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The Tailors of Wall Street

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THE TAILORS OF WALL STREET

GRAHAM S. STEELE*

The narrative that emerged in the aftermath of the COVID-19 financial crisis has focused on nonbank financial intermediation as the primary vulnerability that plagued financial markets starting in March of 2020 and the exogenous nature of a public health crisis as a unique precipitating event. As a result, the crisis has largely been viewed as vindication for financial regulation as it applies to banks, with the Federal Reserve playing the role of heroic rescuer of the financial system.

This Article offers an alternative—and critical—analysis of the performance of banks during the COVID-19 financial crisis and the Fed's role as a financial regulator. Charting the course from the landmark reforms of the Dodd-Frank Wall Street Reform and Consumer Protection Act to the COVID-19 crisis reveals disconnects between the legal and policy objectives of financial regulation and the actions taken by policymakers. Rather than completing the implementation of Dodd-Frank and addressing known sources of financial fragility, the Fed pivoted to a focus on "tailoring" regulations for the largest bank holding companies. Tailoring resulted in a banking system that was unable to respond effectively to the financial market disruptions imposed by the COVID-19 pandemic, necessitating unprecedented fiscal and monetary support.

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A thorough analysis of the financial policy choices in the lead-up to, and policy responses during, the COVID-19 pandemic yields important insights into the ideological underpinnings and substantive impacts of the Fed's role as a financial regulator. The Fed's emphasis on tailored regulation and its financial support for a range of markets during times of stress should be seen as two sides of a financial regulatory policy that has prioritized efficiency above resiliency and situated private interests above the public interest. Above all, this analysis reveals that, rather than being value-neutral, the project of tailoring, as practiced during this period, is fundamentally deregulatory. A better alternative to tailoring is a "precautionary approach" to financial regulation, ensuring that large bank holding companies are able to withstand a wide range of existing and emerging financial risks.

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INTRODUCTION

In recent years, bank supervision and regulation has undergone a little-noticed but nonetheless radical shift. A consensus has emerged that bank regulation should be "tailored," meaning that financial regulation should focus on the unique risks presented by particular classes of institutions and that smaller banks, in particular, should be subject to less stringent regulation.[1] The idea that policymakers should focus only on the riskiest institutions and activities is intuitively appealing in its simplicity. What reasonable person could oppose the commonsense virtue of right-sizing regulation? This purported simplicity is illusory. It obscures important truths about the roles of financial risk and regulation in our modern banking system.

The evolution toward a robust regime of bank supervision and regulation took decades and was born out of painful experiences and lessons culminating in the Global Financial Crisis (GFC) of 2008. Despite a post-crisis commitment to a new approach to banking regulation prioritizing the stability of both individual banks and the banking system as a whole, some prescient observers voiced concerns that financial markets nonetheless remained vulnerable to shocks and disruptions.[2]

1. *See* Exec. Order No. 13,772, 3 C.F.R. 286 (2018) (declaring the policy of the Administration of President Donald J. Trump that financial regulation should be "efficient, effective, and appropriately tailored"); *see also* U.S. DEP'T OF THE TREASURY, A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES: BANKS AND CREDIT UNIONS 9 (2017) ("[R]egulatory burdens must be appropriately tailored based on the size and complexity of a financial organization's business model and take into account risk and impact.").

2. Scholars and policymakers alike noted the fragility of certain short-term money markets and the unfinished business of implementing post-GFC reforms as

Ignoring these critiques, regulators self-imposed a new mandate to tailor their regulations, cutting back on rules like excess cloth and crafting rules to fit banks like bespoke garments. Many of the warnings came to fruition during the early months of the COVID-19 pandemic in 2020, as the Federal Reserve (Fed) provided unprecedented support to preserve the basic functioning of the financial markets and prevent a full-scale banking crisis.[3]

The narratives that emerged in the aftermath of this panic have rightly focused on nonbank financial intermediation as a vulnerability plaguing financial markets.[4] Others have highlighted the exogenous nature of a public health crisis serving as the precipitating event.[5] These analyses are incomplete, insofar as they obscure the role played by bank holding companies (BHCs), including those not necessarily considered systemically important, during the COVID-19 crisis.[6] This Article seeks to

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potential sources of financial risk. *See generally* Arthur E. Wilmarth, Jr., *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-to-Fail Problem*, 89 OR. L. REV. 951 (2011); *see also* Press Release, Dep't of the Treasury, Remarks of Secretary Lew at Pew Charitable Trusts (Dec. 5, 2013), https://www.treasury.gov/press-center/press-releases/Pages/jl2232.aspx [https://perma.cc/MKW8-VW4B] (identifying the triparty repurchase agreement and money market mutual fund markets as areas of potential weakness).

3. *See, e.g.*, Jeanna Smialek & Deborah B. Solomon, *A Hedge Fund Bailout Highlights How Regulators Ignored Big Risks*, N.Y. TIMES (July 24, 2020), https://www.nytimes.com/2020/07/23/business/economy/hedge-fund-bailout-dodd-frank.html [https://perma.cc/2SRE-5NDQ].

