule—including the exemption for “[r]isk-mitigating hedging activities”³³⁵—are yet to be determined. Those terms will be defined in regulations to be issued jointly by the federal banking regulators, the CFTC, and the SEC after those agencies review recommendations contained in a forthcoming FSOC study.³³⁶

Mr. Volcker has urged the FSOC to recommend “[c]lear and concise definitions [and] firmly worded prohibitions” to carry out “the basic intent” of section 619.³³⁷ However, LCFIs have already deployed their considerable political influence to weaken the Volcker Rule, and newly-elected Republican House leaders have declared their intention to exercise “aggressive oversight” with respect to the Rule’s implementation by federal regulators.³³⁸ Given the Volcker

³³² Dodd-Frank Act § 619 (enacting new § 13(d)(1)(D) & (h)(4) of the BHC Act).

³³³ See CARNELL ET AL., *supra* note 118, at 130, 528–29 (describing the roles of “dealers” (i.e., proprietary traders) and “market makers” and indicating that the two roles frequently overlap).

³³⁴ Nelson D. Schwartz & Eric Dash, *Despite Reform, Banks Have Room for Risky Deals*, N.Y. TIMES, Aug. 26, 2010, at A1; see also Michael Lewis, *Proprietary Trading Under Cover*, BLOOMBERG (Oct. 27, 2010), <http://www.bloomberg.com/news/2010-10-27/wall-street-proprietary-trading-under-cover-commentary-by-michael-lewis.html>; Jia Lynn Yang, *Major Banks Gird for “Volcker rule,”* WASH. POST, Aug. 14, 2010, at A08.

³³⁵ Dodd-Frank Act § 619 (adding new § 13(d)(1)(C) of the BHC Act); see also Dash & Schwartz, *supra* note 328 (“[T]raders [on Wall Street] say it will be tricky for regulators to define what constitutes a proprietary trade as opposed to a reasonable hedge against looming risks. Therefore, banks might still be able to make big bets by simply classifying them differently.”).

³³⁶ *Id.* (adding new § 13(b) of the BHC Act).

³³⁷ Cheyenne Hopkins, *Volcker Wants a Clear, Concise Rule*, AM. BANKER, Nov. 3, 2010, at 3.

³³⁸ Hopkins, *supra* note 264; Kaper, *supra* note 264 (reporting that incoming House Financial Services Committee Chairman Spencer Bachus sent a letter to FSOC opposing any “rigid interpretation” of the Volcker Rule and arguing that regulators should not “unfairly disadvantage U.S. financial firms”); Mattingly, *supra* note 264 (quoting Representative Bachus’s statement that House Republicans would use “aggressive

Rule's ambiguous terms and numerous exemptions that rely on regulatory interpretation, as well as its long phase-in period, commentators have concluded that the rule probably will not have a significant impact in restraining risk taking by major banks or in preventing them from exploiting their safety net subsidies to fund speculative activities.³³⁹

c. The Lincoln Amendment

Section 726 of Dodd-Frank, the "Lincoln Amendment," was originally sponsored by Senator Blanche Lincoln (D-AR).³⁴⁰ In April 2010, Senator Lincoln, as chair of the Senate Agriculture Committee, included the Lincoln Amendment in derivatives reform legislation, which was passed by the Agriculture Committee and subsequently combined with the Senate Banking Committee's regulatory reform bill. As adopted by the Agriculture Committee, the Lincoln Amendment would have barred dealers in swaps and other OTC derivatives from receiving assistance from the DIF or from the Fed's discount window or other emergency lending facilities.³⁴¹

Senator Lincoln designed the provision to force major banks to "spin off their derivatives operations" in order "to prevent a situation in which a bank's derivatives deals failed and forced taxpayers to bail

oversight" to influence the implementation of the Volcker Rule and other provisions of Dodd-Frank). *Cf.* Cassidy, *supra* note 328 (quoting the statement of Anthony Dowd, Mr. Volcker's personal assistant, that the financial services industry deployed "fifty-four lobbying firms and three hundred million dollars . . . against us" during congressional consideration of Dodd-Frank).

³³⁹ Cassidy, *supra* note 328 (stating that "[w]ithout the legislative purity that Volcker was hoping for, enforcing his rule will be difficult, and will rely on many of the same regulators who did such a poor job the last time around"); Harper & Keoun, *supra* note 330, at 43 (quoting the comment of William T. Winters, former co-chief executive officer of Chase's investment bank, that "I don't think [the Volcker Rule] will have any impact at all on most banks"); Johnson, *supra* note 309 (stating that the Volcker Rule was "negotiated down to almost nothing"); Bradley Keoun & Dawn Kopecki, *Bank of America, JPMorgan Lead Bank Shares of Reform Deal*, BLOOMBERG BUSINESSWEEK (June 25, 2010), <http://www.businessweek.com/news/2010-06-25/bank-of-america-jpmorgan-lead-bank-shares-on-reform-deal.html> (quoting analyst Nancy Bush's view that the final compromise on the Volcker Rule meant that "the largest banks' operations are largely left intact").

³⁴⁰ Harper & Keoun, *supra* note 330, at 43; Johnson, *supra* note 309.

³⁴¹ Richard Hill, *Derivatives: Lincoln Derivatives Language Recommended by Ag Panel: Merger with Dodd Bill Expected*, 42 Sec. Reg. & L. Rep. (BNA) 810 (April 26, 2010).

out the institution.”³⁴² The Lincoln Amendment was “also an effort to crack down on the possibility that banks would use cheaper funding provided by deposits insured by the FDIC, to subsidize their trading activities.”³⁴³ Thus, the purposes of the Lincoln Amendment—to insulate banks from the risks of speculative activities and to prevent the spread of safety net subsidies—were similar to the objectives of the Volcker Rule, but the Lincoln Amendment focused on dealing and trading in derivatives instead of all types of proprietary trading.³⁴⁴

Senator Lincoln’s decision to sponsor the provision was reportedly motivated in part by her involvement in a difficult primary election, in which some liberal groups criticized her for being too close to Wall Street.³⁴⁵ Senator Lincoln’s sponsorship of a “spinoff requirement” for bank derivatives dealers was eagerly applauded by consumer advocates and was also endorsed by Senator Maria Cantwell as a “stare-down of Wall Street interests.”³⁴⁶ Senator Lincoln prevailed in her primary election on June 8, 2010, a victory that “bolstered” her political leverage to fight for passage of the Lincoln Amendment.³⁴⁷ However, Senator Lincoln’s Amendment and her support for Dodd-Frank alienated bankers and may have contributed to her defeat in the November general election.³⁴⁸

³⁴² Richard Hill, *Derivatives: Conferees Reach Compromise: Banks Could Continue to Trade Some Derivatives*, 42 Sec. Reg. & L. Rep. (BNA) 1234 (June 28, 2010); see also Hill, *supra* note 341.

³⁴³ Robert Schmidt & Phil Mattingly, *Banks Would Be Forced to Push Out Derivative Trading Under Plan*, BLOOMBERG (April 14, 2010), <http://www.bloomberg.com/news/2010-04-15/banks-would-be-forced-to-push-out-derivative-trading-under-plan.html>.

³⁴⁴ Cf. Cassidy, *supra* note 328.

After Senator Blanche Lincoln . . . put forward an amendment that would force the big banks to move their derivatives-trading desks into separate subsidiaries backed by more capital, Volcker wrote a letter to [Senator] Dodd saying that such a move was unnecessary, providing that the Merkley-Levin amendment [which embodied a strict version of the Volcker Rule] was enacted.

Id.

³⁴⁵ See Phil Mattingly & Robert Schmidt, *How ‘Hard to Fathom’ Derivatives Rule Emerged in U.S. Senate*, BLOOMBERG BUSINESSWEEK (May 6, 2010), <http://www.businessweek.com/news/2010-05-06/how-hard-to-fathom-derivatives-rule-emerged-in-u-s-senate.html>.

³⁴⁶ Kaper & Hopkins, *supra* note 330; Mattingly & Schmidt, *supra* note 345.

³⁴⁷ Kaper & Hopkins, *supra* note 330.

³⁴⁸ Seth Blomley, *Boozman Trounces Senate’s Lincoln*, ARK. DEMOCRAT-GAZETTE (Little Rock), Nov. 3, 2010 (reporting that Republican John Boozman, who defeated Senator Lincoln, campaigned against her for supporting federal health-care legislation as well as “the federal economic-stimulus package and banking regulatory changes”); Stacy

The Lincoln Amendment “engendered tremendous pushback . . . from Republicans, fellow Democrats, the White House, banking regulators, and Wall Street interests.”³⁴⁹ Large banks claimed that the provision would require them to provide more than \$100 billion of additional capital to organize separate derivatives trading subsidiaries.³⁵⁰ A prominent industry analyst opined that the provision “eliminates all of the advantages of the affiliation with an insured depository institution, which are profound.”³⁵¹ Those statements reflected the fact that, as discussed below, bank dealers in OTC derivatives enjoy significant competitive advantages over nonbank dealers due to the banks’ explicit and implicit safety net subsidies.³⁵² The Lincoln Amendment was specifically intended to remove those advantages and to force major banks to conduct their derivatives trading operations without reliance on federal subsidies.³⁵³

In addition to broad opposition from Republicans (with the prominent exceptions of Senators Charles Grassley and Olympia Snowe), the Lincoln Amendment encountered intense opposition from the “New Democrats” of moderate House Democrats, especially those from New York who claimed that the provision would drive a significant portion of the derivatives trading business out of New York City and into foreign financial centers.³⁵⁴ As was also true with

Kaper, *Election 2010: Reshaping of Senate Panel Is a Certainty*, AM. BANKER, Sept. 9, 2010, at 1 (reporting that Arkansas bankers were unhappy with Senator Lincoln’s vote for Dodd-Frank, and they also felt that she “supported amendments that made the bill worse in our mind” (quoting Charles Miller, chief lobbyist for the Arkansas Bankers Association)).

