



GW Law Faculty Publications & Other Works

Faculty Scholarship

2010

Narrow Banking: An Overdue Reform that Could Solve the Too-Big-To-Fail Problem and Align U.S. And U.K. Regulation of Financial Conglomerates

Arthur E. Wilmarth Jr.

George Washington University Law School, awilmarth@law.gwu.edu

Follow this and additional works at: https://scholarship.law.gwu.edu/faculty_publications



Part of the [Law Commons](#)

Recommended Citation

Arthur E. Wilmarth Jr., *Narrow Banking: An Overdue Reform that Could Solve the Too-Big-To-Fail Problem and Align U.S. And U.K. Regulation of Financial Conglomerates*, 31 *Banking & Fin. Services Pol'y Rep.* 3 (2012).

This Article is brought to you for free and open access by the Faculty Scholarship at Scholarly Commons. It has been accepted for inclusion in GW Law Faculty Publications & Other Works by an authorized administrator of Scholarly Commons. For more information, please contact spagel@law.gwu.edu.

Narrow Banking: An Overdue Reform That Could Solve the Too-Big-to-Fail Problem and Align US and UK Financial Regulation of Financial Conglomerates (Part 1)

By Arthur E. Wilmarth, Jr.

Introduction

In an article published in 2002, I warned that the too-big-to-fail (TBTF) policy was the “great unresolved problem of bank supervision” because it “undermine[d] both supervisory and market discipline.”¹ I pointed out that Congress’ enactment of the Gramm-Leach-Bliley Act (GLBA) allowed financial conglomerates to span the entire range of our financial markets. I cautioned that the emerging financial giants would bring “major segments of the securities and life insurance industries . . . within the scope of the TBTF doctrine, thereby expanding the scope and cost of federal ‘safety net’ subsidies.” I predicted that financial conglomerates would take advantage of their new powers under GLBA and their TBTF status by pursuing risky activities in the capital markets and by increasing their leverage through “capital arbitrage.”²

In a subsequent article written seven years later, I noted that the financial crisis had “confirmed” all of my earlier predictions. As I explained:

[R]egulators in developed nations encouraged the expansion of large financial conglomerates and failed to restrain their pursuit of short-term profits through increased leverage and high-risk activities. As a result, [those institutions] were allowed to promote an enormous credit boom [that] precipitated a worldwide financial crisis.

Professor of Law and Executive Director of the Center for Law, Economics & Finance, George Washington University Law School. This article is based on testimony I presented on December 7, 2011, before the Subcommittee on Financial Institutions and Consumer Protection of the Senate Committee on Banking, Housing and Urban Affairs. Portions of this article are adapted from two of my previous articles, which are cited in note 4. This article appears in two parts, with Part 2 scheduled for the April issue of the Banking & Financial Services Policy Report.

In order to avoid a complete collapse of global financial markets, central banks and governments [in the United States and Europe] have already provided almost \$9 trillion of support . . . for major banks, securities firms and insurance companies. Those support measures—which are far from over—establish beyond any doubt that the TBTF policy now embraces the entire financial services industry.³

The financial crisis has demonstrated that TBTF subsidies create dangerous distortions in our financial markets and our general economy. We must eliminate those subsidies in order to restore a more level playing field for smaller financial institutions and to encourage the voluntary breakup of inefficient, risky financial conglomerates.⁴ The financial crisis has also proven, beyond any reasonable doubt, that large financial conglomerates operate based on a hazardous business model that is riddled with conflicts of interest and prone to speculative risk-taking.⁵

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) establishes a new regulatory regime for systemically important financial institutions (SIFIs). As discussed below, Dodd-Frank authorizes the Financial Stability Oversight Council (FSOC) and the Federal Reserve Board (FRB) to adopt more stringent capital requirements and other enhanced prudential standards for SIFIs. Dodd-Frank also establishes the Orderly Liquidation Authority, which provides a superior alternative to the “bailout or bankruptcy” choice that federal regulators confronted when they dealt with failing SIFIs during the financial crisis.

However, Dodd-Frank does not completely shut the door to future government bailouts for creditors

of SIFIs. As shown below, the Fed can still provide emergency liquidity assistance to troubled financial conglomerates through the discount window and (potentially) through group liquidity facilities similar to the Primary Dealer Credit Facility, which are designed to help the largest financial institutions. Federal Home Loan Banks can still make collateralized advances to major banks. The FDIC can potentially use its Treasury borrowing authority and the “systemic risk exception” (SRE) to the Federal Deposit Insurance Act to protect uninsured creditors of failed SIFIs and their subsidiary banks. Dodd-Frank has made TBTF bailouts more difficult, but the continued existence of these avenues for financial assistance creates serious doubts about Dodd-Frank’s ability to prevent bailouts during future episodes of severe financial distress.

Dodd-Frank relies heavily on the same supervisory tools—capital-based regulation and prudential supervision—that failed to prevent the banking and thrift crises of the 1980s and the current financial crisis. The reforms contained in Dodd-Frank also depend for their effectiveness on many of the same federal regulatory agencies that failed to stop excessive risk-taking by financial institutions during the credit booms that preceded both crises.

As an alternative to Dodd-Frank’s regulatory reforms, Congress could have tackled 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 about \$600 billion in assets for commercial banks and about \$300 billion of assets for securities firms. Those size caps would require a significant reduction in size for all of the six largest US banking organizations (Bank of America (BoFA), JP Morgan Chase (Chase), Citigroup, Wells Fargo, Goldman Sachs (Goldman) and Morgan Stanley).⁶ 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.⁷

A third possible approach—and the one I advocate—is to impose structural requirements and activity limitations that would (i) prevent SIFIs from using the

federal safety net to subsidize their speculative activities in the capital markets, and (ii) make it easier for regulators to separate banks from their nonbank affiliates if a SIFI fails. As described below, my proposals for a pre-funded Orderly Liquidation Fund (OLF), a repeal of the SRE, and a two-tiered system of bank regulation would accomplish the goals of shrinking safety net subsidies and minimizing the need for government bailouts of SIFIs.

A pre-funded OLF would require all SIFIs to pay risk-based assessments to finance the future costs of resolving failed SIFIs. A repeal of the SRE would prevent the Deposit Insurance Fund (DIF) from being used as a backdoor bailout fund for nondeposit creditors of megabanks. A two-tiered system of bank regulation would (i) restrict traditional banking organizations to deposit-taking, lending, fiduciary services and other activities that are “closely related” to banking, and (ii) mandate a “narrow bank” structure for banks owned by financial conglomerates. The narrow bank structure would insulate the DIF from the risks of capital markets activities conducted by nonbank subsidiaries of SIFIs, and would also prevent narrow banks from transferring their FDIC-insured, low-cost funding and other safety net subsidies to their nonbank affiliates.

My approach is similar to the “ring-fencing” proposal recently issued by the UK’s Independent Commission on Banking, which the UK government has pledged to enact. Thus, the narrow banking reform provides a promising way for the United States and the United Kingdom to develop a common approach for regulating large financial conglomerates. If the host countries for the two most important financial centers—New York and London—establish consistent regimes for dealing with SIFIs, they would place great pressure on other developed nations to follow suit.

In combination, the “narrow bank” concept and my other proposed reforms would strip away many of the safety net subsidies exploited by SIFIs and would subject SIFIs to the same type of market discipline that investors have applied in breaking up many commercial and industrial conglomerates during the past three decades. If (as I believe) SIFIs cannot produce favorable returns to investors without their current TBTF subsidies, my approach should enable market forces to compel SIFIs to break up voluntarily.

TBTF Financial Institutions Received Extraordinary Governmental Assistance during the Financial Crisis

The federal government provided massive amounts of financial assistance to large, complex financial institutions (LCFIs) during the financial crisis. The 19 largest US banks (each with more than \$100 billion of assets) and the largest US insurance company, American International Group (AIG), received \$290 billion of capital assistance from the Troubled Asset Relief Program (TARP). Federal regulators also enabled the same 19 banks and GE Capital (a huge finance company owned by General Electric) to issue \$290 billion of FDIC-guaranteed, low-interest debt. In contrast, smaller banks (with assets under \$100 billion) received only \$41 billion of TARP capital assistance and issued only \$11 billion of FDIC-guaranteed debt.⁸

The Federal Reserve System (Fed) also provided enormous amounts of liquidity assistance to financial institutions through a series of emergency lending programs. The total outstanding amount of Fed emergency credit reached a single-day peak of \$1.2 trillion in December 2008. The Fed extended the vast majority of this emergency credit to large US and European banks and provided very little help to smaller institutions. The highest daily amount of the Fed's emergency credit to the ten largest US commercial and investment banks was \$669 billion, representing more than half of the daily peak amount for all Fed lending programs.⁹

The Fed and the Treasury also supported financial institutions and the financial markets by purchasing more than \$1.5 trillion of direct obligations and mortgage-backed securities (MBS) issued by government-sponsored enterprises (GSEs). In combination, the federal government provided more than \$6 trillion of support to financial institutions during the financial crisis, when such support is measured by the peak amounts of outstanding assistance under the TARP capital assistance programs, Fed emergency lending programs, FDIC debt guarantees, and other asset purchase and guarantee programs.¹⁰ European nations similarly provided more than \$4 trillion of financial support to their financial institutions by the end of 2009.¹¹

Federal regulators acted most dramatically in rescuing LCFIs that were threatened with failure. Authorities

bailed out two of the three largest US banks—BofA and Citigroup—as well as the largest US insurance company, AIG. In addition, federal regulators provided financial support for emergency acquisitions of two other major banks (Wachovia and National City), the two largest thrifts (Washington Mutual (WaMu) and Countrywide), and two of the five largest securities firms (Bear Stearns (Bear) and Merrill Lynch (Merrill)). Regulators also approved emergency conversions of two other leading securities firms (Goldman and Morgan Stanley) into bank holding companies (BHCs), thereby placing those institutions under the Fed's protective umbrella.¹²

Moreover, the federal government publicly guaranteed that none of the 19 largest banks would be allowed to fail. When federal regulators announced their “stress tests” in early 2009, they declared that the Treasury Department would provide any additional capital that was needed to ensure the survival of all 19 banks. Regulators also stated that they would not impose regulatory sanctions on the top 19 banks under the “prompt corrective action” (PCA) regime established by Congress in 1991, despite the non-discretionary nature of those sanctions. Instead of issuing public enforcement orders, regulators entered into private and confidential “memoranda of understanding” with BofA and Citigroup despite the gravely weakened conditions of both banks. Thus, federal regulators gave white-glove treatment to the 19 largest banks and unequivocally promised that they would survive.¹³

In stark contrast, federal regulators imposed PCA orders and other public enforcement sanctions on hundreds of community banks and allowed many of those institutions to fail.¹⁴ Almost 400 FDIC-insured depository institutions failed between January 1, 2008 and September 30, 2011.¹⁵ Only one of those institutions—WaMu, a large thrift institution—had more than \$50 billion of assets.¹⁶ In view of the massive TBTF assistance that the federal government provided to our largest banks, it is small wonder that those banks enjoy a decisive advantage in funding costs over smaller banks. As FDIC Chairman Sheila Bair pointed out in a speech on May 5, 2011, “In the fourth quarter of [2010], the average interest cost of funding earning assets for banks with more than \$100 billion in assets was about half the average for community banks with less than \$1 billion in assets.”¹⁷

When the federal government finally promised to help community banks, it failed to deliver. On February 2, 2010, President Obama announced a new program that would use \$30 billion of TARP funds to assist community banks in making small business loans.¹⁸ However, in September 2011, the Treasury Department shut down the Small Business Lending Fund after providing only \$4.2 billion—just 14 percent of the promised amount—to community banks. Members of Congress strongly criticized the Treasury Department for long delays in approving applications by community banks and for imposing onerous conditions on applicants.¹⁹

TBTF Subsidies Distort Financial Markets and Create Perverse Incentives for Excessive Risk-Taking and Unhealthy Consolidation

In March 2009, Fed Chairman Ben 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.²⁰ Several months later, 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.”²¹ He further argued that TBTF subsidies provided a likely 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.²²

Industry studies and anecdotal evidence confirm that TBTF subsidies create significant economic distortions

and promote moral hazard. In recent years, and particularly during the present crisis, LCFIs have operated with much lower capital ratios and have benefited from a much lower cost of funds, compared with smaller banks. In addition, credit ratings agencies and bond market investors have given preferential treatment to TBTF institutions because of the explicit and implicit government backing they receive.²³

A recent study confirms that large banks have received huge benefits from the implicit TBTF subsidy over the past two decades.²⁴ This study, which analyzed publicly-traded bonds issued by US banks between 1990 and 2010, concluded that bond investors expected the federal government to support the largest banks throughout that period. Although the largest banks pursued riskier strategies, they issued bonds with significantly lower yield spreads over Treasury bonds, compared to bonds issued by smaller banks.²⁵ Additionally, the authors found that bond investors responded significantly to Fitch’s “issuer” ratings (which included Fitch’s expectation of government support for the biggest banks), but bond investors did not respond significantly to Fitch’s “individual” ratings (which were based on the standalone strength of the same banks). In other words, “investors do not price the true, intrinsic ability of a [big] bank to repay its debts, but instead price implicit government support for the bank.”²⁶

The authors determined that the implicit TBTF subsidy gave the largest banks:

an annual [average] funding cost advantage of approximately 16 basis points before the financial crisis, increasing to 88 basis points during the crisis, peaking at more than 100 basis points in 2008. The total value of the subsidy amounted to about \$4 billion per year before the crisis, increasing to \$60 billion [annually] during the crisis, topping \$84 billion in 2008.²⁷

Moreover, the authors found that “[t]he passage of Dodd-Frank in July of 2010 did not eliminate investors’ expectations of government support. In fact, expectations of government support rose in 2010 [compared to 2009].”²⁸ The authors concluded that the value of the implicit TBTF subsidy to the largest banks was highest during times of financial crisis (i.e., the 1980s, 1997–98,

2000-02, and 2007-10). However, the subsidy “persists even during times of relative tranquility” and therefore represents “an ongoing wealth transfer” from taxpayers to large banks.²⁹

The financial crisis has vividly illustrated the tendency of LCFIs to exploit their explicit safety net subsidies (including federal deposit insurance and access to the Fed’s liquidity assistance) and their implicit TBTF subsidy by using lower-cost funds to finance high-risk activities.³⁰ As I have explained in previous articles, LCFIs were “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.”³¹ Eighteen major LCFIs—including ten leading US financial institutions and eight giant foreign banks—were the dominant players in global securities and derivatives markets during the credit boom.³² Those 18 LCFIs included most of the top underwriters for nonprime MBS, other types of asset-backed securities (ABS) and leveraged buyout (LBO) loans, as well as related collateralized debt obligations (CDOs) and credit default swaps (CDS). Although Fannie Mae and Freddie Mac funded about a fifth of the nonprime mortgage market between 2003 and 2007, they did so primarily by purchasing nonprime mortgages and private-label MBS that were originated or underwritten by LCFIs. LCFIs provided most of the rest of the funding for nonprime home mortgages, as well as much of the financing for risky credit card loans, commercial real estate (CRE) loans and LBO loans.³³