4. *See, e.g.*, Randal K. Quarles, Vice Chair for Supervision, Bd. of Governors of the Fed. Rsrv. Sys., The FSB in 2021: Addressing Financial Stability Challenges in an Age of Interconnectedness, Innovation, and Change 2 (Mar. 30, 2021), https://www.federalreserve.gov/newsevents/speech/files/quarles20210330a.pdf [https://perma.cc/J3KV-VJVS] ("[N]on-bank financial intermediation . . . and cross-border payments . . . are priority areas that will have significant impact on the financial landscape going forward.").

5. *See* Jeanna Smialek, *The Financial Crisis the World Forgot*, N.Y. TIMES (Mar. 17, 2021), https://www.nytimes.com/2021/03/16/business/economy/fed-2020-financial-crisis-covid.html [https://perma.cc/7LCT-76U7] ("[There is] little popular outrage over the March 2020 meltdown, both because it was set off by a health crisis—not bad banker behavior—and because it was resolved quickly.").

6. *See* Randal K. Quarles, Member, Bd. of Governors of the Fed. Rsrv. Sys., Between the Hither and the Farther Shore: Thoughts on Unfinished Business 2–3 (Dec. 2, 2021), https://www.federalreserve.gov/newsevents/speech/files/quarles20211202a.pdf [https://perma.cc/TG2A-W5ZR]. "Systemically important" banks are defined as "the largest firms that pose the greatest risk to U.S. financial stability." BD. OF GOVERNORS OF THE FED. RSRV. SYS., SR 19-3/CA 19-2, LARGE FINANCIAL INSTITUTION (LFI) RATING SYSTEM (Feb. 26, 2019), https://www.federalreserve.gov/supervisionreg/srletters/sr1903.pdf [https://perma.cc/Q43Z-QHSP]. For a list of the eight U.S. banks currently identified as systemically important, see *Large Institution Supervision Coordinating Committee*, BD. OF GOVERNORS OF THE

clarify and recover some of the already forgotten history of this consequential episode by untangling the complex web of banking regulations implemented in the wake of the GFC, as well as considering the disruptions that occurred in financial markets during the onset of the COVID-19 pandemic.

A holistic view of the Fed's financial regulation in the years since the GFC yields a subtle and nuanced storyline about the contributing causes of the instability in financial markets during the spring of 2020. First, the Fed prioritized an extralegal mandate to maximize "efficiency," declaring all but the most systemically important BHCs nearly irrelevant for the purposes of regulatory scrutiny.[7] Second, the project of regulatory tailoring rests upon faulty premises about the nature of banking risks, including the existence of correlated risks, the sources of panics and contagion, and the likelihood of risks arising out of unique business models. This rethinking discards important lessons learned not just from the GFC, but also from prior banking panics, and narrows the aperture of regulation to the small class of institutions that have been deemed "Too Big to Fail."[8] Third, this regulatory approach prioritizes the private costs to the banking industry from banking regulation over the benefits to the public from such regulation. The prioritization and implementation of the tailoring project, thus, shifted the trend in the post-GFC era from increasing regulation to deregulation and resulted in a less resilient financial system that exhibited high levels of dysfunction during the COVID-19 crisis.

Dissecting the concrete regulatory actions of the tailoring project and the ensuing events of the COVID-19 financial crisis—and connecting these seemingly disparate episodes—reframes the narrative about BHCs' performance during the pandemic. In particular, it brings to light BHCs' inability, or unwillingness, to serve their customary role as reliable financial intermediaries during market disruptions. Rather than suggesting BHCs were victims of exogenous events during the COVID-19 financial crisis, it reveals that banks and regulators simply reaped what they had sowed as a result of a shared ideological project of deregulation. It also makes clear that, while there

FED. RSRV. SYS. (Dec. 18, 2020), https://www.federalreserve.gov/supervisionreg/large-institution-supervision.htm [https://perma.cc/2PDV-NLLV].

7. *See infra* Section IV.A.1. Even then, systemically important BHCs also enjoyed a measure of regulatory relaxation. *See infra* Section IV.A.4.

8. *See infra* Section IV.A.2.

have been incremental improvements in the resilience of the financial sector, critical vulnerabilities in banking regulation persist. These vulnerabilities are evidenced by the significant assistance provided to the banking sector by fiscal, monetary, and regulatory authorities in the form of fiscal support, emergency lending, and regulatory forbearance.[9]

Part I of this Article documents the Fed's policy responses to the GFC, as the lead architect of BHC regulation, through its novel macroprudential approach to financial regulation. Part II then traces the subsequent shift in the Fed's policy focus towards tailoring its regulations. Part III recounts the salient details of the financial system's performance during the COVID-19 financial crisis and the Fed's subsequent policy interventions. Part IV then summarizes the lessons and implications of this episode, including the emphasis on efficiency as a regulatory objective, the misunderstandings of financial risk, and other subtle political and ideological aspects of the tailoring project. Finally, Part IV also suggests some potential implications from this episode for financial regulation moving forward.