³⁴⁹ Hill, *supra* note 342; *see also* Kaper & Hopkins, *supra* note 330 (“Banks have vigorously opposed the Lincoln amendment, arguing it would cost them billions of dollars to spin off their derivatives units. Regulators, too, have argued against the provision, saying it would drive derivatives trades overseas or underground, where they would not be regulated.”).

³⁵⁰ Agnes Crane & Rolfe Winkler, *Reuters Breakingviews: Systemic Risk Knows No Borders*, N.Y. TIMES, May 3, 2010, at B2.

³⁵¹ Schmidt & Mattingly, *supra* note 343 (quoting Karen Petrou).

³⁵² *See infra* notes 407–10 and accompanying text.

³⁵³ Schmidt & Mattingly, *supra* note 343; *see also* Crane & Winkler, *supra* note 350 (“Senator Blanche Lincoln . . . says that there should be a clear division between banking activities that the government should support or at least provide liquidity to, and riskier business that it should not.”).

³⁵⁴ *See* Devlin Barrett & Damien Paletta, *A Fight to the Wire as Pro-Business Democrats Dig In on Derivatives*, WALL ST. J., June 26, 2010, <http://online.wsj.com/article/SB10001424052748704569204575329222524350534.html>; Phil Mattingly, *House Democrats Target Senator Lincoln’s Swap Proposal for Banking Bill*, BLOOMBERG (May 24, 2010), <http://www.bloomberg.com/news/2010-05-24/house-democrats-target-senator>

the Volcker Rule, the Obama Administration negotiated a last-minute compromise that significantly weakened the Lincoln Amendment.³⁵⁵ As enacted, the Lincoln Amendment allows an FDIC-insured bank to act as a swaps dealer with regard to (1) “[h]edging and other similar risk mitigating activities directly related to the [bank’s] activities”; (2) swaps involving interest rates, currency rates, and other “reference assets that are permissible for investment by a national bank,” including gold and silver but not other types of metals, energy, or agricultural commodities; and (3) credit default swaps that are cleared pursuant to Dodd-Frank and carry investment-grade ratings.³⁵⁶ In addition, the Lincoln Amendment allows banks up to five years to divest or spin off nonconforming derivatives operations into separate affiliates.³⁵⁷

Analysts estimate that the compromised Lincoln Amendment will require major banks to spin off only 10-20% of their existing derivatives activities into separate affiliates.³⁵⁸ In addition, banks will be able to argue for retention of derivatives that are used for “hedging” purposes, an open-ended standard that will require elaboration by regulators.³⁵⁹ As in the case of the Volcker Rule, commentators concluded that the Lincoln Amendment was “greatly diluted,”³⁶⁰ “significantly weakened,”³⁶¹ and “watered down,”³⁶²

-lincoln-s-swaps-proposal-for-banking-bill.html; Edward Wyatt & David M. Herszenhorn, *Accord Reached for an Overhaul of Finance Rules*, N.Y. TIMES, June 26, 2010, at A1.

³⁵⁵ See Barrett & Paletta, *supra* note 354; David Cho et al., *Lawmakers Guide Wall Street Reform into Homestretch: Industry Left Largely Intact*, WASH. POST, June 26, 2010, at A1; see also *supra* notes 329–31 and accompanying text (discussing the last-minute compromise that weakened the Volcker Rule).

³⁵⁶ Dodd-Frank Act § 716(d); see also Hill, *supra* note 342; Heather Landy, *Derivatives Compromise Is All About Enforcement*, AM. BANKER, June 30, 2010, at 1; Wyatt & Herszenhorn, *supra* note 354. It is highly ironic that Congress chose to rely on credit ratings as a reliable basis for exempting CDS from the Lincoln Amendment. Congress declared in section 931(5) of Dodd-Frank that inaccurate credit ratings on structured financial products “contributed significantly to the mismanagement of risks by financial institutions and investors, which in turn adversely impacted the health of the economy in the United States and around the world.” Dodd-Frank Act § 931(5); see also *supra* Part III.B. (describing conflicts of interest that encouraged CRAs to assign inaccurate and misleading credit ratings to structured financial products).

³⁵⁷ See Dodd-Frank Act § 716(h) (providing that the Lincoln Amendment will take effect two years after Dodd-Frank’s effective date); *id.* § 716(f) (permitting up to three additional years for banks to divest or cease nonconforming derivatives operations).

³⁵⁸ Harper & Keoun, *supra* note 330; Smith & Lucchetti, *supra* note 260.

³⁵⁹ Wyatt & Herszenhorn, *supra* note 354.

³⁶⁰ Johnson, *supra* note 309.

³⁶¹ Hill, *supra* note 342 (quoting the Consumer Federation of America).

with the result that “the largest banks’ [derivatives] operations are largely left intact.”³⁶³

The requirement that banks must clear their trades of CDS to be exempt from the Lincoln Amendment is potentially significant, in view of the new clearing requirements set forth in other provisions of Dodd-Frank.³⁶⁴ However, there is no clearing requirement for other derivatives (e.g., interest and currency rate swaps) that reference assets permissible for investment by national banks (“bank-eligible” derivatives). Consequently, banks may continue to trade and deal in OTC derivatives (except for CDS) without any interference from the Lincoln Amendment, as long as those derivatives are bank-eligible.³⁶⁵ As discussed above, all “proprietary trading” by banks in derivatives must also comply with the Volcker Rule as implemented by regulators.³⁶⁶

2. Banks Controlled by Financial Holding Companies Should Operate as “Narrow Banks” so That They Cannot Transfer Their Federal Safety Net Subsidies to Their Nonbank Affiliates

A fundamental purpose of both the Volcker Rule and the Lincoln Amendment is to prevent LCFIs from using the federal safety net subsidies to support their speculative activities in the capital markets. As enacted, however, both provisions have numerous gaps and exemptions that undermine their stated purpose.³⁶⁷ Given the greatly

³⁶² Smith & Lucchetti, *supra* note 260.

³⁶³ Keoun & Kopecki, *supra* note 339 (quoting analyst Nancy Bush).

³⁶⁴ Title VII of Dodd-Frank establishes comprehensive clearing, reporting, and margin requirements for a wide range of derivatives. See S. REP. NO. 111-176, at 29–35, 92–101 (2010) (discussing Title VII as proposed in the Senate committee bill); Alison Vekshin & Phil Mattingly, *Lawmakers Reach Compromise on Financial Regulation*, BLOOMBERG (June 25, 2010), <http://www.bloomberg.com/news/2010-06-25/lawmakers-reach-compromise-on-financial-regulation.html> (summarizing Title VII as approved by the House-Senate conference committee). A detailed analysis of Title VII is beyond the scope of this Article. Major financial institutions have already engaged in heavy lobbying to influence the adoption of regulations that will implement Title VII. See Asjlynn Loder & Phil Mattingly, *Wall Street Lobbyists Besiege CFTC to Shape Derivatives Rules*, BLOOMBERG (Oct. 13, 2010), <http://www.bloomberg.com/news/2010-10-14/wall-street-lobbyists-besiege-cftc-to-influence-regulations-on-derivatives.html>.

³⁶⁵ Dodd-Frank Act § 716(d)(2); see also Andrew Leonard, *How the World Works: The Dodd-Frank Bank Reform Bill: A Deeply Flawed Success*, SALON.COM (June 25, 2010), http://www.salon.com/technology/how_the_world_works/2010/06/25/the_dodd_frank_bank_reform_bill.

³⁶⁶ See *supra* Part V.D.1.b.

³⁶⁷ See *supra* Part V.D.1.b & 1.c.

weakened versions of both statutes, Paul Volcker was undoubtedly correct when he said that the Dodd-Frank legislation “went from what is best to what could be passed.”³⁶⁸

As shown below, the most effective way to prevent the spread of federal safety net subsidies from banks to their affiliates involved in the capital markets would be to create a two-tiered structure of bank regulation and deposit insurance. The first tier of “traditional” banking organizations would provide a relatively broad range of banking-related services, but those organizations would not be allowed to engage (or affiliate with firms that are engaged) in securities underwriting or dealing, insurance underwriting, or derivatives dealing or trading. In contrast, the second tier of “narrow banks” could affiliate with “nontraditional” financial conglomerates engaged in capital markets activities (except for private equity investments). However, as described below, “narrow banks” would be prohibited from making any extensions of credit or other transfers of funds to their nonbank affiliates, with the exception of lawful dividends paid to their parent holding companies. The “narrow bank” approach provides the most feasible approach for ensuring that banks cannot transfer their safety net subsidies to affiliated companies engaged in speculative activities in the capital markets, and it is therefore clearly superior to both the Volcker Rule and the Lincoln Amendment.³⁶⁹

a. The First Tier of Traditional Banking Organizations

Under my proposal, the first tier of regulated banking firms would be “traditional” banking organizations that limit their activities (including the activities of all holding company affiliates) to lines of business that satisfy the “closely related to banking” test under

³⁶⁸ Uchitelle, *supra* note 3 (quoting Mr. Volcker).

³⁶⁹ The following discussion of my proposal for a two-tiered structure of bank regulation and deposit insurance is adapted from Wilmarth, *supra* note 6, at 764–79. I am indebted to Robert Litan for a number of the concepts incorporated in my two-tiered proposal. See generally ROBERT E. LITAN, WHAT SHOULD BANKS DO? 164–89 (1987). For additional works favoring the use of “narrow banks” to achieve a strict separation between banking institutions and affiliates engaged in capital markets operations, see Emiliios Avgouleas, The Reform of ‘Too Big-to-Fail’ Bank: A New Regulatory Model for the Institutional Separation of ‘Casino’ from ‘Utility’ Banking (Feb. 14, 2010) (unpublished manuscript), available at <http://ssrn.com/abstract=1552970>; Kay, *supra* note 144, at 39–92; Ronnie J. Phillips & Alessandro Roselli, *How to Avoid the Next Taxpayer Bailout of the Financial System: The Narrow Banking Proposal* (Networks Fin. Inst., Pol’y Brief 2009-PB-05, 2009), available at http://ssrn.com/abstract_id=1459065.