I have estimated that LCFIs were responsible for financing about \$9 trillion of risky private-sector debt that was outstanding in US financial markets in 2007 in the form of nonprime home mortgages, credit card loans, CRE loans, LBO loans and junk bonds. Even worse, LCFIs underwrote some \$25 trillion of structured-finance securities and derivatives whose value depended on the performance of the foregoing risky debt, including MBS, ABS, cash flow CDOs, synthetic CDOs and CDS. Thus, LCFIs created “an inverted pyramid of risk,” which allowed investors to place “multiple layers of financial bets” on the performance of high-risk loans in securitized pools. Consequently, when the underlying loans began to default, the leverage inherent in this “pyramid of risk” produced losses that were much larger than the face amounts of the defaulted loans.³⁴

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 2010.³⁵ The list of top LCFIs is “a who’s who of the current financial crisis” that includes “[m]any of the firms that either went bust . . . or suffered huge write-downs that led to significant government intervention.”³⁶ Lehman failed, while two other members of the “big 18” LCFIs (AIG and RBS) were nationalized and three others (Bear, Merrill and Wachovia) were acquired by other LCFIs with substantial governmental assistance. Three additional members of the group (Citigroup, BofA and UBS) survived only because they received costly government bailouts.³⁷ Chase, Goldman and Morgan Stanley received substantial infusions of TARP capital, and Goldman and Morgan 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.”³⁸

Thus, only Lehman failed of the “big 18” LCFIs, but the United States, the United Kingdom and European nations provided massive financial assistance to ensure the survival of at least twelve other members of the group.³⁹ Studies have shown 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 US LCFIs.⁴⁰ In addition, a recent study concluded that the “below-market rates” charged by the Fed on its emergency credit programs produced \$13 billion of profits for the banks that participated in those programs, including \$4.8 billion of earnings for the six largest US banks.⁴¹

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 considered TBTF by regulators and the financial markets. Each of today’s four largest US banks (Chase, BofA, Citigroup and Wells Fargo) is the product of serial acquisitions and explosive growth since 1990. BofA’s and Citigroup’s rapid expansions led them to brink of failure, from which they were saved by huge federal bailouts. Wachovia (the

fourth-largest US bank at the beginning of the financial crisis) pursued a similar path of frenetic growth until it collapsed in 2008 and was rescued by Wells Fargo in a federally-assisted merger. A comparable pattern of rapid expansion, collapse and bailout occurred among RBS, UBS and other European LCFIs.⁴²

By arranging and assisting acquisitions of troubled LCFIs by major banks, US regulators have produced domestic financial markets in which the largest banks enjoy an unhealthy dominance. In 2009, the four largest US banks (BoFA, Chase, Citigroup and Wells Fargo) controlled 56 percent of domestic banking assets, up from 35 percent in 2000, while the top ten US banks controlled 75 percent of domestic banking assets, up from 54 percent in 2000. The four largest banks also controlled a majority of the product markets for home mortgages, home equity loans, and credit card loans. The same four banks and Goldman accounted for 97 percent of the aggregate notional values of OTC derivatives contracts written by US banks.⁴³

The combined assets of the six largest banks—the foregoing five institutions plus Morgan Stanley—were equal to 63 percent of US GDP in 2009, compared with only 17 percent of GDP in 1995.⁴⁴ 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 begin with.”⁴⁵ Similarly, Simon Johnson and James Kwak maintain 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.”⁴⁶

Dodd-Frank Does Not Solve the TBTF Problem

The financial crisis has demonstrated that TBTF subsidies create dangerous distortions in our financial markets and our general economy. Those subsidies 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, risky financial conglomerates.⁴⁷ Accordingly, US and European governments must adopt reforms to ensure that effective supervisory and market discipline is applied against large financial institutions.

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 SIFIs, (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 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.⁴⁸

The following sections of this article discuss my proposed reforms and compare those proposals to relevant provisions of Dodd-Frank. Dodd-Frank includes a portion of my first proposal as well as 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. A careful reading of Dodd-Frank indicates that Congress has left the door open for taxpayer-funded protection of creditors of SIFIs during future financial crises.

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 (Riegle-Neal Act).⁴⁹ 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.⁵⁰ 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 (i) 10 percent or more of the total deposits of all depository institutions in the United States, or (ii) 30 percent or more of the total deposits of all depository institutions in a single state.⁵¹

Unfortunately, Riegle-Neal’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. Third, the deposit caps did not apply to acquisitions of, or mergers with, banks that were “in default or in danger of default” (the “failing bank” exception).⁵²

The emergency acquisitions of Countrywide, Merrill, WaMu and Wachovia in 2008 demonstrated the significance of Riegle-Neal’s loopholes and the necessity of closing them. In reliance on the “non-bank” loophole, the FRB allowed BofA to acquire Countrywide and Merrill even though (i) 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 (ii) both transactions allowed BofA to exceed the 10 percent nationwide deposit cap. Similarly, after the FDIC seized control of WaMu as a failed depository institution, the FDIC sold the giant thrift to Chase even though the transaction enabled Chase to exceed the 10 percent nationwide deposit cap. Finally, although the FRB determined that Wells Fargo’s acquisition of Wachovia gave Wells Fargo control of just under 10 percent of nationwide deposits, the FRB could have approved the acquisition in any case by designating Wachovia as a bank “in danger of default.”⁵³

As a result of the foregoing acquisitions, BofA, Chase and Wells Fargo each surpassed the 10% nationwide deposit cap by October 2008. To prevent further breaches of the Riegle-Neal concentration limits, I proposed that Congress should extend the 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.⁵⁴

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. In addition, each SRD would be audited by the Government Accountability Office (GAO) to determine whether regulators satisfied the criteria for an SRD, and would also be reviewed in 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 ensure much greater public transparency of, and scrutiny for, any federal agency order that invokes the failing bank exception to the Riegle-Neal deposit caps.⁵⁵

Section 623 of Dodd-Frank does extend Riegle-Neal’s 10 percent 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. However, § 623 leaves open the other Riegle-Neal 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 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. Hence, § 623 of Dodd-Frank closes one important loophole but fails to close other significant exemptions that continue to undermine the effectiveness of Riegle-Neal’s deposit caps.⁵⁶

Section 622 of Dodd-Frank authorizes federal regulators to impose a separate concentration limit on mergers and acquisitions involving “financial companies.” As defined in § 622, the term “financial companies” includes insured depository institutions and their holding companies, nonbank SIFIs, and foreign banks operating in the United States. Subject to two significant exceptions described below, § 622 potentially bars any acquisition or merger that would give a “financial company” control of more than 10 percent of the total “liabilities” of all financial companies. This limitation on control of nationwide liabilities

“liabilities cap”) was originally proposed by former FRB Chairman Paul Volcker.⁵⁷

The liabilities cap in § 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 funding from the capital markets instead of deposits.⁵⁸ However, the liabilities cap has two significant exceptions. First, it is subject to a “failing bank” exception (similar to the “failing bank” loophole in Riegle-Neal), which regulators can invoke without making any SRD. Second, and more importantly, the liabilities cap is not self-executing. Section 622 requires the Financial Stability Oversight Council (FSOC) to consider (based on a cost-benefit analysis) whether the statutory liabilities cap should be modified. Section 622 also requires the FRB to implement the liabilities cap in accordance with any modifications recommended by FSOC.⁵⁹

Thus, § 622 allows the FSOC and FRB to weaken (and perhaps even eliminate) the liabilities cap if they determine that the cap would have adverse effects that outweigh its potential benefits. Consequently, it is doubtful whether Dodd-Frank will impose any meaningful new limit on the growth of SIFIs beyond the statute’s beneficial extension of the nationwide deposit cap to reach all interstate acquisitions and mergers involving FDIC-insured institutions.

Dodd-Frank Establishes a Special Resolution Regime for Systemically Important Financial Institutions But Does Not Prevent the FDIC and Other Agencies from Protecting Creditors of Those Institutions

Dodd-Frank’s Orderly Liquidation Authority Allows the FDIC to Provide Full Protection for Favored Creditors of SIFIs

Dodd-Frank establishes an Orderly Liquidation Authority (OLA), which 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.”⁶⁰ In some respects, the OLA for SIFIs—which is similar to the FDIC’s existing resolution regime for failed depository

institutions⁶¹—resembles my earlier proposal for a special resolution regime for SIFIs.⁶² However, contrary to the statute’s stated purpose,⁶³ Dodd-Frank’s OLA does not preclude future bailouts for favored creditors of TBTF institutions.

Dodd-Frank establishes FSOC as an umbrella organization with systemic risk oversight authority. FSOC’s voting members include the leaders of nine federal financial regulatory agencies and an independent member having insurance experience. By a two-thirds vote, 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. In deciding whether to impose Dodd-Frank’s systemic risk regime on a nonbank financial company, the crucial question to be decided by 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.”⁶⁴

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 nonbank SIFIs. Dodd-Frank 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.⁶⁵ 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.⁶⁶ However, it is noteworthy—and disturbing—that FSOC has not yet publicly designated any large nonbank financial firm as a nonbank SIFI, even though more than 18 months have gone by since Dodd-Frank’s enactment.

As I and many others have proposed, Article II of Dodd-Frank establishes a systemic resolution process—the OLA—to handle the failures of SIFIs.⁶⁷ 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). The Treasury Secretary's SRD must find that (i) 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," (ii) application of the OLA would "avoid or mitigate such adverse effects," and (iii) "no viable private sector alternative is available to prevent" the company's failure.⁶⁸

I have 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: (A) 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, (B) removing senior managers and other employees who were responsible for the SIFI's failure, and (C) requiring unsecured creditors to accept meaningful "haircuts" in the form of significant reductions of their debt claims or an exchange of substantial portions of their debt claims for equity in a successor institution.⁶⁹

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 managers responsible for the failure are removed. At first sight, Dodd-Frank also seems to embody the third principle by directing the FDIC to impose losses on unsecured creditors if a failed SIFI's assets are insufficient to pay all secured and unsecured debts. However, a careful reading of the statute reveals that Dodd-Frank allows the FDIC to provide full protection to favored classes of unsecured creditors of failed SIFIs.⁷⁰

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. 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. In either case, the FDIC may (i) take steps to "mitigate[] the potential for serious adverse effects to the financial system," and (ii) 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 BFC. 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.⁷¹

In October 2010, the FDIC issued a proposed rule to implement its authority under the OLA. The FDIC subsequently approved an interim final OLA rule⁷² and a final OLA rule.⁷³ Under the OLA rule, 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."⁷⁴ The OLA rule excludes the following classes of creditors from any possibility of preferential treatment: (i) holders of unsecured senior debt with a term of more than 360 days, and (ii) holders of subordinated debt. Accordingly, the OLA 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."⁷⁵

The OLA rule would allow the FDIC to give full protection to short-term liabilities of SIFIs, including commercial paper and securities repurchase agreements. Those types of wholesale liabilities proved to be highly volatile and prone to creditor "runs" during the financial crisis.⁷⁶ Unfortunately, by stating 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, the OLA rule is likely have at least two perverse effects. The OLA rule (i) creates the appearance of an implicit subsidy to short-term creditors of SIFIs, and (ii) encourages SIFIs to rely even *more* heavily on vulnerable, short-term funding strategies that led to repeated disasters during the financial crisis.⁷⁷

As indicated by the OLA 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, 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 in amounts up to (i) 10 percent of a failed SIFI's assets within thirty days after the FDIC's appointment as receiver, plus (ii) 90 percent of the "fair value" of the SIFI's assets that are "available for repayment" thereafter.⁷⁸ 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, since the "fair value" standard does not require the FDIC to rely on current market values in measuring the value of a failed SIFI's assets.⁷⁹

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 has borrowed from the Treasury to finance the liquidation. However, 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."⁸⁰ 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 determines that such a waiver is necessary to maintain the stability of the financial markets.⁸¹

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 failed 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).⁸² 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.⁸³ Dodd-Frank bars the FDIC from using the DIF to assist the OLF or from using the OLF to assist the DIF.⁸⁴ However, the FDIC could conceivably assert that it has 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 normal 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."⁸⁵

The "systemic risk exception" (SRE) to the Federal Deposit Insurance Act (FDI Act) provides a further potential source of funding to protect creditors of failed SIFIs.⁸⁶ 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."⁸⁷ 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.⁸⁸ Thus, if a failing SIFI owned a bank that was placed in receivership, the SRE would permit the FDIC (with the FRB's concurrence and 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 provide indirect support to the SIFI or its creditors.

Two provisions of Dodd-Frank limit the authority of the FRB and the FDIC to provide financial support to failing SIFIs or their subsidiary banks outside the OLA or the SRE. First, §1101 of Dodd-Frank provides that the FRB may not extend emergency secured loans under §13(3) of the Federal Reserve Act⁸⁹ 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.⁹⁰ Second, § 1105 of Dodd-Frank forbids the FDIC from guaranteeing 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.⁹¹

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 § 1101 or § 1105 of Dodd-Frank.⁹² However, the FRB could conceivably use its remaining authority under § 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 SIFIs that the FRB deems to be “solvent.”⁹³ As shown by the events of 2008, it is extremely difficult for outsiders (including members of Congress) to second-guess a regulator’s determination of solvency in 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 SIFIs.⁹⁴ Thus, during a financial crisis the FRB could potentially assert its authority under amended § 13(3) to provide emergency loans to a targeted group of troubled SIFIs that it identified as “solvent.”