Section 4(c)(8) of the BHC Act.³⁷⁰ For example, this first tier of traditional banks could take deposits, make loans, offer fiduciary services, and act as agents in selling securities, mutual funds, and insurance products underwritten by non-affiliated firms. Additionally, they could underwrite and deal solely in “bank-eligible” securities that national banks are permitted to underwrite and deal in directly.³⁷¹ First-tier banking organizations could also purchase, as end users, derivatives that (1) hedge against their own firm-specific risks and (2) qualify for hedging treatment under Financial Accounting Standard (FAS) Statement No. 133.³⁷²

Most first-tier banking firms would probably be small and midsize community-oriented banks, because those banks have shown little interest in engaging in insurance underwriting, securities underwriting or dealing, derivatives dealing or trading, or other capital markets activities. Community banks are well positioned to continue their traditional business of attracting core deposits, providing relationship loans to consumers and to small and midsize businesses, and offering wealth management and other fiduciary services to local customers.³⁷³ First-tier banks and their holding companies should continue to operate under their current supervisory arrangements, and all deposits of first-tier banks (up to the current statutory maximum of \$250,000³⁷⁴) should be covered by deposit insurance.

In order to provide reasonable flexibility to first-tier banking organizations, Congress should amend section 4(c)(8) of the BHC Act by permitting the FRB to expand the list of “closely related” activities that are permissible for holding company affiliates of traditional banks.³⁷⁵ However, Congress should prohibit first-tier BHCs from

³⁷⁰ See 12 U.S.C. § 1843(c)(8) (2006); CARNELL ET AL., *supra* note 118, at 442–44 (describing “closely related to banking” activities that are permissible for nonbank subsidiaries of BHCs under § 4(c)(8)).

³⁷¹ See Wilmarth, *supra* note 120, at 225, 225–26 n.30 (discussing “bank-eligible” securities that national banks are authorized to underwrite or purchase or sell for their own account); CARNELL ET AL., *supra* note 118, at 132–34 (same).

³⁷² See Wilmarth, *supra* note 6, at 766.

³⁷³ For a discussion of the business strategies typically followed by community banks, see Wilmarth, *supra* note 120, at 268–72.

³⁷⁴ Dodd-Frank Act § 335(a) (amending 12 U.S.C. § 1821(a)(1)(E) to increase permanently the “standard maximum deposit insurance amount” to \$250,000).

³⁷⁵ Unfortunately, the Gramm-Leach-Bliley Act (GLBA) of 1999 prohibits the FRB from approving any new “closely related” activities for bank holding companies under section 4(c)(8) of the BHC Act. See CARNELL ET AL., *supra* note 118, at 444 (explaining that the GLBA does not permit the FRB to expand the list of permissible activities under section 4(c)(8) beyond the activities that were approved as of November 11, 1999).

engaging as principal in underwriting or dealing in securities, underwriting any type of insurance (except for credit insurance), dealing or trading in derivatives, or making private equity investments.

b. The Second Tier of Nontraditional Banking Organizations

Unlike first-tier banking firms, the second tier of “nontraditional” banking organizations would be allowed, through nonbank subsidiaries, to engage in (1) underwriting and dealing (i.e., proprietary trading) in “bank-ineligible” securities,³⁷⁶ (2) underwriting all types of insurance, and (3) dealing and trading in derivatives. Second-tier banking organizations would include (1) FHCs registered under sections 4(k) and 4(l) of the BHC Act,³⁷⁷ (2) holding companies owning grandfathered “nonbank banks,” and (3) grandfathered “unitary thrift” holding companies.³⁷⁸ In addition, firms controlling industrial banks should be required either to register as FHCs or to divest their ownership of such banks if they cannot comply with the BHC Act’s prohibition against commercial activities.³⁷⁹ Second-tier holding companies would thus encompass

Congress should revise section 4(c)(8) by authorizing the FRB to approve a limited range of new activities that are “closely related” to the traditional banking functions of accepting deposits, extending credit, discounting negotiable instruments, and providing fiduciary services. See Wilmarth, *supra* note 6, at 767.

³⁷⁶ See Wilmarth, *supra* note 120, at 219–20, 225–26 n.30, 318–20 (discussing the distinction between (1) “bank-eligible” securities, which banks may underwrite and deal in directly, and (2) “bank-ineligible” securities, which affiliates of banks—but not banks themselves—may underwrite and deal in under GLBA).

³⁷⁷ 12 U.S.C. § 1843(k), (l) (2006); see also CARNELL ET AL., *supra* note 118, at 467–70 (describing “financial” activities, such as securities underwriting and dealing and insurance underwriting, that are authorized for FHCs under the BHC Act, as amended by GLBA).

³⁷⁸ See Arthur E. Wilmarth, Jr., *Wal-Mart and the Separation of Banking and Commerce*, 39 CONN. L. REV. 1539, 1569–71, 1584–86 (2007) (explaining that (1) during the 1980s and 1990s, many securities firms, life insurers, and industrial firms used the “nonbank bank” loophole or the “unitary thrift” loophole to acquire FDIC-insured institutions, and (2) those loopholes were closed to new acquisitions by a 1987 statute and by GLBA, respectively).

³⁷⁹ Industrial banks are exempted from treatment as “banks” under the BHC Act. See 12 U.S.C. § 1841(c)(2)(H). As a result, the BHC Act allows commercial (i.e., nonfinancial) firms to retain their existing ownership of industrial banks. However, Dodd-Frank imposes a three-year moratorium on the authority of federal regulators to approve any new acquisitions of industrial banks by commercial firms. Dodd-Frank Act § 603(a). In addition, Dodd-Frank requires the GAO to conduct a study and report to Congress on whether commercial firms should be permanently barred from owning industrial banks. *Id.* § 603(b); see also Wilmarth, *supra* note 378, at 1543–44, 1554–1620 (arguing that

all of the largest banking organizations—most of which are heavily engaged in capital markets activities—as well as other financial conglomerates that control FDIC-insured depository institutions.

(i) *Congress Should Require a “Narrow Bank” Structure for Second-Tier Banks*

Under my proposal, FDIC-insured banks that are subsidiaries of second-tier holding companies would be required to operate as “narrow banks.” The purpose of the narrow bank structure would be to prevent a “nontraditional” second-tier holding company from transferring the benefits of the bank’s federal safety net subsidies to its nonbank affiliates.

Narrow banks could offer FDIC-insured deposit accounts, including checking and savings accounts and certificates of deposit. Narrow banks would hold all of their assets in the form of cash and marketable, short-term debt obligations, including qualifying government securities; highly rated commercial paper; and other liquid, short-term debt instruments that are eligible for investment by money market mutual funds (MMMFs) under the SEC’s rules.³⁸⁰ Narrow banks could not hold any other types of loans or investments, nor could they accept any uninsured deposits. Narrow banks would present a very small risk to the DIF because (1) each narrow bank’s noncash assets would consist solely of short-term securities that could be “marked to market” on a daily basis and the FDIC could therefore readily determine whether a narrow bank was threatened with insolvency and (2) the FDIC could promptly convert a narrow bank’s assets into cash if the FDIC decided to liquidate the bank and pay off the claims of its insured depositors.³⁸¹

Congress should prohibit commercial firms from owning industrial banks because such ownership (1) undermines the long-established U.S. policy of separating banking and commerce, (2) threatens to spread federal safety net subsidies to the commercial sector of the U.S. economy, (3) threatens the solvency of the DIF, (4) creates competitive inequities between commercial firms that own industrial banks and other commercial firms, and (5) increases the likelihood of federal bailouts of commercial companies).

³⁸⁰ See REPORT OF THE PRESIDENT’S WORKING GROUP ON FINANCIAL MARKETS: MONEY MARKET FUND REFORM OPTIONS (2010) [hereinafter PWGFM-MMF REPORT], at 7–8 (describing restrictions imposed by the SEC’s Rule 2a-7 on the investments and other assets that MMMFs may hold), available at <http://www.treasury.gov/press-center/press-releases/Documents/10.21%20PWG%20Report%20Final.pdf>.

³⁸¹ See Wilmarth, *supra* note 6, at 768; Kenneth E. Scott, *Deposit Insurance and Bank Regulation: The Policy Choices*, 44 BUS. LAWYER 907, 921–22, 928–29 (1989).

Thus, narrow banks would effectively operate as FDIC-insured MMMFs. To prevent unfair competition with narrow banks, and to avoid future government bailouts of uninsured MMMFs, MMMFs should be prohibited from representing, either explicitly or implicitly, that they will redeem their shares based on a “constant net asset value” (NAV) of \$1 per share.³⁸² Currently, the MMMF industry, which manages about \$3 trillion of assets, leads investors to believe that their funds will be available for withdrawal (redemption) based on “a stable price of \$1 per share.”³⁸³ Not surprisingly, “the \$1 share price gives investors the false impression that money-market funds are like [FDIC-insured] banks accounts and can’t lose money.”³⁸⁴ However, “[t]hat myth was shattered in 2008” when Lehman’s default on its commercial paper caused Reserve Primary Fund (a large MMMF that invested heavily in Lehman’s paper) to suffer large losses and to “break the buck.”³⁸⁵ Reserve Primary Fund’s inability to redeem its shares based on a NAV of \$1 per share caused an investor panic that precipitated runs on several MMMFs. The Treasury Department responded by establishing the Money Market Fund Guarantee Program (MMFGP), which protected investors in participating MMMFs between October 2008 and September 2009.³⁸⁶

Critics of MMMFs maintain that the Treasury’s MMFGP has created an expectation of similar government bailouts if MMMFs

³⁸² Cf. Daisy Maxey, *Money Funds Exhale After New SEC Rules, but Should They?*, WALL ST. J., Feb. 2, 2010, at C9 (describing the SEC’s adoption of new rules governing MMMFs and reporting on concerns expressed by representatives of the MMMF industry that the SEC might someday force the industry to adopt a “floating NAV” in place of the industry’s current practice of quoting a constant NAV of \$1 per share).

³⁸³ David Reilly, *Goldman Sachs Wimps Out in Buck-Breaking Brawl*, BLOOMBERG (Feb. 2, 2010), <http://www.bloomberg.com/news/2010-02-02/goldman-sachs-wimps-out-in-buck-breaking-brawl-david-reilly.html>.

³⁸⁴ *Id.*; see also Kay, *supra* note 144, at 65 (arguing that an MMMF with a constant NAV of \$1 per share “either confuses consumers or creates an expectation of government guarantee”).

³⁸⁵ Reilly, *supra* note 383; see also Christopher Condon, *Volcker Says Money-Market Funds Weaken U.S. Financial System*, BLOOMBERG (Aug. 25, 2009), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a5O9Upz5e0Qc>.

³⁸⁶ Reilly, *supra* note 383 (describing “panic” that occurred among investors in MMMFs after Lehman’s collapse forced the Reserve Primary Fund to “break the buck”); Malini Manickavasagam, *Mutual Funds: Citing Stability, Treasury Allows Expiration of Money Market Fund Guarantee Program*, 93 BANKING REP. (BNA) 508 (Sept. 22, 2009) (reporting that “[t]o prevent other money market funds from meeting the Reserve fund’s fate, Treasury launched its [MMFGP] in October 2008” and continued that program until September 18, 2009); see also PWGFM-MMF REPORT, *supra* note 380, at 8–13 (discussing support provided by the Treasury and the FRB in order to stop the “run” by investors on MMMFs following Lehman’s collapse in September 2008).

“break the buck” in the future.³⁸⁷ In addition, former FRB chairman Paul Volcker has argued that MMMFs weaken banks because of their ability to offer bank-like products without equivalent regulation. MMMFs typically offer accounts with check-writing features, and they provide returns to investors that are higher than bank checking accounts because MMMFs do not have to pay FDIC insurance premiums or comply with other bank regulations.³⁸⁸ A Group of Thirty report, which Mr. Volcker spearheaded, proposed that MMMFs “that want to offer bank-like services, such as checking accounts and withdrawals at \$1 a share, should reorganize as a type of bank, with appropriate supervision and government insurance.”³⁸⁹ In contrast, MMMFs that do not wish to operate as banks “should not maintain the implicit promise that investors’ money is always safe” and should be required to base their redemption price on a floating NAV.³⁹⁰

³⁸⁷ Jane Bryant Quinn, *Money Funds Are Ripe for ‘Radical Surgery,’* BLOOMBERG (July 28, 2009), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a6iLSIGSSoFo>; see also Reilly, *supra* note 383 (arguing that the failure of federal authorities to reform the regulation of MMMFs “creates the possibility of future market runs and the need for more government bailouts”); PWGFM-MMF REPORT, *supra* note 380, at 17 (warning that “if further measures to insulate the [MMMF] industry from systemic risk are not taken *before* the next liquidity crisis, market participants will likely expect that the government would provide emergency support at minimal cost for [MMMFs] *during* the next crisis”).

³⁸⁸ Condon, *supra* note 385; Quinn, *supra* note 387 (“Banks have to hold reserves against demand deposits and pay for [FDIC] insurance” while “[m]oney funds offer similar transaction accounts without being burdened by these costs. That’s why they usually offer higher interest rates than banks.”).

³⁸⁹ Quinn, *supra* note 387 (summarizing recommendation presented in a January 2009 report by the Group of Thirty); see also GRP. OF THIRTY, FINANCIAL REFORM: A FRAMEWORK FOR FINANCIAL STABILITY 29 (2009) (recommending that “[m]oney market mutual funds wishing to continue to offer bank-like services, such as transaction account services, withdrawals on demand at par, and assurances of maintaining a stable net asset value (NAV) at par, should be required to reorganize as special-purpose banks, with appropriate prudential regulation and supervision, government insurance, and access to central bank lender-of-last resort facilities” (Recommendation 3.a.)).

³⁹⁰ Quinn, *supra* note 387 (summarizing recommendation of Group of Thirty); see also GRP. OF THIRTY, *supra* note 389, at 29 (Recommendation 3.b., stating that MMMFs “should be clearly differentiated from federally insured instruments offered by banks” and should base their pricing on “a fluctuating NAV”); Reilly, *supra* note 383 (supporting the Group of Thirty’s recommendation that MMMFs “either use floating values—and so prepare investors for the idea that these instruments can lose money—or be regulated as if they are bank products”); Kay, *supra* note 144, at 65 (similarly arguing that “[i]t is important to create very clear blue water between deposits, subject to government guarantee, and [uninsured MMMFs], which may be subject to market fluctuation”).

For the above reasons, uninsured MMMFs should be prohibited from representing, either explicitly or implicitly, that they will redeem shares based on a stable NAV. If Congress imposed this prohibition on MMMFs and also adopted my proposal for a two-tiered structure of bank regulation, many MMMFs would probably reorganize as FDIC-insured narrow banks and would become subsidiaries of second-tier FHCs.³⁹¹ As noted above, my proposed rules restricting the assets of narrow banks to commercial paper, government securities, and other types of marketable, highly-liquid investments should protect the DIF from any significant loss if a narrow bank failed.³⁹²

(ii) *Four Additional Rules Would Prevent Narrow Banks from Transferring the Benefits of Their Safety Net Subsidiaries to Their Affiliates*

Four supplemental rules are needed to prevent second-tier holding companies from exploiting their narrow banks' safety net subsidies. First, narrow banks should be absolutely prohibited—without any possibility of a regulatory waiver—from making any extensions of credit or other transfers of funds to their affiliates, except for the payment of lawful dividends out of profits to their parent holding companies.³⁹³ Currently, transactions between FDIC-insured banks and their affiliates are restricted by sections 23A and 23B of the Federal Reserve Act.³⁹⁴ However, the FRB repeatedly waived those restrictions during recent financial crises. The FRB's waivers allowed bank subsidiaries of FHCs to provide extensive support to affiliated securities broker-dealers and MMMFs. By granting those waivers, the FRB enabled banks controlled by FHCs to transfer to

³⁹¹ See Quinn, *supra* note 387 (describing strong opposition by Paul Schott Stevens, Chairman of the Investment Company Institute (the trade association representing the mutual fund industry), against any rule requiring uninsured MMMFs to quote floating NAVs because “[i]nvestors seeking guaranteed safety and soundness would migrate back to banks” and “[t]he remaining funds would become less attractive because of their fluctuating price”); see also PWGFM-MMF REPORT, *supra* note 380, at 32–35 (discussing potential advantages and logistical challenges that could result from adopting the Group of Thirty's proposal to require MMMFs with stable NAVs to reorganize and operate as regulated banks).

³⁹² See *supra* notes 380–81 and accompanying text.

³⁹³ Scott, *supra* note 381, at 929; Wilmarth, *supra* note 6, at 771–72.

³⁹⁴ 12 U.S.C. §§ 371c, 371c-1 (2006).

their nonbank affiliates the safety net subsidy provided by the banks' low-cost, FDIC-insured deposits.³⁹⁵

Dodd-Frank limits the authority of the FRB to issue orders or rules granting future waivers or exemptions under sections 23A and 23B because it requires the FRB to act with the concurrence of the OCC and the FDIC (with respect to waivers granted by orders for national banks) or the FDIC alone (with respect to waivers granted by orders for state banks or exemptions granted by regulation for any type of bank).³⁹⁶ Even so, it is unlikely that the OCC or the FDIC would refuse to concur with the FRB's proposal for a waiver under conditions of financial stress. Accordingly, Dodd-Frank does not ensure that the restrictions on affiliate transactions in sections 23A and 23B will be adhered to in a crisis setting.

In contrast, my proposal for second-tier narrow banks would replace sections 23A and 23B with an absolute rule. That rule would completely prohibit any extensions of credit or other transfers of funds by second-tier banks to their nonbank affiliates (except for lawful dividends paid to parent holding companies). That rule would also bar federal regulators from approving any such transactions between narrow banks and their nonbank affiliates. An absolute bar on affiliate transactions is necessary to prevent either LCFIs or federal regulators from using the low-cost funding advantages of FDIC-insured banks to provide backdoor bailouts to nonbank affiliates.

Second, as discussed above, Congress should repeal the "systemic risk exception" (SRE) currently included in the FDI Act. By repealing the SRE, Congress would require the FDIC to follow the

³⁹⁵ Wilmarth, *supra* note 120, at 456–57, 472–73 (discussing the FRB's waiver of section 23A restrictions so major banks could make large loans to their securities affiliates following the terrorist attacks on September 11, 2001); Ashcraft et al., *supra* note 214, at 563–64, 564 n.22, 575 n.34 (explaining that, after the subprime financial crisis began in August 2007, the FRB granted exemptions from section 23A restrictions to six major U.S. and foreign banks—Bank of America, Citigroup, Chase, Barclays, Deutsche, and RBS—so those banks could provide loans to support their securities affiliates); *Transactions Between Member Banks and Their Affiliates: Exemption for Certain Purchases of Asset-Backed Commercial Paper by a Member Bank from an Affiliate*, 74 Fed. Reg. 6226 (Feb. 6, 2009) (adopting rules to be codified at 12 C.F.R. §§ 223.42(o), 223.56(a)) (announcing the FRB's approval of blanket waivers of sections 23A and 23B to "increase the capacity" of banks to purchase ABCP from affiliated MMMFs, and declaring that such waivers—which were originally granted in September 2008—were justified "[i]n light of ongoing dislocations in the financial markets, and the impact of such dislocations on the functioning of ABCP markets and on the operation of [MMMFS]").