Moreover, Dodd-Frank does not limit the ability of individual SIFIs 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. Similarly, FHLBs—sometimes described as “lender[s] of next-to-last resort”—provide collateralized advances to member institutions, including banks and insurance companies.⁹⁵

During the financial crisis, banks did not borrow significant amounts from the discount window due to (i) the perceived “stigma” of doing so and (ii) the availability of alternative sources of credit through FHLBs and several emergency liquidity facilities that the FRB established under its § 13(3) authority. 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 failed, were acquired in emergency transactions, or received “exceptional assistance” from the federal government. Accordingly, FHLB advances provided a significant source of support for troubled LCFIs, especially during the early phase of the financial crisis. 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 § 13(3).⁹⁶

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. To the extent that the FRB or FHLBs provide 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.⁹⁷

Thus, notwithstanding Dodd-Frank’s explicit promise to end bailouts of SIFIs, 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 does not bind future Congresses. When a future Congress confronts the next systemic financial crisis, that Congress may well decide 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. However, those statements did not prevent Congress and President George W. Bush from using public funds to bail out major financial institutions in 2008.⁹⁸ As Adam Levitin has observed:

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 and drown. Instead, we want to be sure his hands are free—to bail.⁹⁹

Levitin predicts that future Congresses will relax or remove Dodd-Frank's constraints on TBTF bailouts, or will permit federal regulators to evade those limitations, if such actions are deemed necessary to prevent failures of SIFIs that could destabilize our financial system.¹⁰⁰

Cheryl Block has similarly 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.”¹⁰¹ Based on comparable reasoning, Standard & Poor's (S&P) determined in July 2011 that “under certain circumstances and with selected systemically important financial institutions, future extraordinary government support is still possible.”¹⁰²

Dodd-Frank Subjects SIFIs to Enhanced Supervisory Standards, But Those Provisions Are Not Likely to Prevent Future Bailouts of SIFIs

Dodd-Frank provides the FRB with consolidated supervision and enforcement authority over nonbank SIFIs comparable to the FRB's umbrella supervisory and enforcement powers over BHCs and financial holding companies (FHCs). Dodd-Frank also requires the FRB (either on its own motion or on 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.”¹⁰³ The enhanced standards must be “more stringent” than the ordinary supervisory rules that apply to nonbank financial companies and BHCs that are not SIFIs.¹⁰⁴

For example, Dodd-Frank requires the FRB to adopt enhanced risk-based capital requirements, leverage limits, liquidity requirements, overall risk management rules, risk concentration limits, requirements for resolution plans (“living wills”) and credit exposure reports. 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.¹⁰⁵

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-based regulation has repeatedly failed in the past.¹⁰⁶ As regulators learned during the banking and thrift crises of the 1980s and early 1990s, capital levels are “lagging indicators” of bank problems¹⁰⁷ because (i) “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 (ii) bank managers “have strong incentives to postpone any recognition of asset depreciation and capital losses” until their banks have already suffered serious damage.¹⁰⁸

Second, LCFIs have repeatedly demonstrated their ability to engage in “regulatory capital arbitrage” in order to weaken the effectiveness of capital requirements.¹⁰⁹ For example, the Basel II international capital accord was designed to prevent arbitrage techniques (including securitization) that banks used to undermine the effectiveness of the Basel I accord.¹¹⁰ However, many analysts have concluded that the Basel II accord (including its heavy reliance on internal risk-based models developed by LCFIs) contained significant flaws and allowed LCFIs to operate with seriously inadequate capital levels during the period leading up to the financial crisis.¹¹¹

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.¹¹² Similarly, there is widespread agreement that federal banking and securities regulators failed to restrain excessive risk-taking by LCFIs during the two decades leading up to the financial crisis.¹¹³

Fourth, repeated regulatory failures during past financial crises reflect a “political economy of regulation”¹¹⁴ 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 testimony. 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 (i) large political contributions and lobbying expenditures made by LCFIs, (ii) an intellectual and policy environment favoring deregulation, and (iii) a continuous interchange of senior personnel between the largest financial institutions and the top echelons of the financial regulatory agencies.¹¹⁵ Commentators have also noted that LCFIs skillfully engaged in global regulatory arbitrage by threatening to move operations from the United States to London or other foreign financial centers if US regulators did not make regulatory concessions.¹¹⁶

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. Thus, the actual achievement of stronger prudential standards will depend upon implementation by the FRB through rulemaking, and LCFIs have marshaled an imposing array of lobbying resources to persuade the FRB to adopt more lenient rules.¹¹⁷ 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.”¹¹⁸ Domestic and foreign LCFIs have already succeeded in weakening and delaying the imposition of enhanced capital standards under the Basel III accord, and they are determined to prevent US regulators from adopting stronger capital requirements that would go beyond Basel III.¹¹⁹

For all of the foregoing reasons, as John Coffee has noted, “the intensity of regulatory supervision is likely to follow a sine curve: tight regulation after a crash, followed by gradual relaxation thereafter” as the economy improves and the crisis fades in the memories of regulators and the public.¹²⁰ When the next economic boom occurs, regulators will face escalating political pressures to reduce the regulatory burdens on LCFIs in order to help those institutions continue to finance the boom. If an unsustainable boom triggers a severe financial and

economic crisis, a different set of political factors will push regulators and legislators to provide forbearance and bailouts to SIFIs and their creditors. Accordingly, while Dodd-Frank’s provisions for stronger supervision and enhanced prudential standards represent improvements over prior law, they are unlikely to prevent future failures of SIFIs and governmental protection of systemically important creditors.¹²¹

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 any assessments to pre-fund the OLF. Instead, Dodd-Frank authorizes the FDIC to borrow from the Treasury to provide the necessary funding for the OLF after a SIFI is placed in receivership.¹²²

The FDIC must normally repay any borrowings from the Treasury within five years, but the Treasury may extend the repayment period in order “to avoid a serious adverse effect on the financial system of the United States.”¹²³ Dodd-Frank authorizes the FDIC to repay borrowings from the Treasury by making ex post assessments on (i) creditors who received preferential payments (to the extent of such preferences), (ii) non-bank SIFIs supervised by the FRB under Dodd-Frank, (iii) BHCs with assets of \$50 billion or more, and (iii) other financial companies with assets of \$50 billion or more.¹²⁴

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 financial reform 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 nonbank SIFIs and large BHCs. 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. FDIC Chairman Sheila Bair strongly championed the concept of a pre-funded OLF.¹²⁵

However, Senate Republicans repeatedly blocked consideration of the financial reform bill by the

full Senate until Senate Democratic leaders agreed to remove the pre-funding provision. The Obama Administration never supported the pre-funding mechanism and urged Senate leaders to remove it from the bill. During the House-Senate conference committee's deliberations on Dodd-Frank, House Democratic conferees tried to revive the pre-funding mechanism but their efforts failed.¹²⁶

It is contrary to customary insurance principles to establish an OLF that is funded only after a SIFI fails and must be liquidated.¹²⁷ 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."¹²⁸ No one advocates a post-funded DIF today; indeed, analysts have generally argued that the DIF needs a *higher* level of pre-funding in order to respond adequately to systemic banking crises.¹²⁹

In stark contrast to the FDI Act—which requires banks to pay deposit insurance premiums 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 receive an implicit subsidy, and they benefit from lower funding costs due to the protection their creditors expect to receive from the Treasury-backed OLF. SIFIs will pay nothing for that subsidy until the first SIFI fails.¹³⁰ Not surprisingly, leading financial institutions viewed the removal of OLF pre-funding from the Dodd-Frank Act as a significant "victory," because it relieved them of the burden of paying an "upfront fee" to cover the potential costs of their implicit subsidy.¹³¹

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."¹³² To offset that deficit, the House-Senate conferees on Dodd-Frank proposed a \$19 billion tax on financial companies with assets of \$50 billion or more and on hedge funds with managed 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

while substituting other measures that effectively shifted most of the legislation's estimated net cost to taxpayers and midsized banks.¹³³

Thus, LCFIs and their allies were successful in defeating the \$19 billion tax as well as 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."¹³⁴

A pre-funded OLF is essential to shrink TBTF subsidies for LCFIs. The FDIC should assess risk-adjusted premiums over a period of several years to establish a pre-funded OLF with financial resources that would provide reasonable protection to taxpayers against the cost of resolving failures of SIFIs during a future systemic financial crisis. As noted above, federal regulators provided \$290 billion of capital assistance to the 19 largest BHCs—each with assets of more than \$100 billion—and to AIG during the current crisis. Accordingly, \$300 billion (appropriately adjusted for inflation) would be the minimum acceptable size for a pre-funded OLF. OLF premiums should be paid by all BHCs with assets of more than \$100 billion (also adjusted for inflation) and by all designated nonbank SIFIs. The FDIC should impose additional assessments on SIFIs in order to replenish the OLF within three years after the OLF incurs any loss due to the failure of a SIFI.¹³⁵

There are four essential reasons why Congress should amend Dodd-Frank to require SIFIs to pay risk-based insurance premiums to pre-fund 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 ("herding") during the credit boom that led to the crisis. 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. Consequently, (i) the FDIC 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 (ii) the FDIC therefore will have to borrow large sums from the Treasury to cover short-term 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 rightly conclude that the federal government (and, ultimately, the taxpayers) provided bridge loans to pay the creditors of failed SIFIs.¹³⁶

Second, under Dodd-Frank's post-funded OLF, the most reckless SIFIs will effectively shift the potential costs of their risk-taking to more 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."¹³⁷

Third, a pre-funded OLF would encourage each SIFI to monitor other SIFIs and to alert regulators to excessive risk-taking by those institutions. Every SIFI would know that the failure of another SIFI would deplete the OLF 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.¹³⁸

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 cost) of their activities. A pre-funded OLF would provide a reserve fund, paid for by SIFIs, which would shield governments and taxpayers from having to incur the expense of underwriting future resolutions of failed SIFIs.¹³⁹ Jeffrey Gordon and Christopher Muller point out that a pre-funded OLF would also reduce the TBTF subsidy by making Dodd-Frank's "liquidation threat more credible."¹⁴⁰ In their view, a pre-funded OLF would encourage regulators to mandate an OLA receivership for a failing SIFI.¹⁴¹ In contrast, Dodd-Frank's post-funded OLF creates a strong incentive for regulators to grant forbearance in order to postpone (and hopefully avoid) an OLA receivership, because such a receivership would involve the politically unpopular step of borrowing from the Treasury in order to finance a failed SIFI's liquidation.¹⁴²

To further reduce the potential TBTF subsidy for SIFIs, the OLF should be strictly separated from the DIF, which insures bank deposits. As discussed above, the 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.¹⁴³ 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 (i) the FDIC must apply the FDI Act's least-cost test in resolving all future bank failures, (ii) the DIF must be used solely to pay the claims of bank depositors, and (iii) 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 subsidy currently enjoyed by SIFIs.¹⁴⁴

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

Dodd-Frank contains three sections that are intended to prevent the federal "safety net" for banks¹⁴⁵ from being used to support risky nonbanking activities connected to the capital markets. None of those sections is likely to be effective. The 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.

The Kanjorski Amendment

Section 121 of Dodd-Frank, the "Kanjorski Amendment," was originally sponsored by Representative Paul Kanjorski. Section 121 provides the FRB with potential authority to require large BHCs (with more than \$50 billion of assets) or non-bank SIFIs to divest high-risk operations. However, the FRB may exercise its divestiture authority under § 121 only if (i) the BHC or nonbank SIFI "poses a grave threat to the financial stability of the United States" and (ii) the FRB's proposed action is approved by at least two-thirds of FSOC's voting members.¹⁴⁶ Additionally, 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.¹⁴⁷ 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.”¹⁴⁸

The FRB’s divestiture authority under § 121 is thus a last resort, and it is restricted by numerous procedural requirements (including, most notably, approval by a two-thirds vote of FSO). The Bank Holding Company Act (“BHC Act”) 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.¹⁴⁹ 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 a 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.”¹⁵⁰ 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.

The Volcker Rule

Section 619 of Dodd-Frank, the “Volcker Rule,” was originally proposed by former FRB Chairman Paul Volcker.¹⁵¹ As approved by the Senate Banking Committee, the Volcker Rule would have generally barred banks and BHCs from (i) sponsoring or investing in hedge funds or private equity funds and (ii) engaging in proprietary trading—i.e., buying and selling securities, derivatives and other tradable assets for their own account. Thus, the Volcker Rule sought to prohibit equity investments and trading activities by banks and BHCs except for “market making” activities conducted on behalf of clients.¹⁵²

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.”¹⁵³ 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.”¹⁵⁴ 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.”¹⁵⁵ Thus, the Senate report made clear that a primary goal of the Volcker Rule was to prevent banks from spreading their federal safety net subsidies to nonbank affiliates engaged in capital markets activities.

LCFIs vehemently opposed the Volcker Rule as embodied in the Senate committee bill.¹⁵⁶ However, the Volcker Rule—and the financial reform bill as a whole—gained significant political momentum from two events related to Goldman. First, the Securities and Exchange Commission (SEC) filed a lawsuit on April 16, 2010, alleging that Goldman defrauded two institutional purchasers of interests in a CDO that Goldman structured and marketed. The SEC charged that Goldman did not disclose to the CDO’s investors that a large hedge fund, Paulson & Co., helped to select the CDO’s portfolio of MBS 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 MBS that it expected to default within the near-term future. The institutional investors in the CDO lost more than \$1 billion, while Paulson & Co. reaped a corresponding gain. Goldman subsequently settled the SEC’s lawsuit by paying restitution and penalties of \$550 million.¹⁵⁷

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 an 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.” 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 reform legislation as a whole.¹⁵⁸

Nevertheless, large financial institutions continued their aggressive lobbying campaign to weaken the Volcker rule during the conference committee’s deliberations on the final terms of Dodd-Frank. The conference committee accepted a last-minute compromise that significantly weakened the Volcker Rule and

“disappointed” Mr. Volcker.¹⁵⁹ The final compromise inserted exemptions in the Volcker Rule that allow banks and BHCs to (i) invest up to 3% of their Tier 1 capital in hedge funds or private equity funds (as long as a bank’s investments do not exceed 3% of the total ownership interests in any single fund), (ii) purchase and sell government securities, (iii) engage in “risk-mitigating hedging activities,” (iv) make investments through insurance company affiliates, and (v) make small business investment company investments. The compromise also delayed the Volcker Rule’s effective date so that banks and BHCs will have (A) 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 (B) up to twelve years to bring “illiquid” investments that were in existence on May 1, 2010, into compliance with the Rule.¹⁶⁰

Probably the most troublesome aspect of the Volcker Rule is that the Rule attempts to distinguish between prohibited “proprietary trading” and permissible “market making.” The Rule defines “proprietary trading” as “engaging as a principal for the trading account of the banking entity,” but the Rule allows “[t]he purchase, sale, acquisition, or disposition of securities and other instruments . . . on behalf of customers.”¹⁶¹ Distinguishing between proprietary trading and market making is “notoriously difficult,”¹⁶² and analysts predict that large Wall Street banks will seek to evade the Volcker Rule by shifting their trading operations into so-called “client-related businesses.”¹⁶³ Moreover, the parameters of “proprietary trading,” “market making” and other crucial terms in the Volcker Rule—including the exemption for “[r]isk-mitigating hedging activities”¹⁶⁴—are left open by the statute.

As a result, the precise meaning of key terms that will determine the Volcker Rule’s impact must be defined in regulations adopted jointly by the federal banking agencies, the Commodity Futures Trading Commission and the SEC.¹⁶⁵ The agencies issued lengthy proposed regulations in October 2011, but the proposed rules were “roundly criticized for being overly complex and riddled with uncertainty.”¹⁶⁶ In view of the Volcker Rule’s ambiguous terms and numerous exemptions that rely on regulatory implementation, many commentators believe 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.¹⁶⁷

The Lincoln Amendment

Section 726 of Dodd-Frank, the “Lincoln Amendment,” was originally sponsored by Senator Blanche Lincoln. In April 2010, Senator Lincoln, as chair of the Senate Agriculture Committee, included the Lincoln Amendment in derivatives reform legislation that was passed by the Agriculture Committee and subsequently was 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 any assistance from the DIF or from the Fed’s discount window or other emergency lending facilities.¹⁶⁸

Senator Lincoln designed her amendment 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 out the institution.”¹⁶⁹ 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.”¹⁷⁰ Thus, the purposes of the Lincoln Amendment—insulating banks from the risks of speculative activities and preventing 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.¹⁷¹

The Lincoln Amendment provoked “tremendous pushback . . . from Republicans, fellow Democrats, the White House, banking regulators, and Wall Street interests.”¹⁷² Large banks claimed that the provision would require them to furnish more than \$100 billion of additional capital to organize separate derivatives trading subsidiaries.¹⁷³ A prominent industry analyst opined that the provision “eliminates all of the advantages of the affiliation with an insured depository institution, which are profound.”¹⁷⁴ Those statements reflect a common understanding that, as discussed in Part 2 of this article, bank dealers in OTC derivatives enjoy significant competitive advantages over nonbank dealers due to the banks’ explicit and implicit safety net subsidies. 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.¹⁷⁵

As was true with the Volcker Rule, the House-Senate conference committee agreed to a final compromise that significantly weakened the Lincoln Amendment.¹⁷⁶ As enacted, the Lincoln Amendment allows an FDIC-insured bank to act as a swaps dealer with regard to (i) “[h]edging and other similar risk mitigating activities directly related to the [bank’s] activities,” (ii) 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) and energy or agricultural commodities, and (iii) credit default swaps that are cleared pursuant to Dodd-Frank and carry investment-grade ratings.¹⁷⁷ In addition, the Lincoln Amendment allows banks up to five years after Dodd-Frank’s effective date to divest or spin off nonconforming derivatives operations into separate affiliates.¹⁷⁸

Analysts estimate that the compromised Lincoln Amendment will require major banks to spin off only ten to twenty percent of their pre-Dodd-Frank derivatives activities into separate affiliates.¹⁷⁹ 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 much elaboration by regulators.¹⁸⁰ As in the case of the Volcker Rule, commentators concluded that the final version of the Lincoln Amendment was “greatly diluted,”¹⁸¹ “significantly weakened,”¹⁸² and “watered down,”¹⁸³ with the result that “the largest banks’ [derivatives] operations are largely left intact.”¹⁸⁴

The requirement that banks must clear their trades of CDS in order to be exempt from the Lincoln Amendment is potentially significant.¹⁸⁵ 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 bank-eligible derivatives (except for CDS) without restriction under the Lincoln Amendment.¹⁸⁶ As discussed above, however, all “proprietary trading” by banks in derivatives must comply with the Volcker Rule as implemented by regulators.

A fundamental purpose of the Volcker Rule and the Lincoln Amendment is to prevent LCFIs from using

federal safety net subsidies to support their speculative activities in the capital markets. As enacted, both provisions have numerous gaps and exemptions that undermine their stated purpose. In Part 2 of this article (to be published in April 2012), I propose a different system of bank regulation and deposit insurance that is specifically designed to prevent the spread of safety net subsidies from banks to affiliated companies doing business in the capital markets. My proposal would require financial conglomerates to operate their subsidiary banks as “narrow banks” and would prohibit “narrow banks” from making extensions of credit or other transfers of funds to capital markets affiliates. As described in Part 2, the “narrow bank” concept and related reforms would force financial conglomerates to prove that they can produce attractive returns to investors without relying on explicit and implicit safety net subsidies. My proposed reforms are similar to the “ring-fencing” approach recently advocated by the UK Independent Commission on Banking and endorsed by the Cameron government.

Notes

1. Arthur E. Wilmarth, Jr., “The Transformation of the US Financial Services Industry: Competition, Consolidation, and Increased Risks,” 2002 *University of Illinois Law Review* 215, 475 [hereinafter Wilmarth, “Transformation”], available at <http://ssrn.com/abstract=315345>.
2. *Id.* at 444-476 (quotes at 447, 476).
3. Arthur E. Wilmarth Jr., “The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis,” 41 *Connecticut Law Review* 963, 1049-50 (2009) [hereinafter Wilmarth, “Subprime Financial Crisis”], available at <http://ssrn.com/abstract=1403973>.
4. Arthur E. Wilmarth, Jr., “The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-To-Fail Problem,” 89 *Oregon Law Review* 951, 987 (2011) [hereinafter Wilmarth, “Dodd-Frank”], available at <http://ssrn.com/abstract=1719126>; Arthur E. Wilmarth, Jr., “Reforming Financial Regulation to Address the Too-Big-To-Fail Problem,” 35 *Brooklyn Journal of International Law* 707, 748-49 (2010) [hereinafter Wilmarth, “Reforming Financial Regulation”], available at <http://ssrn.com/abstract=1645921>.
5. Wilmarth, “Subprime Financial Crisis,” *supra* note 3, at 970-72, 994-1002, 1024-50; Simon Johnson & James Kwak, *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown* 74-87, 120-41, 193, 202-05 (2010); John Kay, *Narrow Banking: The Reform of Financial Regulation* 12-16, 41-44, 86-88 (Sept. 15, 2009) (unpublished manuscript), available at <http://www.johnkay.com/wp-content/uploads/2009/12/JK-Narrow-Banking.pdf>.
6. Johnson & Kwak, *supra* note 5, at 214-17.

7. See *id.* 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”).
8. Wilmarth, “Reforming Financial Regulation,” *supra* note 4, at 737-38.
9. Bradley Keoun & Phil Kuntz, “Wall Street Aristocracy Got \$1.2 Trillion in Secret Fed Loans,” *Bloomberg.com*, Aug. 22, 2011; Bob Ivry, Bradley Keoun & Phil Kuntz, “Secret Fed Loans Helped Banks Net \$13 Billion,” *Bloomberg.com*, Nov. 27, 2011.
10. The “high-water mark” of the combined emergency financial assistance programs, based on the largest outstanding amount of each program at any one time, was \$6.3 trillion. The federal government’s maximum potential exposure under those programs was \$23.9 trillion. Office of the Special Inspector General for the Troubled Asset Relief Program (“SIGTARP”), Quarterly Report to Congress, July 21, 2010, at 116-19, 118 tbl. 3.1.
11. Adrian Blundell-Wignall et al., “The Elephant in the Room: The Need to Deal with What Banks Do,” 2 *Organization for Economic Co-operation & Development Journal: Financial Market Trends*, Vol. 2009, No. 2, at 1, 4-5, 14, 15 tbl.4, available at <http://www.oecd.org/dataoecd/13/8/44357464.pdf> (stating that the United States provided \$6.4 trillion of assistance to financial institutions through capital infusions, asset purchases, asset guarantees, and debt guarantees as of October 2009, while the United Kingdom and European nations provided \$4.3 trillion of such assistance).
12. Wilmarth, “Dodd-Frank,” *supra* note 4, at 958-59, 983.
13. *Id.*; see also Wilmarth, “Reforming Financial Regulation,” *supra* note 4, at 712-13, 743-44.
14. Wilmarth, “Reforming Financial Regulation,” *supra* note 4, at 744, 744 n.145.
15. 5 *FDIC Quarterly* No. 4 (2011), at 16 (Table II-B).
16. 2 *FDIC Quarterly* No. 4 (2008), at 14 (referring to the failure of Washington Mutual Bank, with \$307 billion of assets, on Sept. 25, 2008).
17. Sheila C. Bair, “We Must Resolve to End Too Big to Fail,” 5 *FDIC Quarterly* No. 2 (2011), at 25, 26 (reprinting speech delivered on May 5, 2011); see also *infra* notes 24-29 and accompanying text (citing a recent economic study, which found that the largest banks have benefited from a much lower cost of bond funding, compared to smaller banks, since 1990 and particularly during the recent financial crisis).
18. Cheryl Bolen, “Troubled Asset Relief Program: White House Explains \$30 Billion Plan To Expand Bank Loans to Small Businesses,” 94 *BNA’s Banking Report* 262 (Feb. 9, 2010).
19. Kevin Wack, “Lending Fund Puts Geithner on the Defensive,” *American Banker*, Oct. 19, 2011.
20. Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve, 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>.
21. Mervyn King, Governor of the Bank of England, Speech to Scottish Business Organizations in Edinburgh 4 (Oct. 20, 2009), available at <http://www.bankofengland.co.uk/publications/speeches/2009/speech406.pdf> [hereinafter *King 2009 Speech*]. See also Richard S. Carnell, Jonathan R. Macey & Geoffrey P. Miller, *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”).
22. King 2009 Speech, *supra* note 21, at 3.
23. Wilmarth, “Dodd-Frank,” *supra* note 4, at 981-84 (citing studies and other evidence).
24. A. Joseph Warburton & Daniz Anginer, “The End of Market Discipline? Investor Expectations of Implicit State Guarantees” (Nov. 18, 2011), available at <http://ssrn.com/abstract=1961656>.
25. *Id.* at 3, 10-11, 14-15.
26. *Id.* at 3, 15-17.
27. *Id.* at 4, 12.
28. *Id.* at 19, 33 (Figure 4).
29. *Id.* at 18-20, 33 (Figure 4).
30. A recent study explains that “[a] nation’s financial safety net consists of whatever array of programs it uses to protect bank depositors and to keep systemically important markets and institutions from breaking down in difficult circumstances.” The study further concludes that, during the current financial crisis, government agencies in the United States and the European Union “exercised a loss-shifting ‘taxpayer put’ that converted most of the losses incurred by insolvent [TBTF] firms into government debt.” Edward J. Kane et al., Safety-Net Benefits Conferred on Difficult-to-Fail-and-Unwind Banks in the US and EU Before and During the Great Recession at 2, 4 (July 1, 2011), Paolo Baffi Center Research Paper No. 2011-95, available at <http://ssrn.com/abstract=1884131>.
31. Wilmarth, “Dodd-Frank,” *supra* note 4, at 977 (quoting Wilmarth, “Subprime Financial Crisis,” *supra* note 3, at 1046).
32. During the credit boom that led to the financial crisis, the 18 leading LCFIs in global and US markets for securities underwriting, securitizations, structured-finance products and over-the-counter derivatives (the “big 18”) included the four largest US banks (BoFA, Chase, Citigroup and Wachovia), the five largest US securities firms (Bear, Goldman, Lehman, Merrill and Morgan Stanley), the largest US insurance company (AIG), and eight foreign universal banks (Barclays, BNP Paribas, Credit Suisse, Deutsche, HSBC, Royal Bank of Scotland (RBS), Société Générale and UBS). See Wilmarth, “Dodd-Frank,” *supra* note 4, at 966 n.45.
33. *Id.* at 977-78; see also Phil Angelides, “Fannie, Freddie and the Financial Crisis,” *Bloomberg.com*, Aug. 3, 2011 (summarizing report prepared by the staff of the Financial Crisis Inquiry Commission (FCIC), and stating that Fannie and Freddie were “disasters” but not the “primary cause of the crisis” because (i) the GSEs “purchased the highest-rated portions of ‘private label’ mortgage securities produced by Wall Street,” (ii) “[w]hile such

- purchases added helium to the housing balloon, they represented just 10.5 percent of 'private-label' subprime-mortgage-backed securities in 2001, then rose to 40 percent in 2004, and fell back to 28 percent in 2008," (iii) "[p]rivate investors gobbled up the lion's share of those securities, including the riskier portions," and (iv) "data compiled by the FCIC for a subset of borrowers with [credit] scores below 660 shows that by the end of 2008, far fewer GSE mortgages were seriously delinquent than non-GSE securitized mortgages: 6.2 percent versus 28.3 percent").
34. Wilmarth, "Dodd-Frank," *supra* note 4, at 966-67; Wilmarth, "Subprime Financial Crisis," *supra* note 3, at 988-96, 1024-41.
 35. Wilmarth, "Dodd-Frank," *supra* note 4, at 978.
 36. *Id.* (quoting study by Dwight Jaffee).
 37. *Id.*; Wilmarth, "Subprime Financial Crisis," *supra* note 3, at 1044-45 (explaining that Citigroup and BofA "received huge bailout packages from the US 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").
 38. David Wessel, *In Fed We Trust: Ben Bernanke's War on the Great Panic* 217-18, 227, 236-40 (2009) (noting that Chase received \$25 billion of TARP capital while Goldman and Morgan Stanley each received \$10 billion); *see also* Ivry, Keoun & Kuntz, *supra* note 9 (stating that BofA's acquisition of Merrill was supported by more than \$60 billion of Fed emergency credit, while Wells Fargo's takeover of Wachovia was helped by \$50 billion of Fed emergency credit and Chase's acquisition of Bear was assisted by \$30 billion of Fed emergency credit).
 39. Wilmarth, "Dodd-Frank," *supra* note 4, at 978-79.
 40. Elijah Brewer III & Anne Marie Klingenhagen, "Be Careful What You Wish For: The Stock Market Reactions to Bailing Out Large Financial Institutions," 18 *Journal of Financial Regulation and Compliance* 56, 57-59, 64-66 (2010) (finding significant increases in stock market valuations for the 25 largest US 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," 97 *Journal of Financial Economics* 339, 340-41, 364 (2010) (concluding that the TARP capital infusions and FDIC debt guarantees announced in October 2008 produced \$130 billion of gains for holders of equity and debt securities of the nine largest US banks, at an estimated cost to taxpayers of \$21 to \$44 billion); Eric de Bodt et al., "The Paulson Plan's Competitive Effects" (May 2011), at 2-4, 15-21 (finding that TARP capital infusions between October 2008 and December 2009 produced significant gains for shareholders of the largest banks and also imposed losses on shareholders of smaller banks by injuring the competitiveness of those banks); Congressional Oversight Panel, *February Oversight Report: Valuing Treasury's Acquisitions* (Feb. 6, 2009), at 4-8, 26-29, 36-38 (presenting a valuation study concluding that (i) TARP capital infusions into eight major banks (BofA, Citigroup, Chase, Goldman, Morgan Stanley, US Bancorp and Wells Fargo) provided an average subsidy to those banks equal to 22 percent of Treasury's investment, and (ii) additional capital infusions into AIG and Citigroup under TARP provided an average subsidy to those institutions equal to 59 percent of Treasury's investment), available at <http://cybercemetery.unt.edu/archive/cop/20110402010539/http://cop.senate.gov/documents/cop-020609-report.pdf>.
 41. Ivry, Keoun & Kuntz, *supra* note 9 (reporting that "[d]uring the crisis, Fed loans were among the cheapest around, with funding available for as low as 0.01 percent in December 2008").
 42. Wilmarth, "Dodd-Frank," *supra* note 4, at 984-85; Wilmarth, "Reforming Financial Regulation," *supra* note 4, at 746 n.153.
 43. Wilmarth, "Dodd-Frank," *supra* note 4, at 985.
 44. Johnson & Kwak, *supra* note 5, at 202-03, 217; Peter Boone & Simon Johnson, "Shooting Banks," *New Republic*, Mar. 11, 2010, at 20. *See also* Thomas M. Hoenig, President, Federal Reserve Bank of Kansas City, "It's Not Over 'Til It's Over: Leadership and Financial Regulation" (William Taylor Memorial Lecture, Oct. 10, 2010) (noting that "the largest five [US 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") [hereinafter Hoenig October 10, 2010 Speech], available at <http://www.kansascityfed.org/speechbio/hoenigpdf/william-taylor-hoenig-10-10-10.pdf>; Ivry, Keoun & Kuntz, *supra* note 9 (reporting that "[t]otal assets held by the six biggest US banks increased 39 percent to \$9.5 trillion on Sept. 30, 2011, from \$6.8 trillion on the same day in 2006").
 45. Wilmarth, "Dodd-Frank," *supra* note 4, at 985-86 (quoting Ms. Prins).
 46. Johnson & Kwak, *supra* note 5, at 191.
 47. Wilmarth, "Dodd-Frank," *supra* note 4, at 987. Large financial conglomerates have never proven their ability to achieve superior performance without the extensive TBTF subsidies they currently receive. Most economic studies have failed to verify favorable economies of scale or scope in banks larger than \$100 billion. Wilmarth, "Reforming Financial Regulation," *supra* note 4, at 748-49; Boone & Johnson, *supra* note 44.
 48. Wilmarth, "Reforming Financial Regulation," *supra* note 4, at 747-79.
 49. Pub. L. No. 103-328, 108 Stat. 2338, Sept. 29, 1994.
 50. *See* House Report No. 103-448, at 65-66 (1994) (additional views of Rep. Neal and Rep. McCollum) (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.A.N. 2039, 2065-66.
 51. Wilmarth, "Dodd-Frank," *supra* note 4, at 988.
 52. *Id.* at 988-89.
 53. *Id.* at 989.
 54. *Id.* at 989-90.
 55. *Id.* at 990. As discussed below, § 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.
 56. *Id.* at 990-91.