³⁹⁶ Dodd-Frank Act § 608(a)(4) (amending 12 U.S.C. § 371c(f)); *id.* § 608(b)(6) (amending 12 U.S.C. § 371c-1(e)(2)).

least costly resolution procedure for every failed bank, and the FDIC could no longer rely on the TBTF policy as a justification for protecting uninsured creditors of a failed bank or its nonbank affiliates.³⁹⁷

Repealing the SRE would ensure that the DIF could not be used to support a bailout of uninsured creditors of a failed or failing SIFI. Removing the SRE from the FDIA would make clear to the financial markets that the DIF could be used only to protect depositors of failed banks. Uninsured creditors of SIFIs and their nonbank subsidiaries would therefore have stronger incentives to monitor the financial operations and condition of such entities.³⁹⁸

Additionally, a repeal of the SRE would mean that smaller banks would no longer bear any part of the cost of protecting uninsured creditors of TBTF banks.³⁹⁹ Under current law, all FDIC-insured banks must pay a special assessment (allocated in proportion to their total assets) to reimburse the FDIC for the cost of protecting uninsured claimants of a TBTF bank under the SRE.⁴⁰⁰ A 2000 FDIC report noted the unfairness of expecting smaller banks to help pay for “systemic risk” bailouts when “it is virtually inconceivable that they would receive similar treatment if distressed.”⁴⁰¹ The FDIC report suggested that the way to correct this inequity is “to remove the [SRE],”⁴⁰² as I have proposed here.

Third, second-tier narrow banks should be barred from purchasing derivatives except as end users in transactions that qualify for hedging treatment under FAS 133.⁴⁰³ That prohibition would require all derivatives dealing and trading activities of second-tier banking organizations to be conducted through separate nonbank affiliates. GLBA currently allows FHCs to underwrite and deal in bank-ineligible securities and to underwrite insurance products only if such activities are conducted through nonbank subsidiaries.⁴⁰⁴

³⁹⁷ See *supra* notes 303–07 and accompanying text.

³⁹⁸ See Wilmarth, *supra* note 6, at 772.

³⁹⁹ See *id.*

⁴⁰⁰ 12 U.S.C. § 1823(c)(4)(G)(ii) (2006).

⁴⁰¹ FED. DEPOSIT INS. CORP., OPTIONS PAPER, AUG. 2000, at 33, available at http://www.fdic.gov/deposit/insurance/initiative/Options_080700m.pdf.

⁴⁰² *Id.*

⁴⁰³ See *supra* note 372 and accompanying text (discussing FAS 133).

⁴⁰⁴ See CARNELL ET AL., *supra* note 118, at 27, 130–34, 153, 467–70, 490–91 (explaining that, under GLBA, all underwriting of bank-ineligible securities and insurance products by FHCs must be conducted either through nonbank holding company

Accordingly, FHC-owned banks (1) should be barred from dealing or trading in derivatives that function as synthetic substitutes for bank-ineligible securities or insurance, and (2) should be required to conduct such activities in separate nonbank affiliates.⁴⁰⁵ Prohibiting second-tier banks from dealing and trading in derivatives would accomplish an essential goal of the Volcker Rule and the Lincoln Amendment because it would prevent FHCs from conducting speculative capital markets activities within subsidiary banks in order to exploit the banks' low-cost funding due to federal safety net subsidies.⁴⁰⁶

I have previously pointed out that bank dealers in OTC derivatives enjoy significant competitive advantages over nonbank dealers because of the banks' explicit and implicit safety net subsidies.⁴⁰⁷ Banks typically borrow funds at significantly lower interest rates than their holding company affiliates because (1) banks can obtain direct, low-cost funding through FDIC-insured deposits and (2) banks present lower risks to their creditors because of their direct access to other federal safety net resources, including (a) the FRB's discount window lending facility, (b) the FRB's guarantee of interbank payments made on Fedwire, and (c) the greater potential availability of TBTF bailouts for uninsured creditors of banks (as compared to creditors of BHCs).⁴⁰⁸ The OCC has confirmed that FHCs generate higher profits when they conduct derivatives activities directly within their banks, in part because the "favorable [funding] rate enjoyed by the banks" is lower than "the borrowing rate of their holding

subsidiaries or (in the case of securities) through nonbank financial subsidiaries of banks); Wilmarth, *supra* note 120, at 219–20, 225–26 n.30, 226 n.31, 227 n.33, 318–20 (same).

⁴⁰⁵ See Wilmarth, *supra* note 120, at 337–38 (describing financial derivatives as "synthetic investments" because they can be tailored to mimic, with desired variations, the risk and return profiles of "fundamental securities" such as stocks and bonds"); Caiola v. Citibank, N.A., 295 F.3d 312, 315–17 (2d Cir. 2002) (describing a "synthetic trading" program designed by Citibank that enabled the plaintiff to use equity swaps and cash-settled, over-the-counter options to "economically replicate the ownership and physical trading of shares and [exchange-traded] options" without leaving "footprints" in the public securities markets); *supra* note 40 and accompanying text (explaining that a CDS operates as the functional equivalent of insurance with respect to specified credit-related events).

⁴⁰⁶ See *supra* notes 319–22, 342–44, 353 and accompanying text (explaining that a central objective of the both Volcker Rule and the Lincoln Amendment is to prevent the transfer of safety net subsidies from FDIC-insured banks to their nonbank affiliates).

⁴⁰⁷ Wilmarth, *supra* note 120, at 336–37, 372–73.

⁴⁰⁸ CARNELL ET AL., *supra* note 118, at 492; Wilmarth, *supra* note 221, at 5–7, 16 n.39.

companies.”⁴⁰⁹ Such an outcome may be favorable to FHCs, but it is certainly not beneficial to the DIF or the taxpayers. The DIF and the taxpayers are exposed to a significantly higher risk of losses when derivatives dealing and trading activities are conducted directly within banks instead of within nonbank holding company affiliates.⁴¹⁰ Congress should terminate this artificial, federally subsidized advantage for bank derivatives dealers.

Fourth, Congress should strengthen the Volcker Rule by prohibiting all private equity investments by second-tier banks and their holding company affiliates.⁴¹¹ To accomplish this reform, Congress should repeal sections 4(k)(4)(H) and (I) of the BHC Act,⁴¹² which allow FHCs to make merchant banking investments and insurance company portfolio investments.⁴¹³ Private equity investments involve a high degree of risk and have inflicted significant losses on FHCs in the past.⁴¹⁴ In addition, private equity investments threaten to “weaken the separation of banking and commerce” by allowing FHCs “to maintain long-term control over entities that conduct commercial (i.e., nonfinancial) businesses.”⁴¹⁵ Such affiliations between banks and commercial firms are undesirable because they are likely to create serious competitive and economic distortions, including the spread of federal safety net benefits to the commercial sector of our economy.⁴¹⁶

In combination, the four supplemental rules described above would help to ensure that narrow banks cannot transfer the benefits of their federal safety net subsidies to their nonbank affiliates. Restricting the scope of safety net subsidies is of utmost importance in order to

⁴⁰⁹ Interpretive Letter #892 from John D. Hawke, Jr., Comptroller of the Currency, to James A. Leach, Chairman of House Comm. on Banking & Fin. Servs. (Sept. 30, 2000), available at <http://www.occ.gov/static/interpretations-and-precedents/sep00/int892.pdf>.

⁴¹⁰ Wilmarth, *supra* note 120, at 372–73. For general discussions of the risks posed by OTC derivatives to banks and other financial institutions, see *id.* at 337–78; RICHARD BOOKSTABER, *A DEMON OF OUR OWN DESIGN: MARKETS, HEDGE FUNDS, AND THE PERILS OF FINANCIAL INNOVATION* 7–147 (2007); TETT, *supra* note 79, *passim*.

⁴¹¹ As discussed above, the Volcker Rule limits, but does not completely bar, private equity investments by BHCs and FHCs. See *supra* Part V.E.1.b.

⁴¹² 12 U.S.C. § 1843(k)(4)(H), (I) (2006).

⁴¹³ See CARNELL ET AL., *supra* note 118, at 483–85 (explaining that “through the merchant banking and insurance company investment provisions, [GLBA] allows significant nonfinancial affiliations” with banks).

⁴¹⁴ See Wilmarth, *supra* note 120, at 330–32, 375–78.

⁴¹⁵ Wilmarth, *supra* note 378, at 1581–82.

⁴¹⁶ For further discussion of this argument, see *id.* at 1588–1613; *supra* note 379.

restore a more level playing field between small and large banks and between banking and nonbanking firms. The safety net and TBTF subsidies enjoyed by large banking organizations—in the form of lower capital ratios, higher risk-adjusted stock prices and reduced funding costs—have increasingly distorted our regulatory and economic policies over the past three decades.⁴¹⁷ During the same period, (1) nonbanking firms have pursued every available avenue to acquire FDIC-insured depository institutions so they can secure the funding advantages provided by low-cost, FDIC-insured deposits, and (2) nonbank affiliates of banks have made every effort to exploit the funding advantages and other safety net benefits conferred by their affiliation with FDIC-insured institutions.⁴¹⁸ The enormous benefits conferred by federal safety net subsidies are conclusively shown by the following facts: (1) no major banking organization has ever voluntarily surrendered its bank charter and (2) large nonbanking firms have aggressively pursued strategies to secure control of FDIC-insured depository institutions.⁴¹⁹

The most practicable way to prevent the spread of federal safety net subsidies—as well as their distorting effects on regulation and economic activity—is to establish strong barriers that prohibit narrow banks from transferring the benefits of those subsidies to their nonbanking affiliates, including those engaged in speculative capital markets activities.⁴²⁰ The narrow bank structure and the supplemental rules described above would force financial conglomerates to prove that they can produce superior risk-related returns to investors without relying on explicit and implicit government subsidies. As I have previously explained elsewhere, economic studies have failed to confirm the existence of favorable economies of scale or scope in financial conglomerates, and those conglomerates have not been able to generate consistently positive

⁴¹⁷ See *supra* notes 116–39 and accompanying text (discussing competitive and economic distortions created by safety net and TBTF subsidies).