57. *Id.* at 991.
58. *Id.* at 991-92.
59. *Id.* at 992.
60. Senate Report No. 111-176, at 4 (2010).
61. See Carnell, Macey & Miller, *supra* note 21, 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 *Federal Register* 64173, 64175 (Oct. 19, 2010) (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) [hereinafter FDIC Proposed OLA Rule].
62. See Wilmarth, "Reforming Financial Regulation," *supra* note 4, at 754-57.
63. See Dodd-Frank (preamble) (stating that the statute is designed "to end 'too big to fail' [and] to protect the American taxpayer by ending bailouts").
64. Wilmarth, "Dodd-Frank," *supra* note 4, at 993-94 (discussing and quoting §113 of Dodd-Frank).
65. *Id.* at 994 (discussing §§ 115 and 165 of Dodd-Frank).
66. *Id.* at 994-95.
67. Senate Report No. 111-176, at 4-6, 57-65 (2010); Wilmarth, "Reforming Financial Regulation," *supra* note 4, at 756-57.
68. Wilmarth, "Dodd-Frank," *supra* note 4, at 996 (quoting § 203(b) of Dodd-Frank).
69. *Id.* at 996-97; Wilmarth, "Reforming Financial Regulation," *supra* note 4, at 756-57.
70. Wilmarth, "Dodd-Frank," *supra* note 4, at 997.
71. *Id.* at 997-98 (discussing and quoting various provisions of Article II of Dodd-Frank). See also FDIC Proposed OLA Rule, *supra* note 61, at 64175, 64177 (explaining Dodd-Frank's minimum guarantee for creditors of a failed SIFI).
72. Fed. Deposit Ins. Corp., Interim final rule, 76 Fed. Reg. 4267 (Jan. 25, 2011) [hereinafter FDIC Interim OLA Rule].
73. Fed. Deposit Ins. Corp., Final rule, 76 Fed. Reg. 41626 (July 15, 2011) (adopting regulations to be codified at 12 C.F.R. Part 380) [hereinafter FDIC Final OLA Rule].
74. FDIC Proposed OLA Rule, *supra* note 61, at 64175; FDIC Interim OLA Rule, *supra* note 72, at 4211.
75. FDIC Proposed OLA Rule, *supra* note 61, at 64177-78; FDIC Interim OLA Rule, *supra* note 72, at 4211; see also FDIC Final OLA Rule, *supra* note 73, at 41634 (reaffirming position set forth in the interim OLA rule)..
76. See Zoltan Pozsar et al., "Shadow Banking" (Federal Reserve Bank of N.Y. Staff Report No. 458, July 2010), at 2-6, 46-59, available at <http://ssrn.com/abstract=1645337>.
77. Wilmarth, "Dodd-Frank," *supra* note 4, at 998-99.
78. Dodd-Frank, § 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).
79. Wilmarth, "Dodd-Frank," *supra* note 4, at 999.
80. Dodd-Frank § 206(1). See also § 210(a)(9)(E)(iii).
81. Wilmarth, "Dodd-Frank," *supra* note 4, at 1000.
82. Dodd-Frank § 201(n)(8)(A).
83. Under § 1824(a), the FDIC may 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 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."
84. Dodd-Frank, § 210(n)(8)(A).
85. *Id.* § 210(a)(9)(E)(i), (iii).
86. Wilmarth, "Dodd-Frank," *supra* note 4, at 1001 (referring to 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).
87. 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).
88. See Dodd-Frank, § 1106(b) (amending 12 U.S.C. § 1823(c)(4)(G)).
89. 12 U.S.C. § 343. See Wilmarth, "Dodd-Frank," *supra* note 4, at 1002 (referring to § 13(3) as amended in 1991 and as applied by the FRB to provide emergency credit to particular firms and segments of the financial markets during the financial crisis).
90. Dodd-Frank, § 1101(a) (requiring the Fed to use its § 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 Senate Report No. 111-176, at 6, 182-83 (2010) (discussing Dodd-Frank's restrictions on the FRB's lending authority under § 13(3)).
91. Dodd-Frank, § 1105. In addition, § 1106(a) of Dodd-Frank bars the FDIC from establishing any "widely available debt guarantee program" based on the SRE under the FDI Act. 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 Wilmarth, "Dodd-Frank," *supra* note 4, at 1002 n.212. Section 1106(a) of Dodd-Frank prohibits the use of the SRE to establish any program similar to the DGP. See Senate Report No. 111-176, at

- 6-7, 183-84 (2010) (discussing Dodd-Frank's limitations on the FDIC's authority to guarantee debt obligations of depository institutions and their holding companies).
92. Wilmarth, "Dodd-Frank," *supra* note 4, at 1002.
 93. 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 19 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 19 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 FRB's list of primary dealers included all of the "big eighteen" LCFIs except for AIG, Société Générale and Wachovia. Wilmarth, "Dodd-Frank," *supra* note 4, at 1002-03 n.214.
 94. *Id.* at 1002-03.
 95. *Id.* at 1003-04.
 96. *Id.* at 1004.
 97. *Id.* at 1004-05; see also 12 U.S.C. § 347b(b) (allowing the FRB to make discount window loans to "undercapitalized" banks subject to specified limitations).
 98. Wilmarth, "Dodd-Frank," *supra* note 4, at 1005.
 99. Adam J. Levitin, "In Defense of Bailouts," 99 *Georgetown Law Review* 435, 439 (2011).
 100. *Id.*, at 489.
 101. Cheryl D. Block, "Measuring the True Cost of Government Bailout," 88 *Washington University Law Review* 149, 224 (2010); see also *id.* at 227 ("pretending that there will never be another bailout simply leaves us less prepared when the next severe crisis hits").
 102. Standard & Poor's, "The U.S. Government Says Support for Banks Will Be Different 'Next Time'—But Will It?" (July 12, 2011), at 2.
 103. Wilmarth, "Dodd-Frank," *supra* note 4, at 1006-07 (discussing §§ 115 and 165 of Dodd-Frank).
 104. Dodd-Frank § 161(a)(1)(A), (d).
 105. Dodd-Frank § 165(b)(1)(B).
 106. Wilmarth, "Dodd-Frank," *supra* note 4, at 1009-10.
 107. 1 Fed. Deposit Insurance Corp., *History of the Eighties: Lessons for the Future* 39-40, 55-56 (1997) [hereinafter *FDIC History Lessons*].
 108. Wilmarth, "Transformation," *supra* note 1, at 459; see also Daniel K. Tarullo, *Banking on Basel: The Future of International Financial Regulation* 171-72 (2008).
 109. Johnson & Kwak, *supra* note 5, at 137-41; Wilmarth, "Transformation," *supra* note 1, at 457-61.
 110. Tarullo, *supra* note 108, at 79-83.
 111. *Id.* at 139-214 (identifying numerous shortcomings in the Basel II accord); Wilmarth, "Dodd-Frank," *supra* note 4, at 1010 (noting that Basel II allowed LCFIs to operate with inadequate capital).
 112. *FDIC History Lessons*, *supra* note 107, at 39-46, 245-47, 373-78.
 113. See, e.g., Kathleen C. Engel & Patricia A. McCoy, *The Subprime Virus* 157-223 (2011); Johnson & Kwak, *supra* note 5, at 6-10, 120-50; Arthur E. Wilmarth, Jr., "The Dodd-Frank Act's Expansion of State Authority to Protect Consumers of Financial Services," 36 *Journal of Corporation Law* 895, 897-919 (2011), available at <http://ssrn.com/abstract=1891970>. See also John C. Coffee, Jr., "Bail-Ins Versus Bail-Outs: Using Contingent Capital to Mitigate Systemic Risk" (Columbia Law School Center for Law & Economic Studies, Working Paper No. 380, 2010), 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").
 114. Jeffrey N. Gordon & Christopher Muller, "Confronting Financial Crisis: Dodd-Frank's Dangers and the Case for a Systemic Emergency Insurance Fund" (Columbia Law School Center for Law & Economic Studies, Working Paper No. 374), at 26.
 115. Johnson & Kwak, *supra* note 5, 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, Dec. 2009), available at <http://ssrn.com/abstract=1531520>; *Sold Out: How Wall Street and Washington Betrayed America* (Essential Information & Consumer Education Foundation, Mar. 2009), available at http://www.wallstreetwatch.org/reports/sold_out.pdf.
 116. Coffee, *supra* note 113, at 18-21; Gordon & Muller, *supra* note 114, at 27.
 117. Wilmarth, "Dodd-Frank," *supra* note 4, at 1012.
 118. Randall Smith & Aaron Lucchetti, "The Financial Regulatory Overhaul: Biggest Banks Manage to Dodge Some Bullets," *Wall Street Journal*, June 26, 2010, at A5 (quoting, in part, Timothy Ryan, chief executive of the Securities Industry and Financial Markets Ass'n).
 119. Wilmarth, "Dodd-Frank," *supra* note 4, at 1010-11, 1013.
 120. Coffee, *supra* note 113, at 20-21.
 121. Gordon & Muller, *supra* note 114, at 22-23; Johnson & Kwak, *supra* note 5, at 205-08.
 122. Wilmarth, "Dodd-Frank," *supra* note 4, at 1015.
 123. Dodd-Frank, §§ 210(n)(9)(B), 210(o)(1)(B), (C) (quote).
 124. *Id.* § 210(o)(1).
 125. Wilmarth, "Dodd-Frank," *supra* note 4, at 1015-16.
 126. *Id.* at 1016-17.
 127. See Carnell, Macey & Miller, *supra* note 21, at 535 (noting that ordinarily "an insurer collects, pools, and invests policyholders' premiums and draws on that pool to pay policyholders' claims").
 128. *Id.* at 328.
 129. See, e.g., Viral V. Acharya, Joao A.C. Santos & Tanju Yorulmazer, "Systemic Risk and Deposit Insurance Premiums," *Economic Policy Review* (Fed. Res. Bank of NY, Aug. 2010), at 89.
 130. Wilmarth, "Dodd-Frank," *supra* note 4, at 1017.
 131. Mike Ferrulo, "Regulatory Reform: Democrats Set to Begin Final Push to Enact Dodd-Frank Financial Overhaul," 94