⁴¹⁸ Wilmarth, *supra* note 378, at 1569–70, 1584–93; Wilmarth, *supra* note 221, at 5–8. As John Kay has pointed out:

The opportunity to gain access to the retail deposit base has been and remains irresistible to ambitious deal makers. That deposit base carries an explicit or implicit government guarantee and can be used to leverage a range of other, more exciting, financial activities. The archetype of these deal-makers was Sandy Weill, the architect of Citigroup.

Kay, *supra* note 144, at 43.

⁴¹⁹ Wilmarth, *supra* note 378, at 1590–93.

⁴²⁰ See Kay, *supra* note 144, at 57–59.

returns, even under the current regulatory system that allows them to receive extensive federal subsidies.⁴²¹

In late 2009, a prominent bank analyst suggested that, if Congress prevented nonbank subsidiaries of FHCs from relying on low-cost deposit funding provided by their affiliated banks, large FHCs would not be economically viable and would be forced to break up voluntarily.⁴²² It is noteworthy that many of the largest commercial and industrial conglomerates in the United States and Europe have been broken up through hostile takeovers and voluntary divestitures during the past three decades because they proved to be “less efficient and less profitable than companies pursuing more focused business strategies.”⁴²³ It is long past time for financial conglomerates to be stripped of their safety net subsidies (except for the carefully limited protection that would be provided to narrow banks) as well as their presumptive access to TBTF bailouts. If Congress took such action, financial conglomerates would become subject to the same type of scrutiny and discipline that the capital markets have applied to commercial and industrial conglomerates during the past thirty years. Hence, the narrow bank concept provides a workable plan to impose effective market discipline on FHCs.

c. Responses to Critiques of the Narrow Bank Proposal

Critics have raised three major objections to the narrow bank concept. First, critics point out that the asset restrictions imposed on narrow banks would prevent them from acting as intermediaries of funds between depositors and most borrowers. Many narrow bank proposals (including mine) would require narrow banks to invest their deposits in safe, highly marketable assets such as those permitted for MMMFs. Narrow banks would therefore be largely or entirely barred from making commercial loans. As a result, critics warn that a

⁴²¹ Wilmarth, *supra* note 6, at 748–49; *see also* JOHNSON & KWAK, *supra* note 137, at 212–13.

⁴²² Karen Shaw Petrou, the managing partner of Federal Financial Analytics, explained that “[i]nteraffiliate restrictions would limit the use of bank deposits on nonbanking activities,” and “[y]ou don’t own a bank because you like branches, you own a bank because you want cheap core funding.” Stacy Kaper, *Big Banks Face Most Pain Under House Bill*, AM. BANKER, Dec. 2, 2009, at 1 (quoting Ms. Petrou). Ms. Petrou therefore concluded that an imposition of stringent limits on affiliate transactions, “really strikes at the heart of a diversified banking organization” and “I think you would see most of the very large banking organizations pull themselves apart” if Congress passed such legislation. *Id.* (same).

⁴²³ Wilmarth, *supra* note 120, at 284; *see also* Wilmarth, *supra* note 6, at 775–76.

banking system composed exclusively of narrow banks could not provide credit to small and midsize business firms that lack access to the capital markets and depend on banks as their primary source of outside credit.⁴²⁴

However, my two-tiered proposal would greatly reduce any disruption of the traditional role of banks in acting as intermediaries between depositors and bank-dependent firms because my proposal would allow first-tier “traditional” banks (primarily community-oriented banks) to continue making commercial loans that are funded by deposits. Community banks make most of their commercial loans in the form of longer-term “relationship” loans to small and midsize firms.⁴²⁵ Under my proposal, community banks could continue to carry on their deposit-taking and lending activities as first-tier banking organizations without any change from current law, and their primary commercial lending customers would continue to be smaller, bank-dependent firms.

In contrast to community banks, big banks do not make a substantial amount of relationship loans to small firms. Instead, big banks primarily make loans to large and well-established firms, and they provide credit to small businesses mainly through highly automated programs that use impersonal credit scoring techniques.⁴²⁶ Under my proposal, as indicated above, most large banks would operate as subsidiaries of second-tier “nontraditional” banking organizations. Second-tier holding companies would conduct their business lending programs through nonbank finance subsidiaries that are funded by commercial paper and other debt instruments sold to investors in the capital markets. This operational structure should not create a substantial disincentive for the highly automated small-business lending programs offered by big banks because most loans produced by those programs (e.g., business credit card loans) can be financed by the capital markets through securitization.⁴²⁷

Thus, my two-tier proposal should not cause a significant reduction in bank loans to bank-dependent firms because big banks have

⁴²⁴ See, e.g., Neil Wallace, *Narrow Banking Meets the Diamond-Dybvig Model*, 20 FED. RES. BANK MINNEAPOLIS Q. REV. No. 1, Winter 1996, at 3.

⁴²⁵ Wilmarth, *supra* note 120, at 261–66; see also Allen N. Berger et al., *Does Function Follow Organizational Form? Evidence from the Lending Practices of Large and Small Banks*, 76 J. FIN. ECON. 237, 239–46, 254–62, 266 (2005).

⁴²⁶ Wilmarth, *supra* note 120, at 264–66; see also Berger et al., *supra* note 425, at 240–41, 266.

⁴²⁷ Wilmarth, *supra* note 6, at 777–78.

already moved away from traditional relationship-based lending funded by deposits. If Congress wanted to give LCFIs a strong incentive to make relationship loans to small and midsize firms, Congress could authorize second-tier narrow banks to devote a specified percentage (e.g., 10%) of their assets to such loans, as long as the banks held appropriate risk-based capital, retained the loans on their balance sheets and did not securitize them. By authorizing such a limited “basket” of relationship loans, Congress could allow second-tier narrow banks to use deposits to fund those loans without exposing the banks to a significant risk of failure, as the remainder of their assets would be highly liquid and marketable.

The second major criticism of the narrow bank proposal is that it would lack credibility because regulators would retain the inherent authority (whether explicit or implicit) to organize bailouts of major financial firms during periods of severe economic distress. Accordingly, some critics warn that the narrow bank concept would simply shift the TBTF problem from insured banks to their nonbank affiliates.⁴²⁸ However, the force of this objection has been diminished by the systemic risk oversight and resolution regime established by Dodd-Frank. Under Dodd-Frank, LCFIs that might have been considered for TBTF bailouts in the past will be designated and regulated as SIFIs and will also be subject to resolution under Dodd-Frank’s OLA. As shown above, the potential for TBTF bailouts of SIFIs would be reduced further if (1) Congress required all SIFIs to pay risk-based premiums to pre-fund the OLF, so the OLF would have the necessary resources to handle the foreseeable costs of resolving future failures of SIFIs, and (2) Congress repealed the SRE, so the DIF would no longer be available as a potential bailout fund for TBTF institutions.⁴²⁹

Thus, if my proposed reforms were fully implemented, (1) the narrow-bank structure would prevent SIFI-owned banks from transferring the benefits of their safety net subsidies to their nonbank affiliates, and (2) the systemic risk oversight and resolution regime would require SIFIs to internalize the potential risks that their operations present to financial and economic stability. In combination, both sets of regulatory reforms should greatly reduce the

⁴²⁸ See Scott, *supra* note 381, at 929–30 (noting the claim of some critics that there would be “irresistible political pressure” for bailouts of uninsured “substitute-banks” that are created to provide the credit previously extended by FDIC-insured banks).

⁴²⁹ See *supra* Part V.D. (explaining reasons for pre-funding the OLF and repealing the SRE).

TBTF subsidies that might otherwise be available to large financial conglomerates.

Moreover, the narrow bank structure could advance Dodd-Frank's mandate for developing viable resolution plans ("living wills") for SIFIs.⁴³⁰ Because narrow banks would be barred from making extensions of credit and other transfers of funds to their nonbank affiliates, the narrow bank structure would make it easier to separate SIFI-owned banks from their nonbank affiliates if the parent company failed.⁴³¹

The narrow bank structure would also be consistent with a policy known as "subsidiarization," which could potentially facilitate cross-border resolutions of multinational SIFIs. Subsidiarization would require multinational LCFIs to reorganize their international operations into separate, "clear-cut subsidiaries" in each country, thereby making it easier for home and host country regulators to assume distinct responsibilities for resolving the subsidiaries located within their respective jurisdictions.⁴³² Because the narrow bank concept embraces a policy of strict separation between banks and their nonbank affiliates, it might provide greater impetus toward adoption of subsidiarization as a means to promote a coordinated approach to resolution of cross-border SIFIs.

The third principal objection to the narrow-bank proposal is that it would place U.S. FHCs at a significant disadvantage in competing with foreign universal banks that are not required to comply with similar constraints.⁴³³ Again, there are persuasive rebuttals to this objection. For example, government officials in the United Kingdom are considering the possible adoption of a narrow-banking structure based on a proposal developed by John Kay.⁴³⁴ In May 2010, the

⁴³⁰ See Dodd-Frank Act §§ 115(d)(1), 165(d) (authorizing the adoption of standards requiring nonbank SIFIs and large BHCs to adopt plans for "rapid and orderly resolution in the event of material financial distress or failure"); see also Joe Adler, *Living Wills a Live Issue at Big Banks*, AM. BANKER, Sept. 20, 2010, at 1 (discussing Dodd-Frank's requirement for large BHCs to produce resolution plans and the likelihood that, to meet that requirement, "many firms may have to think about creating a simpler structure with clearer lines between entities underneath the holding company").

⁴³¹ See *supra* notes 393–97 and accompanying text.

⁴³² Joe Adler, *Resolution Idea Hard to Say, May Be Hard to Sell*, AM. BANKER, Nov. 16, 2010, at 1 (reporting that financial regulators were discussing the concept of "subsidiarization" as a method of enabling "host countries [to exercise] more authority over subsidiaries operating inside their borders").

⁴³³ See Kay, *supra* note 144, at 71–74; Scott, *supra* note 381, at 931.

⁴³⁴ See Kay, *supra* note 144, at 51–69 (describing the narrow bank proposal as a means for accomplishing "the separation of utility from casino banking"); King, *supra* note 118,

United Kingdom's new coalition government announced that it would establish "an independent commission to investigate separating retail and investment banking in a sustainable way."⁴³⁵ In September, the commission issued its first report, which stated that the narrow banking approach was among the options the commission planned to consider.⁴³⁶ If the United States and the United Kingdom both decided to implement a narrow banking structure (supplemented by strong systemic risk oversight and resolution regimes), their combined leadership in global financial markets would place considerable pressure on other developed countries to adopt similar financial reforms.⁴³⁷

The financial sector accounts for a large share of the domestic economies of the United States and the United Kingdom. Both economies were severely damaged by two financial crises during the past decade (the dotcom-telecom bust and the subprime lending crisis). Both crises were produced by the same set of LCFIs that

at 6–7 (expressing support for Kay's narrow bank proposal and for the Volcker Rule as two alternative possibilities for separating the "utility aspects of banking" from "some of the riskier financial activities, such as proprietary trading"); HOUSE OF COMMONS TREASURY COMM., TOO IMPORTANT TO FAIL—TOO IMPORTANT TO IGNORE, 2009–10, H.C. 9–Vol. 1, at 52, 59, available at <http://www.publications.parliament.uk/pa/cm200910/cmselect/cmtreasy/261/261i.pdf> (expressing qualified support for Kay's narrow banking proposal).

⁴³⁵ Ali Qassim, *International Banking: U.K.'s Ruling Coalition to Investigate Separating Investment, Retail Banks*, 94 Banking Rep. (BNA) 1055 (May 25, 2010).

⁴³⁶ INDEP. COMM'N ON BANKING, ISSUES PAPER: CALL FOR EVIDENCE 4–5, 33–34 (2010), available at <http://bankingcommission.independent.gov.uk/bankingcommission/wp-content/uploads/2010/07/Issues-Paper-24-September-2010.pdf>. For discussions of the Commission's preliminary work, see Richard Northedge, *To Split or Not to Split? What Is the Future for Britain's Banks?*, INDEP. ON SUNDAY (London), Sept. 26, 2010, at 80; Michael Settle, *Big Banks Could Be Broken Up*, HERALD (Glasgow, Scotland), Sept. 25, 2010, at 12.

⁴³⁷ Kay, *supra* note 144, at 74; HOUSE OF COMMONS TREASURY COMM., *supra* note 434, at 70–71 (quoting views of former FRB Chairman Paul Volcker); *see also* TARULLO, *supra* note 246, at 45–54 (describing how the United States and the United Kingdom first reached a mutual agreement on proposed international risk-based bank capital rules in the 1980s and then pressured other developed nations to adopt the Basel I international capital accord). In addition, the FRB could refuse to allow a foreign LCFI to acquire a U.S. bank, or to establish a branch or agency in the United States unless the foreign LCFI agreed to structure its operations within the United States to conform to any narrow bank restrictions imposed on U.S. FHCs. *See Pharaon v. Bd. of Governors of the Fed. Reserve Bd.*, 135 F.3d 148, 152–54 (D.C. Cir. 1998) (upholding the FRB's authority under the BHC Act to regulate foreign companies that control U.S. banks), *cert. denied*, 525 U.S. 947 (1998); 12 U.S.C. § 3105(d) (requiring foreign banks to obtain the FRB's approval before they establish any U.S. branches or agencies); *id.* § 3106 (requiring foreign banks with U.S. branches or agencies to comply with the BHC Act's restrictions on nonbanking activities).

continue to dominate the financial systems in both nations. Accordingly, regardless of what other nations may do, the United States and the United Kingdom have compelling national reasons to make sweeping changes to their financial systems to protect their domestic economies from the threat of a similar crisis in the future.⁴³⁸

Finally, the view that the United States and the United Kingdom must refrain from implementing fundamental financial reforms until all other major developed nations have agreed to do so rests upon two deeply flawed assumptions: (1) the United States and the United Kingdom must allow foreign nations with the *weakest* systems of financial regulation to dictate the level of supervisory constraints on LCFIs until an international accord with stronger standards has been approved by *all* major developed nations, and (2) until a comprehensive international agreement on reform is achieved, the United States and the United Kingdom should be obliged to provide TBTF bailouts and other safety net subsidies that impose huge costs, create moral hazard, and distort economic incentives simply because other nations provide similar benefits to their LCFIs.⁴³⁹ Both assumptions are unacceptable and must be rejected.

VI

CONCLUSION AND POLICY IMPLICATIONS

The TBTF policy remains “the great unresolved problem of bank supervision” more than a quarter century after the policy was invoked to justify the federal government’s rescue of Continental Illinois in 1984.⁴⁴⁰ The recent financial crisis confirms that TBTF institutions “present formidable risks to the federal safety net and are largely insulated from both market discipline and supervisory intervention.”⁴⁴¹ Accordingly, as I observed in 2002, “fundamentally different approaches for regulating financial conglomerates and containing safety net subsidies are urgently needed.”⁴⁴²

⁴³⁸ See, e.g., Hoenig, *supra* note 110, at 4–10; Kay, *supra* note 144, at 14–17, 20–24, 28–31, 39–47, 57–58, 66–75, 86–87; King, *supra* note 118; HOUSE OF COMMONS TREASURY COMM., *supra* note 434, at 71–74; Wilmarth, *supra* note 6, at 712–15, 736–47.

⁴³⁹ See, e.g., Hoenig, *supra* note 110, at 4–10; Kay, *supra* note 144, at 42–46, 57–59, 66–75.

⁴⁴⁰ Wilmarth, *supra* note 120, at 475; see also *id.* at 300–01, 314–15.

⁴⁴¹ *Id.* at 476; see also Wilmarth, *supra* note 4, at 968–72, 1046–50.

⁴⁴² Wilmarth, *supra* note 120, at 476.

Dodd-Frank makes meaningful improvements in the regulation of large financial conglomerates. As discussed in Part V, Dodd-Frank establishes a new umbrella oversight body—the FSOC—that will designate SIFIs and make recommendations for their supervision. Dodd-Frank also empowers the FRB to adopt stronger capital requirements and other enhanced prudential standards for SIFIs. Most importantly, Dodd-Frank establishes a new systemic resolution regime (the OLA), which should provide a superior alternative to the “bailout or bankruptcy” choice that federal regulators confronted when they dealt with failing SIFIs during the financial crisis.

In addition, Title X of Dodd-Frank reduces systemic risk by creating a new federal authority, the Consumer Financial Protection Bureau (CFPB), to protect consumers from unfair, deceptive, or abusive financial products.⁴⁴³ As the recent financial crisis demonstrated, ineffective consumer protection poses a severe threat to financial stability when regulators allow unfair and unsound consumer lending practices to become widespread within the financial system.⁴⁴⁴ During the decade leading up to the financial crisis, federal financial regulators repeatedly failed to protect consumers against pervasive predatory lending abuses and thereby contributed to the severity and persistence of the crisis.⁴⁴⁵ Focusing the mission of consumer financial protection within the CFPB significantly increases the likelihood that the CFPB will act decisively to prevent future lending abuses from threatening the stability of our financial system.⁴⁴⁶

Nevertheless, Dodd-Frank does not solve the TBTF problem. Dodd-Frank (like Basel III) relies primarily on the same supervisory tool—capital-based regulation—that failed to prevent the banking and thrift crises of the 1980s as well as the recent financial crisis.⁴⁴⁷ In addition, the supervisory reforms contained in Dodd-Frank depend for

⁴⁴³ See S. REP. NO. 111-176, at 11, 161–74 (2010).

⁴⁴⁴ See *id.* at 9–17; Bair FCIC Testimony, *supra* note 276, at 3–6, 9–12, 14–20, 47–50; Elizabeth A. Duke, Governor, Fed. Reserve Bd., The Systemic Importance of Consumer Protection, Speech at the Community Development Policy Summit (June 10, 2009), available at <http://www.federalreserve.gov/newsevents/speech/duke20090610a.htm>.

⁴⁴⁵ See S. REP. NO. 111-176, at 9–19; see also JOHNSON & KWAK, *supra* note 137, at 120–44; Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 70–97 (2008); McCoy et al., *supra* note 14, at 1343–66; Wilmarth, *supra* note 15, at 19–31.

⁴⁴⁶ See S. REP. NO. 111-176, at 9–11; see also Bar-Gill & Warren, *supra* note 445, at 98–101.