- Banking Report* (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”).
132. Congressional Budget Office, Cost Estimate, H.R. 4173: Restoring Financial Stability Act of 2010: As passed by the Senate on May 20, 2010 (June 9, 2010), at 6.
 133. Wilmarth, “Dodd-Frank,” *supra* note 4, at 1018, 1018-19 n.287.
 134. Arthur E. Wilmarth, Jr., “Too Big to Fail=Too Powerful to Pay,” *Credit Slips* (blog post on July 7, 2010), available at <http://www.creditslips.org/creditslips/2010/07/too-big-to-fail-too-powerful-to-pay.html#more>.
 135. Wilmarth, “Dodd-Frank,” *supra* note 4, at 1019-20. 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 114, at 51-53. See also Xin Huang et al., “A Framework for Assessing the Systemic Risk of Major Financial Institutions,” 33 *Journal of Banking & Finance* 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 2001-2008, and concluding that the hypothetical aggregate insurance premium would have had an “upper bound” of \$250 billion in July 2008).
 136. Wilmarth, “Dodd-Frank,” *supra* note 4, at 1020-21.
 137. *Id.* at 1021 (quoting FDIC Chairman Sheila Bair).
 138. *Id.*
 139. *Id.* at 1021-22.
 140. Gordon & Muller, *supra* note 114, at 55.
 141. *Id.*
 142. *Id.* at 41, 55-56.
 143. Wilmarth, “Dodd-Frank,” *supra* note 4, at 1022-23.
 144. *Id.* at 1023.
 145. The federal “safety net” for banks includes (i) federal deposit insurance, (ii) protection of uninsured depositors and other uninsured creditors in TBTF banks under the SRE, and (iii) discount window advances and other liquidity assistance provided by the FRB as lender of last resort. See Wilmarth, “Dodd-Frank,” *supra* note 4, at 1023 n.308.
 146. Dodd-Frank, § 121(a).
 147. Under § 121(a) of Dodd-Frank, before the FRB may require a breakup of a large BHC or nonbank SIFI, the FRB must first take all of the following actions with regard to that company: (i) imposing limitations on mergers or affiliations, (ii) placing restrictions on financial products, (iii) requiring termination of activities, and (iv) imposing conditions on the manner of conducting activities.
 148. Dodd-Frank, § 121(a)(5). See Senate Report No. 111-176, at 51-52 (explaining § 121).
 149. 12 U.S.C. § 1844(e)(1).
 150. Hoenig October 10, 2010 Speech, *supra* note 44, at 4.
 151. Wilmarth, “Dodd-Frank,” *supra* note 4, at 1025.
 152. 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 adopted by the federal banking agencies. Senate Report No. 111-176, at 8-9, 90-92 (2010).
 153. *Id.* at 8-9.
 154. *Id.* at 91 (quoting testimony by Mr. Volcker). The Senate 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.* (same).
 155. *Id.* at 90.
 156. Wilmarth, “Dodd-Frank,” *supra* note 4, at 1026.
 157. Wilmarth, “Dodd-Frank,” *supra* note 4, at 1026-27.
 158. *Id.* at 1027 (quoting Zachary A. Goldfarb, “Goldman Sachs Executives Face Senators Investigating Role in Financial Crisis,” *Washington Post*, April 38, 2010, at A01).
 159. *Id.* at 1028 (quoting John Cassidy, “The Volcker Rule: Obama’s economic adviser and his battles over the financial-reform bill,” *New Yorker*, July 26, 2010, at 25).
 160. *Id.* (discussing § 13(d) of the BHC Act, added by Dodd-Frank, § 619).
 161. Dodd-Frank, § 619 (enacting new § 13(d)(1)(D) & (h)(4) of the BHC Act).
 162. Wilmarth, “Dodd-Frank,” *supra* note 4, at 1029; see also Government Accountability Office, Proprietary Trading: Regulators Will Need More Comprehensive Information to Fully Monitor Compliance with New Restrictions When Implemented, GAO-11-529 (July 2011), at 37 (stating that “a key challenge in implementing the proprietary trading restrictions [under the Volcker Rule] will be disentangling [permitted] activities associated with market-making, hedging and underwriting from prohibited proprietary trading activities”).
 163. Nelson D. Schwartz & Eric Dash, “Despite Reform, Banks Have Room for Risky Deals,” *New York Times*, Aug. 26, 2010, at A1; see also Michael Lewis, “Wall Street Proprietary Trading Under Cover,” *Bloomberg.com*, Oct. 26, 2010; Jia Lynn Yang, “Major banks gird for ‘Volcker rule,’” *Washington Post*, Aug. 14, 2010, at A08.
 164. Dodd-Frank, § 619 (adding new § 13(d)(1)(C) of the BHC Act). See Eric Dash & Nelson D. Schwartz, “In a Final Push, Banking Lobbyists Make a Run at Reform Measures,” *New York Times*, June 21, 2010, at B1 (reporting that “traders [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”).

165. Dodd-Frank § 619 (adding new § 13(b) of the BHC Act).
166. Mike Ferrulo, "Regulatory Reform: Senate Banking Members Push Regulators For More Progress Implementing Dodd-Frank," 97 *BNA's Banking Report* 997 (Dec. 13, 2011); see also Yin Wilczek, "Regulatory Reform: Banking Regulators Issue Volcker Proposal," 97 *BNA's Banking Report* 633 (Oct. 18, 2011) (reporting that both supporters and critics of the Volcker Rule attacked the proposed implementing regulations as "too complex, while leaving many questions unanswered").
167. Cassidy, *supra* note 159 (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"); Christine Harper & Bradley Keoun, "Financial Reform: The New Rules Won't Stop the Next Crisis," *Bloomberg BusinessWeek*, July 6-11, 2010, at 42, 43 (quoting William T. Winters, former co-chief executive officer of Chase's investment bank, who remarked: "I don't think [the Volcker Rule] will have any impact at all on most banks"); Simon Johnson, "Flawed Financial Bill Contains Huge Surprise," *Bloomberg.com*, July 8, 2010 (stating that the Volcker Rule was "negotiated down to almost nothing"); Bradley Keoun & Dawn Kopecki, "JP Morgan, Citigroup, Morgan Stanley Rise as Bill Gives Investment Leeway," *Bloomberg.com*, June 25, 2010 (quoting analyst Nancy Bush's view that the final compromise on the Volcker Rule meant that "the largest banks' operations are largely left intact").
168. Wilmarth, "Dodd-Frank," *supra* note 4, at 1030.
169. Richard Hill, "Derivatives: Conferees Reach Compromise: Banks Could Continue to Trade Some Derivatives," 42 *Securities Regulation & Law Report* (BNA) 1234 (June 28, 2010).
170. Robert Schmidt & Phil Mattingly, "Banks Would Be Forced to Push Out Derivatives Trading Under Plan," *Bloomberg.com*, April 15, 2010.
171. Wilmarth, "Dodd-Frank," *supra* note 4, at 1031.
172. Hill, *supra* note 169; see also Stacy Kaper & Cheyenne Hopkins, "Key Issues Unresolved as Reform Finishes Up," *American Banker*, June 25, 2010, at 1 (reporting that "banks have vigorously opposed [the Lincoln Amendment], arguing it would cost them millions 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").
173. Agnes Crane & Rolfe Winkler, "Reuters Breakingviews: Systemic Risk Knows No Borders," *New York Times*, May 3, 2010, at B2.
174. Schmidt & Mattingly, *supra* note 170 (quoting Karen Petrou).
175. *Id.*; see also Crane & Winkler, *supra* note 173 (observing that "Senator Blanche Lincoln . . . says 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").
176. Devlin Barrett & Damien Paletta, "The Financial-Regulation Overhaul: A Fight to the Wire as Pro-Business Democrats Dig In on Derivatives," *Wall Street Journal*, June 26, 2010, at A10; David Cho et al., "Lawmakers guide Wall Street reform into homestretch: Industry left largely intact," *Washington Post*, June 26, 2010, at A01; Edward Wyatt & David M. Herszenhorn, "Accord Reached for an Overhaul of Finance Rules," *New York Times*, June 26, 2010, at A1. See also *supra* notes 159-60 and accompanying text (discussing last-minute compromise that weakened the Volcker Rule).
177. Dodd-Frank, § 716(d); see also Hill, *supra* note 169; Heather Landy, "Derivatives Compromise Is All About Enforcement," *American Banker*, June 30, 2010, at 1; Wyatt & Herszenhorn, *supra* note 176.
178. See Dodd-Frank, § 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).
179. Harper & Keoun, *supra* note 167; Smith & Lucchetti, *supra* note 118.
180. Wyatt & Herszenhorn, *supra* note 176.
181. Johnson, *supra* note 167.
182. Hill, *supra* note 169 (quoting the Consumer Federation of America).
183. Smith & Lucchetti, *supra* note 118.
184. Keoun & Kopecki, *supra* note 167 (quoting analyst Nancy Bush).
185. Title VII of Dodd-Frank establishes comprehensive clearing, reporting and margin requirements for a wide range of derivatives. See H.R. Rep. No. 111-517, at 868-69 (2010) (Conf. Rep.), reprinted in 2010 U.S.C.C.A.N. 722, 725-26; Senate Report No. 111-176, at 29-35, 92-101 (2010); Alison Vekshin & Phil Mattingly, "Lawmakers Agree on Sweeping Wall Street Overhaul," *Bloomberg.com*, June 25, 2010 (summarizing Title VII). Major financial institutions have engaged in heavy lobbying since Dodd-Frank's enactment to weaken the regulatory implementation of Title VII. See, e.g., Robert Schmidt & Silla Brush, "Banks Seek Exemption from Dodd-Frank for Foreign-Exchange Swaps," *Bloomberg.com*, Nov. 24, 2010; "Wall Street Lobbyists Besiege CFTC to Shape Derivatives Trading Regulation," *Bloomberg.com*, Oct. 14, 2010.
186. Wilmarth, "Dodd-Frank," *supra* note 4, at 1034 (discussing Dodd-Frank, § 716(d)(2)).

Narrow Banking: An Overdue Reform That Could Solve the Too-Big-to-Fail Problem and Align US and UK Financial Regulation of Financial Conglomerates (Part II)

By Arthur E. Wilmarth, Jr.

Introduction

In Part I of this article (published in last month's issue), I argued that explicit and implicit subsidies for too-big-to-fail (TBTF) banking organizations create dangerous distortions in our financial markets and our general economy. We must eliminate (or at least greatly reduce) those subsidies in order to restore a more level playing field for smaller financial institutions and to encourage the voluntary breakup of inefficient, risky financial conglomerates. Unfortunately, as described in Part 1, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) fails to solve the TBTF problem and leaves open several potential avenues for future government bailouts of systemically important financial institutions (SIFIs).

Two major provisions of Dodd-Frank—the Volcker Rule and the Lincoln Amendment—seek to prevent large, complex financial institutions (LCFIs) from using federal safety net subsidies to support their speculative activities in the capital markets. However, as explained in Part 1, both provisions have long phase-in periods and broadly-worded exceptions that undermine their stated purpose. The Kanjorski Amendment potentially could enable the Federal Reserve Board (FRB) to force LCFIs to divest high-risk operations. However, the FRB's divestiture authority under that provision is significantly weakened by numerous procedural hurdles, including the required concurrence of two-thirds of the members of the Financial Stability Oversight Council (FSOC). Although Dodd-Frank gives federal agencies valuable new powers to regulate SIFIs, many analysts

and market participants expect that SIFIs will continue to benefit from TBTF bailouts during future systemic financial crises.

Part 2 proposes a new approach to financial regulatory reform. My proposals are designed to (i) prevent SIFIs from using the federal safety net to subsidize their speculative activities in the capital markets, and (ii) make it easier for regulators to separate banks from their nonbank affiliates when SIFIs fail. I recommend a two-tiered system of bank regulation and a pre-funded systemic risk insurance fund that could shrink safety net subsidies and minimize the likelihood of government bailouts for failing SIFIs. I would require banks owned by LCFIs to operate as “narrow banks,” an approach that is similar to the ring-fencing reforms recently endorsed by the UK government for large financial conglomerates. The “narrow bank” concept could create a consistent regulatory regime for LCFIs in the two nations that contain the most important global financial centers—New York and London. Moreover, joint approval of a “narrow bank” requirement by the US and UK would place substantial pressure on other European Union (EU) nations and other developed countries to adopt a similar regulatory approach for LCFIs.

Banks Controlled by Financial Conglomerates Should Operate as “Narrow Banks” so that They Cannot Transfer Their Federal Safety Net Subsidies to Their Nonbank Affiliates

In order to prevent the spread of federal safety net subsidies from banks to their affiliates involved in capital markets activities, Congress should mandate a two-tiered structure of bank regulation and deposit insurance.¹ The first tier of “traditional” banking organizations would provide a relatively broad range of banking-related services, but those organizations would

Arthur E. Wilmarth, Jr. is a Professor of Law and Executive Director of the Center for Law, Economics & Finance, George Washington University Law School. This article is based on testimony he presented on December 7, 2011, before the Subcommittee on Financial Institutions and Consumer Protection of the Senate Committee on Banking, Housing and Urban Affairs.

not be allowed to engage, or affiliate with firms 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 operations (except for private equity investments). However, “narrow banks” would be prohibited from making any extensions of credit or other transfers of funds to their nonbank affiliates, except for lawful dividends paid to their parent holding companies. The “narrow bank” approach provides the most politically feasible approach for ensuring that banks cannot transfer their safety net subsidies to affiliated companies engaged in speculative transactions in the capital markets. It is therefore consistent with the objectives of both the Volcker Rule and the Lincoln Amendment.

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 Section 4(c)(8) of the Bank Holding Company Act (BHC Act).² 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 in “bank-eligible” securities that national banks are permitted to underwrite and deal in directly.³ First-tier banking organizations could also purchase, as end-users, derivatives transactions that (i) hedge against their own firm-specific risks, and (ii) qualify for hedging treatment under Financial Accounting Standard (FAS) Statement No. 133.⁴

Most first-tier banking firms would probably be small and mid-sized community-oriented banks. In the past, those banks typically have not engaged as principal in insurance underwriting, securities underwriting or dealing, derivatives dealing or trading, or other capital markets activities. Community banks should be encouraged to continue their primary business of attracting core deposits, providing “high touch,” relationship-based loans to consumers and to small and medium-sized enterprises (SMEs), and offering wealth management and other fiduciary services to local customers. (In sharp contrast to traditional community banks, large

banks provide impersonal, highly automated lending and deposit programs to SMEs and consumers, and large banks also focus on complex, higher-risk transactions in the capital markets.)⁵ Traditional, 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 \$250,000 per qualifying account) should be covered by deposit insurance.

In order to provide reasonable flexibility to first-tier banking organizations, Congress should amend § 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.⁶ However, Congress should prohibit first-tier bank holding companies from engaging as principal in underwriting or dealing in securities (except for bank-eligible securities), underwriting any type of insurance (except for credit insurance), dealing or trading in derivatives, or making private equity investments.

The Second Tier of Nontraditional Banking Organizations

Unlike first-tier banking firms, the second tier of “nontraditional” banking organizations would be allowed to engage, through nonbank subsidiaries, in (i) underwriting and dealing (i.e., proprietary trading) in “bank-ineligible” securities,⁷ (ii) underwriting all types of insurance, and (iii) dealing and trading in derivatives. Second-tier banking organizations would include: (A) financial holding companies (FHCs) registered under §§ 4(k) and 4(l) of the BHC Act,⁸ (B) holding companies owning grandfathered “nonbank banks,” and (C) grandfathered “unitary thrift” holding companies.⁹ 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.¹⁰ Second-tier holding companies would thus encompass 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.

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 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 rules of the Securities and Exchange Commission (SEC). 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 Deposit Insurance Fund (DIF), because (i) each narrow bank’s non-cash 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 (ii) 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.¹¹

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 stable net asset value (NAV) of \$1 per share. 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 an assured price of \$1 per share.¹² Not surprisingly, “the \$1 share price gives investors the false impression that money-market funds are like [FDIC-insured] bank accounts and can’t lose money.”¹³ 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.”¹⁴ 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 2009.¹⁵

Critics of MMMFs maintain that the Treasury’s MMFGP has created an expectation of similar government bailouts if MMMFs “break the buck” in the future.¹⁶ For example, 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 deposit accounts because MMMFs do not have to pay FDIC insurance premiums or comply with other banking regulations.¹⁷ A Group of Thirty report, which Mr. Volcker spearheaded, proposed that MMMFs that wish to offer bank-like services, such as checking accounts and withdrawals based on a stable NAV of \$1 per share, should reorganize as “special-purpose banks” with appropriate governmental supervision and insurance.¹⁸ In contrast, MMMFs that do not wish to operate as banks should be required to base their redemption price on a floating NAV, so that investors are not encouraged to believe that they can always redeem their shares at par.¹⁹

If Congress required nonbank MMMFs to base their redemption price on a floating NAV and also adopted my proposal for a two-tiered structure of bank regulation, many MMMFs would probably decide to reorganize as FDIC-insured narrow banks and would become subsidiaries of second-tier FHCs.²⁰ As explained above, rules restricting the assets of narrow banks to commercial paper, government securities and other types of marketable, highly-liquid investments would protect the DIF from any significant loss if a narrow bank failed.

Four Additional Rules Would Prevent Narrow Banks from Transferring Safety Net Subsidies to Their Affiliates

Congress should adopt four supplemental rules 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.²¹ Currently, transactions between FDIC-insured banks and their affiliates are restricted by §§ 23A and 23B of the Federal Reserve Act.²² However, the FRB has 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 FHC-owned banks to transfer the safety net subsidy provided by low-cost, FDIC-insured deposits to their nonbank affiliates.²³

Dodd-Frank limits the authority of the FRB to grant future waivers or exemptions under §§ 23A and 23B, because it requires the FRB to obtain the concurrence of either the OCC (with respect to waivers granted by orders for national banks) or the FDIC (with respect to waivers granted by orders for state banks or exemptions granted by rulemaking).²⁴ 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 §§ 23A and 23B will be adhered to in a crisis setting.

For example, in 2011 the FRB permitted Bank of America (BoFA) to evade the restrictions of § 23A by transferring an undisclosed amount of derivatives contracts from its Merrill broker-dealer subsidiary to its subsidiary bank. That transaction increased the potential risk that the DIF and taxpayers ultimately might have to cover losses incurred by BoFA on the transferred derivatives. However, the transfer reportedly allowed BoFA—which was struggling with a host of problems—to avoid contractual requirements to post \$3.3 billion in additional collateral with counterparties, due to the fact that BoFA's subsidiary bank held a significantly higher credit rating than Merrill.²⁵ One commentator noted that “the Fed's priorities seem to lie with protecting [BoFA] from losses at Merrill, even if that means greater risks for the FDIC's insurance fund.”²⁶

My proposal for second-tier narrow banks would replace §§ 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). Thus, my proposal would bar federal regulators from approving any transfers of

safety net subsidies by narrow banks to their affiliates. An absolute bar on affiliate transactions is necessary to prevent FDIC-insured banks from being used as back-door bailout devices for their nonbank affiliates.

Second, as discussed above in Part 1, Congress should repeal the systemic risk exception (SRE) currently included in the Federal Deposit Insurance Act (FDI Act). By repealing the SRE, Congress would require the FDIC to follow the 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. Repealing the SRE would thus 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 FDI Act would also make clear to the financial markets that the DIF only protects bank depositors. Uninsured creditors of SIFIs and their nonbank subsidiaries would therefore have stronger incentives to monitor the financial operations and condition of such entities.²⁷

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. 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.²⁸ 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.”²⁹ The FDIC report suggested that the way to correct this inequity is “to remove the [SRE],”³⁰ as my proposal would do.

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. My proposal would require all second-tier banking organizations to conduct their derivatives dealing and trading activities through separate nonbank affiliates, in the same manner that GLBA currently requires all underwriting and dealing in bank-ineligible securities to be conducted through nonbank affiliates of FHCs.³¹ 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 continuing to exploit federal safety net subsidies by conducting speculative trading activities within their FDIC-insured bank subsidiaries.

As shown by BofA's transfer of derivatives from Merrill to its bank subsidiary in 2011, bank dealers in OTC derivatives enjoy significant competitive advantages over nonbank dealers, due to banks' explicit and implicit safety net subsidies. Banks typically borrow funds at substantially lower interest rates than their holding company affiliates because (i) banks can obtain direct, low-cost funding through FDIC-insured deposits, and (ii) 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 bank holding companies).³²

The OCC has noted 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 companies."³³ Such an outcome may be favorable to FHCs, but it is certainly not beneficial to the DIF and taxpayers. The DIF and 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. Congress should terminate this artificial, federally-subsidized advantage for bank derivatives dealers.³⁴

Fourth, Congress should prohibit all private equity investments by second-tier banks and their holding company affiliates. To accomplish this reform—which would be consistent with the Volcker Rule as originally proposed—Congress should repeal Sections 4(k)(4)(H) and (I) of the BHC Act,³⁵ which allow FHCs to make merchant banking investments and insurance company portfolio investments.³⁶ Private equity investments involve a high degree of risk and have inflicted significant losses on FHCs in the past.³⁷ 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."³⁸ 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.³⁹

In combination, the four supplemental rules described above would help to ensure that narrow banks cannot transfer their federal safety net subsidies to their nonbank affiliates. Restricting the scope of safety net subsidies is of utmost importance in order to restore a more level playing field between small and large banks, and between banking and nonbanking firms. Safety net subsidies have increasingly distorted our regulatory and economic policies over the past three decades. During that period, nonbanking firms have pursued every available avenue to acquire FDIC-insured depository institutions so that they can secure the funding advantages provided by low-cost, FDIC-insured deposits. At the same time, 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.⁴⁰

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 their subsidies to their nonbanking affiliates, including those engaged in speculative capital markets activities. 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. Economic studies have failed to confirm the existence of favorable economies of scale or scope in giant financial conglomerates, and those conglomerates have not been able to generate consistently positive returns, even under the current regulatory system that allows them to capture extensive federal subsidies.⁴¹

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.⁴² Many of the largest commercial

and industrial conglomerates in the U.S. 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.”⁴³ It is long past time for financial conglomerates to be stripped of their safety net subsidies and their presumptive access to TBTF bailouts so that they will be subject to the same type of scrutiny and discipline that the capital markets have already applied to commercial and industrial conglomerates. The narrow bank concept provides a workable plan to impose such scrutiny and discipline on FHCs.

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. Critics warn that a banking system composed *exclusively* of narrow banks could not provide credit to SMEs that lack access to the capital markets and depend on banks as their primary source of outside credit.⁴⁴

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 SMEs. 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.⁴⁵

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. 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. That 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 through the capital markets.⁴⁶

Thus, my two-tier proposal should not cause a significant reduction in bank loans to bank-dependent firms, because big banks have 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 midsized firms, Congress could authorize second-tier banks to devote a limited percentage (e.g., 10 percent) of their assets to such loans, as long as the banks held 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 banks to use deposits to fund those loans without exposing the banks to a significant risk of failure, since 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 maintain that the narrow bank concept would simply shift the TBTF problem from insured banks to their nonbank affiliates.⁴⁷ However, the force of this objection has been weakened by the systemic risk oversight and resolution regime established by Dodd-Frank. As Part 1 explains, FHCs 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 Orderly Liquidation Authority (OLA). As explained in both

Parts 1 and 2, the potential for TBTF bailouts of SIFIs would be reduced further if (i) Congress required all SIFIs to pay risk-based premiums to pre-fund the Orderly Liquidation Fund (OLF), so that the OLF would have the necessary resources to handle future resolutions of failed SIFIs, and (ii) Congress repealed the SRE so that the DIF would no longer be available as a potential bailout fund for TBTF institutions.

Thus, if my proposed reforms were fully implemented, (i) the narrow bank structure would prevent SIFI-owned banks from transferring their safety net subsidies to their nonbank affiliates, and (ii) Dodd-Frank's 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 would greatly reduce the TBTF subsidies that might otherwise be available to large financial conglomerates. Moreover, the narrow bank structure would increase the effectiveness of Dodd-Frank's requirement for "living wills" (resolution plans) by making it much easier for regulators to separate banks owned by failed SIFIs from their nonbank affiliates. As explained above, narrow banks would not be allowed to become entangled with their nonbank affiliates through extensions of credit and other transfers of funds.⁴⁸

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.⁴⁹ Again, there are persuasive rebuttals to this objection. In September 2011 the U.K. Independent Commission on Banking (ICB) issued a report advocating a reform program similar to my proposal. The ICB called for large financial conglomerates to adopt a "ring-fenced" structure that would separate and "insulate" their retail banking operations—including deposit-taking and lending services provided to consumers and SMEs—from their wholesale activities in the capital markets.⁵⁰ Thus, the ICB's program would require financial conglomerates to "build fire-walls between their consumer units and investment banks" and would likely cause "a jump in the cost of funding for their investment-banking divisions as the implicit [U.K.] government guarantee is removed."⁵¹ In December 2011, the U.K. government pledged to enact legislation implementing the ICB's "ring-fencing"

recommendations by May 2015.⁵² U.K. Chancellor of the Exchequer George Osborne declared that the implementing legislation would "separate [retail] banking from investment banking to protect the British economy, protect British taxpayers, and make sure that nothing is too big to fail."⁵³

If the U.S. and the U.K. both decide to mandate a narrow banking structure (supplemented by strong systemic risk oversight and resolution regimes), their combined leadership in global financial markets would (i) preclude claims by global SIFIs that they would face an unlevel playing field if they competed in both the New York and London financial markets, and (ii) place considerable pressure on other major global financial centers to adopt similar financial reforms.⁵⁴ The financial sector accounts for a large share of the domestic economies of the U.S. and U.K. 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 caused (at least in part) by a group of SIFIs that continues to dominate the financial systems in both nations. Accordingly, regardless of what other nations may do, the U.S. and the U.K. have compelling national reasons to make sweeping changes to their financial systems in order to protect their domestic economies from the threat of a similar crisis in the future.⁵⁵

Arguments by the financial services industry that the U.S. and the U.K. should not implement fundamental financial reforms until all other major developed nations have agreed to do so rest upon two deeply flawed assumptions: (i) the U.S. and the U.K. should allow foreign nations with the *weakest* systems of financial regulation to set the *maximum* level of supervisory constraints on global SIFIs, and (ii) until a comprehensive international agreement on supervisory reform is achieved, the U.S. and the U.K. should continue 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 SIFIs.⁵⁶ Both assumptions are unacceptable and must be rejected.

Conclusion

Dodd-Frank makes meaningful improvements in the regulation of large financial conglomerates. Dodd-Frank establishes a new umbrella oversight body—the FSOC—that will designate nonbank SIFIs

and make recommendations for the supervision of those institutions and large bank holding companies. Dodd-Frank also empowers the FRB to adopt stronger capital requirements and other enhanced prudential standards for both types of SIFIs. Most importantly, Dodd-Frank establishes the OLA as a new resolution regime for failed SIFIs. However, the OLA's feasibility remains unproven with regard to global SIFIs that operate across multiple national borders, since most foreign countries have not adopted resolution procedures that are compatible with the OLA.⁵⁷

In addition, as explained in Part 1, the OLA does not completely shut the door to future government support for creditors of SIFIs. The FRB can still provide emergency liquidity assistance to troubled SIFIs through the discount window and through "broad-based" liquidity facilities like the Primary Dealer Credit Facility. FHLBs can still make collateralized advances to SIFIs. The FDIC can potentially use its Treasury borrowing authority and the SRE to protect uninsured creditors of failed SIFIs and their subsidiary banks. While Dodd-Frank has made TBTF bailouts more difficult, the continued existence of these avenues for financial assistance indicates that Dodd-Frank is not likely to stop regulators from protecting creditors of troubled SIFIs during future episodes of systemic financial distress.

Dodd-Frank also relies heavily on the same supervisory tools—capital-based regulation and prudential supervision—and the same regulatory agencies that failed to prevent the banking and thrift crises of the 1980s and the current financial crisis. As Simon Johnson and James Kwak have observed:

[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.⁵⁸

Congress could have addressed the TBTF problem directly by mandating a breakup of large financial conglomerates. Johnson and Kwak have proposed maximum size limits that would require a significant

reduction in size for each of the six largest U.S. banking organizations.⁵⁹ 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."⁶⁰

However, during the Senate's floor debates on Dodd-Frank, the Senate rejected a similar proposal for maximum size limits by almost a two-to-one vote.⁶¹ Given the political clout wielded by megabanks, it seems unlikely that Congress will impose such size limits absent a devastating future crisis.

My recommended approach is to impose structural requirements and activity limitations that would (i) prevent SIFIs from using the federal safety net to subsidize their speculative activities in the capital markets, and (ii) make it much easier for regulators to separate banks from their nonbank affiliates when SIFIs are threatened with failure. A pre-funded OLF would require all 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 as a backdoor bailout fund for nondeposit creditors of megabanks. A two-tiered system of bank regulation would (i) restrict traditional banking organizations to deposit-taking, lending, fiduciary services and other activities that are "closely related" to banking, and (ii) mandate a "narrow bank" structure for banks owned by financial conglomerates. In turn, the narrow bank structure would (A) insulate narrow banks and the DIF from the risks of capital markets activities conducted by nonbank affiliates, and (B) prevent narrow banks from transferring their FDIC-insured, low-cost funding advantages and other safety net subsidies to nonbank affiliates.

My recommended reforms would remove many of the government subsidies that are currently exploited by LCFIs and would subject them to the same type of market discipline that investors have applied in breaking up 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. It is long past time for LCFIs to prove—based on a true market test—that their claimed synergies and their supposedly superior business model are real and

not mythical.⁶² If SIFIs cannot produce favorable results without their current TBTF subsidies, market forces should compel them to break up voluntarily.