⁴⁴⁷ See *supra* notes 244–52 and accompanying text.

their effectiveness on the same federal regulatory agencies that failed to stop excessive risk taking by financial institutions during the booms that preceded both crises.⁴⁴⁸ As Johnson and Kwak observe:

[S]olutions that depend on smarter, better regulatory supervision and corrective action ignore the political constraints on regulation and the political power of the large banks. The idea that we can simply regulate large banks more effectively assumes that regulators will have the incentive to do so, despite everything we know about regulatory capture and political constraints on regulation.⁴⁴⁹

Moreover, the future effectiveness of the FSOC is open to serious question in light of the agency turf battles and other bureaucratic failings that have plagued similar multiagency oversight bodies in other fields of governmental activity (e.g., the Department of Homeland Security and the Office of the Director of National Intelligence).⁴⁵⁰

As explained above, Dodd-Frank's most promising reform for preventing future TBTF bailouts—the OLA—does not completely shut the door to future rescues for creditors of LCFIs. The FRB can provide emergency liquidity assistance to troubled LCFIs through the discount window and (perhaps) through “broad-based” liquidity facilities (like the Primary Dealer Credit Facility) that are designed to help targeted groups of the largest financial institutions. The FHLBs can make secured advances to LCFIs. The FDIC can use its Treasury borrowing authority and the SRE to protect uninsured creditors of failed SIFIs and their subsidiary banks. While Dodd-Frank has undoubtedly made TBTF bailouts more difficult, the continued existence of these avenues for financial assistance indicates that Dodd-Frank is not likely to prevent future TBTF rescues during episodes of systemic financial distress.⁴⁵¹

⁴⁴⁸ See *supra* notes 253–60 and accompanying text.

⁴⁴⁹ JOHNSON & KWAK, *supra* note 137, at 207.

⁴⁵⁰ See, e.g., Dara Kay Cohen et al., *Crisis Bureaucracy: Homeland Security and the Political Design of Legal Mandates*, 59 STAN. L. REV. 673, 675–78, 718–20, 738–43 (2006) (analyzing organizational problems and operational failures within the Department of Homeland Security); Dana Priest & William M. Arkin, *A Hidden World, Growing Beyond Control*, WASH. POST, July 19, 2010, at A1 (discussing organizational problems and operational failures within the Office of the Director of National Intelligence); Paul R. Pillar, *Unintelligent Design*, NAT'L INTEREST (Aug. 24, 2010), <http://nationalinterest.org/article/unintelligent-design-3918> (same).

⁴⁵¹ See *supra* Part V.C. Other commentators agree that Dodd-Frank will not prevent future bailouts of TBTF institutions. See, e.g., Peter Eavis, *A Bank Overhaul Too Weak to Hail*, WALL ST. J., June 26, 2010, at B14; David Pauly, *Congress Puts Out 'Sell' Order on*

As an alternative to Dodd-Frank's regulatory reforms, Congress could have addressed the TBTF problem directly by mandating a breakup of large financial conglomerates. That is the approach advocated by Simon Johnson and James Kwak, who have proposed maximum size limits of four percent of GDP (about \$570 billion in assets) for commercial banks and two percent of GDP (about \$285 billion of assets) for securities firms. Those size caps would require a significant reduction in size for the six largest U.S. banking organizations (Bank of America, Chase, Citigroup, Wells Fargo, Goldman, and Morgan Stanley).⁴⁵² Like Joseph Stiglitz, Johnson and Kwak maintain that "[t]he best defense against a massive financial crisis is a popular consensus that too big to fail is too big to exist."⁴⁵³

Congress did not follow the approach recommended by Johnson, Kwak, and Stiglitz. In fact, the Senate rejected a similar proposal for maximum size limits by almost a two-to-one vote.⁴⁵⁴ As noted above, Congress modestly strengthened the Riegle-Neal Act's 10% nationwide deposit cap, which limits interstate mergers and acquisitions involving depository institutions or their parent holding companies. However, that provision does not restrict intrastate

American Banks, BLOOMBERG (June 28, 2010), <http://www.bloomberg.com/news/2010-06-29/congress-puts-out-sell-order-on-american-banks-david-pauly.html>; Christine Hauser, *Banks Likely to Offset Impact of New Law, Analysts Say*, N.Y. TIMES, June 25, 2010, <http://www.nytimes.com/2010/06/26/business/26reax.html> (quoting Professor Cornelius Hurley's views that Congress "missed the crisis" and that "in no way does [Dodd-Frank] address the too-big-to-fail issue").

⁴⁵² JOHNSON & KWAK, *supra* note 137, at 214–17.

⁴⁵³ *Id.* at 221; *accord id.* at 217 ("Saying that we cannot break up our largest banks is saying that our economic futures depend on these six companies (some of which are in various states of ill health). That thought should frighten us into action."); JOSEPH E. STIGLITZ, *FREEFALL: AMERICA, FREE MARKETS, AND THE SINKING OF THE WORLD ECONOMY* 164–65 (2010) ("There is an obvious solution to the too-big-to-fail banks: break them up. If they are too big to fail, they are too big to exist.").

⁴⁵⁴ A proposed amendment by Senators Sherrod Brown and Ted Kaufman would have imposed the following maximum size limits on LCFIs: (1) a cap on deposit liabilities equal to 10% of nationwide deposits and (2) a cap on non-deposit liabilities equal to 2% of GDP for banking institutions and 3% of GDP for nonbanking institutions. The size caps proposed by Brown and Kaufman would have limited a single institution to about \$750 billion of deposits and about \$300 billion of non-deposit liabilities. The Senate rejected the Brown-Kaufman amendment by a vote of 61–33. See Alison Vekshin, *Senate Rejects Consumer Amendment to Overhaul Bill (Update 1)*, BLOOMBERG BUSINESSWEEK (May 7, 2010), <http://www.businessweek.com/news/2010-05-07/senate-rejects-consumer-amendment-to-overhaul-bill-update1-.html>; Donna Borak, *Proposal Seeks to Limit Size of 6 Biggest Banks*, AM. BANKER, May 5, 2010, at 2; Sewell Chan, *Financial Debate Renews Scrutiny of Banks' Size*, N.Y. TIMES, Apr. 20, 2010, <http://www.nytimes.com/2010/04/21/business/21fail.html>.

mergers or acquisitions or organic (internal) growth by LCFIs. In addition, Congress gave the FSOC and the FRB broad discretion to decide whether to impose a 10% nationwide liabilities cap on mergers and acquisitions involving financial companies.⁴⁵⁵ LCFIs will undoubtedly seek to block the adoption of any such liabilities cap.

I am sympathetic to the maximum size limits proposed by Johnson and Kwak. However, it seems highly unlikely—especially in light of megabanks’ enormous political clout—that Congress could be persuaded to adopt such draconian limits, absent a future disaster comparable to the present financial crisis.⁴⁵⁶

A third possible approach—and the one I advocate—would be to impose structural requirements and activity limitations that would (1) prevent LCFIs from using the federal safety net protections for their subsidiary banks to subsidize their speculative activities in the capital markets and (2) make it easier for regulators to separate banks from their nonbank affiliates if FHCs or their subsidiary banks fail. As originally proposed, both the Volcker Rule and the Lincoln Amendment would have barred proprietary trading and private equity investments by banking organizations and would have forced banks to spin off their derivatives trading and dealing activities into nonbank affiliates. However, the House-Senate conferees on Dodd-Frank greatly weakened both provisions and postponed their effective dates. In addition, both provisions as enacted contain multiple potential loopholes that will allow LCFIs to lobby regulators for further concessions. Consequently, neither provision is likely to be highly effective in restraining risk taking or the spread of safety net subsidies by LCFIs.⁴⁵⁷

My proposals for a pre-funded OLF, a repeal of the SRE, and a two-tiered system of bank regulation would provide a simple, straightforward strategy for accomplishing the goals of shrinking safety net subsidies and minimizing the need for taxpayer-financed bailouts of LCFIs. A pre-funded OLF would require SIFIs to pay risk-based assessments to finance the future costs of resolving failed SIFIs. A repeal of the SRE would prevent the DIF from being used to protect uninsured creditors of megabanks. A two-tiered system of bank regulation would (1) restrict traditional banking organizations to

⁴⁵⁵ See *supra* Part V.A.

⁴⁵⁶ See JOHNSON & KWAK, *supra* note 137, at 222 (“The Panic of 1907 only led to the reforms of the 1930s by way of the 1929 crash and the Great Depression. We hope that a similar [second] calamity will not be a prerequisite to action again.”).

⁴⁵⁷ See *supra* Parts V.E.1.b. & V.E.1.c.

deposit-taking, lending, and fiduciary services and other activities “closely related” to banking and (2) mandate a “narrow bank” structure for banks owned by financial conglomerates. In turn, the narrow bank structure would (1) insulate narrow banks and the DIF from the risks of capital markets activities conducted by nonbank affiliates and (2) prevent narrow banks from transferring the benefits of their low-cost funding and other safety net subsidies to nonbank affiliates.

In combination, my proposed reforms would strip away many of the artificial funding advantages that are currently exploited by LCFIs and would subject them to the same type of market discipline that investors have applied to commercial and industrial conglomerates over the past thirty years. Financial conglomerates have never demonstrated that they can provide beneficial services to their customers and attractive returns to their investors without relying on safety net subsidies during good times and massive taxpayer-funded bailouts during crises.⁴⁵⁸ It is long past time for LCFIs to prove—based on a true market test—that their claimed synergies and their supposedly superior business models are real and not mythical.⁴⁵⁹ If, as I suspect, LCFIs cannot produce favorable returns when they are deprived of their current subsidies and TBTF status, market forces should compel them to break up voluntarily.

⁴⁵⁸ See Wilmarth, *supra* note 6, at 748–49.

⁴⁵⁹ See JOHNSON & KWAK, *supra* note 137, at 212–13 (contending that “[t]here is little evidence that large banks gain economies of scale above a very low size threshold” and questioning the existence of favorable economies of scope for LCFIs); STIGLITZ, *supra* note 453, at 166 (“The much-vaunted synergies of bringing together various parts of the financial industry have been a phantasm; more apparent are the managerial failures and the conflicts of interest.”).