Notes

1. The following description of my proposal for a two-tiered structure of bank regulation and deposit insurance is adapted from Arthur E. Wilmarth, Jr., "The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-To-Fail Problem," 89 *Oregon Law Review* 951, 1034-52 (2011) [hereinafter Wilmarth, "Dodd-Frank"], available at <http://ssrn.com/abstract=1719126>. For discussions of similar "narrow bank" proposals, see, e.g., Robert E. Litan, *What Should Banks Do?* 164-89 (1987); John Kay, *Narrow Banking: The Reform of Financial Regulation* 39-92 (Sept. 15, 2009) (unpublished manuscript), available at <http://www.johnkay.com/wp-content/uploads/2009/12/JK-Narrow-Banking.pdf>; Ronnie J. Phillips & Alessandro Roselli, *How to Avoid the Next Taxpayer Bailout of the Financial System: The Narrow Banking Proposal* (Networks Fin. Instit. Pol'y Brief 2009-PB-05, 2009), available at http://ssrn.com/abstract_id=1459065.
2. See 12 U.S.C. § 1843(c)(8) (2006); Richard S. Carnell, Jonathan R. Macey & Geoffrey P. Miller, *The Law of Banking and Financial Institutions* 442-44 (4th ed. 2009) (describing "closely related to banking" activities that are permissible for nonbank subsidiaries of bank holding companies under § 4(c)(8)).
3. See Arthur E. Wilmarth, Jr., "The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks," 2002 *University of Illinois Law Review* 215, 225-26 n.30 [hereinafter Wilmarth, "Transformation"] (discussing "bank-eligible" securities that national banks are authorized to underwrite or purchase or sell for their own account), available at <http://ssrn.com/abstract=315345>; Carnell, Macey & Miller, *supra* note 2, at 132-34 (same).
4. Wilmarth, "Dodd-Frank," *supra* note 1, at 1036.
5. For discussions of the sharply different business models adopted by community banks and megabanks, see *id.* at 1035-38; Wilmarth, "Transformation," *supra* note 3, at 261-70, 372-407.
6. The Gramm-Leach-Bliley Act (GLBA) prohibits the FRB from approving any new "closely related" activities for bank holding companies under § 4(c)(8) of the BHC Act. See Carnell, Macey & Miller, *supra* note 2, at 444 (explaining that 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 Nov. 11, 1999). Congress should revise § 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, "Dodd-Frank," *supra* note 1, at 1036-37 n.375.
7. See Wilmarth, "Transformation," *supra* note 3, at 219-20, 225-26 n.30, 318-20 (discussing distinction between (i) "bank-eligible" securities, which banks may underwrite and deal in directly, and (ii) "bank-ineligible" securities, which affiliates of banks may underwrite and deal in under GLBA, but banks may not).
8. 12 U.S.C. § 1843(k), (l) (2006). See Carnell, Macey & Miller, *supra* note 2, at 467-70 (describing "financial" activities, including securities underwriting and dealing and insurance underwriting, which are authorized for FHCs under the BHC Act, as amended by GLBA).
9. See Arthur E. Wilmarth, Jr., "Wal-Mart and the Separation of Banking and Commerce," 39 *Connecticut Law Review* 1539, 1569-71, 1584-86 (2007) (explaining that (i) during the 1980's and 1990's, many securities firms, life insurers and industrial firms used the "nonbank bank" loophole or the "unitary thrift" loophole to acquire FDIC-insured institutions, and (ii) those loopholes were closed to new acquisitions by a 1987 statute and by GLBA, respectively), available at <http://ssrn.com/abstract=984103> [hereinafter Wilmarth, "Wal-Mart"].
10. 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, § 603 of Dodd-Frank imposes a three-year moratorium on the authority of federal regulators to approve any new acquisitions of industrial banks by commercial firms. In addition, § 603 requires the GAO to conduct a study and report to Congress on whether commercial firms should be permanently barred from owning industrial banks. See Senate Report No. 111-176, at 83 (2010). See also Wilmarth, "Wal-Mart," *supra* note 9, at 1543-44, 1554-1620 (arguing that Congress should prohibit commercial firms from owning industrial banks because such ownership (i) undermines the long-established U.S. policy of separating banking and commerce, (ii) threatens to spread federal safety net subsidies to the commercial sector of the U.S. economy, (iii) threatens the solvency of the Deposit Insurance Fund, (iv) creates competitive inequities between commercial firms that own industrial banks and other commercial firms, and (v) increases the likelihood of federal bailouts of commercial companies).
11. See Wilmarth, "Dodd-Frank," *supra* note 1, at 1038; Kenneth E. Scott, "Deposit Insurance and Bank Regulation: The Policy Choices," 44 *Business Lawyer* 907, 921-22, 928-29 (1989).
12. David Reilly, "Goldman Sachs Wimps Out in Buck-Breaking Brawl," *Bloomberg.com*, Feb. 3, 2010.
13. *Id.* See also Kay, *supra* note 1, at 65 (arguing that an MMMF with a stable NAV of \$1 per share "either confuses consumers or creates an expectation of government guarantee"). In July 2011, FSOC noted that a "\$1 NAV fosters an expectation that [MMMF] share prices will not fluctuate. However, when shareholders perceive that a fund may suffer losses, each shareholder has an incentive to redeem shares before other shareholders, causing a run on the fund." Financial Stability Oversight Council, *2011 Annual Report* (July 22, 2011), at 50 (Box D) [hereinafter 2011 FSOC Annual Report], available at <http://www.treasury.gov/initiatives/fsoc/Documents/FSOCAR2011.pdf>.
14. Reilly, *supra* note 12.

15. Wilmarth, "Dodd-Frank," *supra* note 1, at 1039.
16. Jane Bryant Quinn, "Money Funds Are Ripe for 'Radical Surgery,'" *Bloomberg.com*, July 29, 2009. *See also* 2011 FSO Annual Report, *supra* note 13, at 51 (Box D) (explaining that "[g]iven the unprecedented government support of [MMMFs] during 2008 and 2009, even sophisticated institutional investors and fund managers may have the impression that the government would be ready to support the industry again"); Reilly, *supra* note 12 (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 bail-outs").
17. Wilmarth, "Dodd-Frank," *supra* note 1, at 1040; *see also* Christopher Condon, "Investing: Money Funds Face Off Over the \$1 Share Price," *Bloomberg Businessweek*, Mar. 12-18, 2012, at 50 (reporting that MMMFs "can offer customers higher rates than many bank savings accounts because [MMMFs] don't have to pay for federal insurance or set aside capital to cover losses"); 2011 FSO Annual Report, *supra* note 13, at 51 (Box D) (observing that MMMFs "have no formal capital buffers or insurance to absorb loss and maintain their stable NAV").
18. Group of Thirty, *Financial Reform: A Framework for Financial Stability* 29 (2009) (Recommendation 3.a.), available at <http://www.group30.org/pubs/reformreport.pdf>.
19. *Id.* at 29 (Recommendation 3.b.). *See also* Reilly, *supra* note 12 (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 1, 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").
20. *See* Quinn, *supra* note 16 (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").
21. Scott, *supra* note 11, at 929; Wilmarth, "Dodd-Frank," *supra* note 1, at 1041.
22. 12 U.S.C. §§ 371c, 371c-1 (2006).
23. Wilmarth, "Dodd-Frank," *supra* note 1, at 1042 n.395 (referring to (i) the FRB's waiver of § 23A restrictions so that major banks could make large loans to their securities affiliates following the terrorist attacks on September 11, 2001; (ii) the FRB's decisions, after the subprime financial crisis began in August 2007, to grant exemptions from § 23A restrictions to six major U.S. and foreign banks—Bank of America, Citigroup, JP Morgan Chase, Barclays Bank, Deutsche Bank and Royal Bank of Scotland—so that those banks could provide loans to support their securities affiliates; and (iii) the FRB's decisions to waive §§ 23A and 23B in 2008 and 2009 so that banks could purchase asset-backed commercial paper ("ABCP") from affiliated MMMFs in order to mitigate "ongoing dislocations in the financial markets, and the impact of such dislocations on the functioning of ABCP markets and on the operation of [MMMFs]"); *see also* Saule T. Omarova, "From Gramm-Leach-Bliley to Dodd-Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act," 89 *North Carolina Law Review* (2011) (forthcoming) (explaining how the FRB greatly weakened the restrictions of § 23A by granting numerous exemptions to large banks between 1996 and 2010).
24. Dodd-Frank, § 608(a)(4) (amending 12 U.S.C. § 371c(f)); *id.* § 608(b)(6) (amending 12 U.S.C. § 371c-1(e)(2)).
25. Kate Davidson, "Democrats Raise Red Flag on BofA Derivatives Transfer," *American Banker*, Oct. 28, 2011; Simon Johnson, "Bank of America Is Too Much of a Behemoth to Fail," *Bloomberg.com*, Oct. 23, 2011; Jonathan Weil, "Bank of America Bosses Find Friend in the Fed," *Bloomberg.com*, Oct. 19, 2011.
26. Weil, *supra* note 25.
27. Wilmarth, "Dodd-Frank," *supra* note 1, at 1042-43.
28. 12 U.S.C. § 1823(c)(4)(G)(ii).
29. Federal Deposit Ins. Corp., Options Paper, Aug. 2000, at 33, available at http://www.fdic.gov/deposit/insurance/initiative/Options_080700m.pdf.
30. *Id.*
31. *See* Carnell, Macey & Miller, *supra* note 2, at 27, 130-34, 467-70, 490-91 (explaining that, under GLBA, all underwriting and dealing of bank-ineligible securities by FHCs must be conducted through nonbank holding company subsidiaries or through nonbank financial subsidiaries of banks); Wilmarth, "Transformation," *supra* note 3, at 219-20, 225-26 n.30, 318-20 (same).
32. Carnell, Macey & Miller, *supra* note 2, at 492; Wilmarth, "Dodd-Frank," *supra* note 1, at 1044.
33. Office of the Comptroller of the Currency, OCC Interpretive Letter No. 892, at 3 (2000) (from Comptroller of the Currency John D. Hawke, Jr., to Rep. James A. Leach, Chairman of House Committee on Banking & Financial Services), available at <http://www.occ.treas.gov/interp/sep00/int892.pdf>.
34. Wilmarth, "Dodd-Frank," *supra* note 1, at 1044-45.
35. 12 U.S.C. § 1843(k)(4)(H), (I) (2006).
36. *See* Carnell, Macey & Miller, *supra* note 2, at 483-85 (explaining that "through the merchant banking and insurance company investment provisions, [GLBA] allows significant nonfinancial affiliations" with banks).
37. Wilmarth, "Transformation," *supra* note 3, at 330-32, 375-78.
38. Wilmarth, "Wal-Mart," *supra* note 9, at 1581-82.
39. For further discussion of this argument, *see id.* at 1588-1613.
40. *Id.* at 1569-70, 1584-93; *see also* Kay, *supra* note 1, at 43 (stating: "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").

41. Arthur E. Wilmarth, Jr., "Reforming Financial Regulation to Address the Too-Big-To-Fail Problem," 35 *Brooklyn Journal of International Law* 707, 748-49 (2010) [hereinafter Wilmarth, "Reforming Financial Regulation"], available at <http://ssrn.com/abstract=1645921>; see also Simon Johnson & James Kwak, *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown* 212-13 (2010).
42. In a newspaper interview, Karen Shaw Petrou, the managing partner of Federal Financial Analytics, explained that "[i]nter-affiliate 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." Ms. Petrou therefore concluded that an imposition of stringent limits on affiliate transactions would "really strike[] 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. Stacy Kaper, "Big Banks Face Most Pain under House Bill," *American Banker*, Dec. 2, 2009, at 1 (quoting Ms. Petrou).
43. Wilmarth, "Dodd-Frank," *supra* note 1, at 1047.
44. See, e.g., Neil Wallace, "Narrow Banking Meets the Diamond-Dybvig Model," 20 *Quarterly Review* (Fed. Res. Bank of Minneapolis, Winter 1996), at 3.
45. Wilmarth, "Dodd-Frank," *supra* note 1, at 1048.
46. *Id.*
47. See Scott, *supra* note 11, 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).
48. Wilmarth, "Dodd-Frank," *supra* note 1, at 1050-51.
49. See Kay, *supra* note 1, at 71-74; Scott, *supra* note 11, at 931.
50. Howard Mustoe & Gavin Finch, "Banks in U.K. Have to Insulate Consumer Units in \$11 Billion Vickers Plan," *Bloomberg.com*, Sept. 12, 2011; see also Kay, *supra* note 1, at 51-69 (advocating adoption by the U.K. of a narrow banking plan that would accomplish "the separation of utility from casino banking").
51. Liam Vaughan, Howard Mustoe & Gavin Finch, "U.K. Bank Investors Chided as Vickers Returns Firms to 1950s," *Bloomberg.com*, Sept. 13, 2011.
52. Ali Quassim, "International Banking: U.K. Banking Reform Includes 'Ringfencing' Retail Banks, Higher Equity Requirements," 98 *BNAs Banking Report* 32 (Jan. 3, 2012) (reporting that U.K. Chancellor of the Exchequer George Osborne endorsed the Vickers Report and described its proposals as the "most far-reaching reform of British banking in our modern history"); Marietta Cauchi, "U.K. Backs Broad Bank Overhaul: Lenders Must 'Ring Fence' Retail Activities From Riskier Activities, Combating 'Too Big to Fail,'" *Wall Street Journal*, Dec. 20, 2011, at C2.
53. Cauchi, *supra* note 52 (quoting Mr. Osborne's speech in Parliament on Dec. 19, 2011).
54. Wilmarth, "Dodd-Frank," *supra* note 1, at 1051; Kay, *supra* note 1, at 74.
55. See, e.g., Kay, *supra* note 1, at 71-74; Wilmarth, "Dodd-Frank," *supra* note 1, at 1051-52; see also Qassim, *supra* note 52 (quoting Chancellor of the Exchequer George Osborne's statement that the ICB's reform program seeks to resolve "the 'British Dilemma': how Britain can be home to one of the world's leading financial centers without exposing British taxpayers to the massive costs of those banks failing").
56. See e.g., Kay, *supra* note 1, at 42-46, 57-59, 66-75; Wilmarth, "Dodd-Frank," *supra* note 1, at 1052.
57. See, e.g., Simon Johnson, "The Myth of the Resolution Authority," *Baseline Scenario* (blog), Mar. 31, 2011, available at <http://baselinescenario.com/2011/03/31/the-myth-of-the-resolution-authority/>.
58. Johnson & Kwak, *supra* note 41, at 207.
59. *Id.* at 214-17.
60. *Id.* at 221. See also Joseph E. Stiglitz, *Freefall: America, Free Markets, and the Sinking of the World Economy* 165-66 (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").
61. A proposed amendment by Senator Sherrod Brown (D-OH) and Senator Ted Kaufman (D-DE) would have imposed the following maximum size limits on LCFIs: (i) a cap on deposit liabilities equal to 10 percent of nationwide deposits, and (ii) a cap on nondeposit liabilities equal to two percent of GDP for banking institutions and three percent of GDP for non-banking 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 nondeposit liabilities. The Senate rejected the Brown-Kaufman amendment by a vote of 61-33. Wilmarth, "Dodd-Frank," *supra* note 1, at 1055 n.454.
62. Wilmarth, "Reforming Financial Regulation," *supra* note 41, at 748-49; see also Peter Boone & Simon Johnson, "Shooting Banks," *New Republic*, Mar. 11, 2010, at 20 (maintaining that economic studies have not verified favorable economies of scale or scope in banks larger than \$100 billion); Stiglitz, *supra* note 60, at 166 (contending that "[t]he much-vaunted synergies of bringing together various parts of the financial industry have been a phantasm; more apparent are the managerial failures and conflicts of interest"); Michael J. Moore, "JPMorgan Would Be Worth More If Split Up: Mayo," *Bloomberg.com*, Feb. 27, 2012 (reporting the opinion of bank analyst Mike Mayo that JP Morgan Chase, the "best-of-breed" among large financial conglomerates, "should consider breaking up and selling businesses because its parts are worth one-third more than its market value," and also noting that "[e]ven after this year's 15 percent gain, the stock [of JP Morgan Chase] is worth about 2 percent less than at the end of 2004").