This Article does not dispute the validity of a tiered approach to regulation; indeed, it advocates for just such an approach. There are many valid justifications for imposing regulations of increasing progressivity in response to a bank's increasing systemic footprint, or for incorporating a range of policy justifications when crafting varying types of financial regulations.[10] In fact, early articulations of the tiered approach to regulation argued not only for relaxed oversight of smaller financial institutions, but also for increased regulation for some large

9. *See* Ronald J. Feldman & Jason Schmidt, *Government Fiscal Support Protected Banks from Huge Losses During the COVID-19 Crisis*, FED. RSRV. BANK MINNEAPOLIS (May 26, 2021), https://www.minneapolisfed.org/article/2021/government-fiscal-support-protected-banks-from-huge-losses-during-the-covid-19-crisis [https://perma.cc/J3MM-E6N2] (estimating that banks may have been protected from somewhere between $130 billion and $230 billion in potential loan losses as a result of government actions during the pandemic); *see also* IMF, *Preempting a Legacy of Vulnerabilities*, Global Financial Stability Report 20 (Apr. 2021) (stating that, without fiscal and monetary support policies and regulatory forbearance, "the estimated proportion of capital-deficient bank assets would have roughly doubled"). *But see* Quarles, *supra* note 6, at 3 (arguing that the Fed's "sensitivity analysis" during the COVID-19 crisis proved that BHCs could have withstood that period without fiscal and monetary supports).

10. *See* Daniel K. Tarullo, Member, Bd. of Governors of the Fed. Rsrv. Sys., Rethinking the Aims of Prudential Regulation 6, 9 (May 8, 2014), https://www.federalreserve.gov/newsevents/speech/files/tarullo20140508a.pdf [https://perma.cc/X9WF-8CVW].

and systemically important BHCs.[11] This Article takes issue with the *specific project* of tailoring as it was carried out during the years 2017 to 2021, which was a fundamentally deregulatory endeavor that exceeded a reasonable reading of Congress's legislative mandate. In addition, while this Article focuses on the actions of the Fed in its role as a macroprudential regulator, many of the trends observed here could be equally applicable to the other financial regulatory agencies and the category of microprudential regulation.

Further, this Article does not seek to discount the role of the nonbank financial sector in the COVID-19 financial crisis. There is a well-founded consensus that a number of nonbanking entities experienced distress in the spring of 2020, prompting the Fed's expansive interventions across various financial markets.[12] The goal is not to write nonbank companies *out* of the COVID-19 financial crisis narrative, thereby undermining the case for reexamination of those activities and entities. Instead, the goal is to write the banking sector *into* the narrative in a manner that broadens and deepens the case for greater banking reform.

I. THE DODD-FRANK ACT AND THE MACROPRUDENTIAL APPROACH TO REGULATION

For an extended period, supervisors and regulators had largely concerned themselves with microprudential issues, namely preserving the solvency and preventing the failure of individual banks.[13] The Bank Holding Company Act of 1956 (BHCA) requires any BHC to limit its activities and investments to banking, managing or owning banks, or to a set of activities determined to be closely related to banking.[14] The Fed was given legal authority to administer the BHCA and to determine the

11. *See id.* at 12–15.

12. *See* Graham Steele, *The New Money Trust: How Large Money Managers Control Our Economy and What We Can Do About It* 15–21 (Am. Econ. Liberties Proj., Working Paper Series on Corporate Power No. 8, 2020).

13. *See Establishing a Framework for Systemic Risk Regulation: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. 76–77 (2009) [hereinafter *Systemic Risk Regulation Hearing*] (prepared statement of Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System).

14. *See* Bank Holding Company Act of 1956, 12 U.S.C. §§ 1841–52. A BHC is a corporation that owns one or more banks. 12 U.S.C. § 1841(a)(1).

scope of permissible activities and acquisitions.[15] The Fed conducts consolidated regulation and supervision, including issuing regulations and orders for, and conducting examinations of, BHCs.[16] Today, most banks operate as BHCs with footprints across a variety of financial services and markets, making the BHCA a critical tool for addressing a range of micro- and macro-level financial risks.

In the wake of the GFC of 2008, the focus of regulatory policy shifted to systemic, or "macroprudential," concerns.[17] As the legislative response to the GFC, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) largely did not break up, restructure, or generally limit affiliations or activities of BHCs.[18] Instead, it updated the regulatory approach applicable to BHCs, seeking to create a "new framework to prevent a recurrence or mitigate the impact of financial crises that could cripple financial markets and damage the economy."[19] The Fed has implemented this framework through the policy of "macroprudential regulation." Whereas the prior regulation and supervision of BHCs was "focused primarily on the safety and soundness of individual organizations, . . . [the] macroprudential outlook, which considers interlinkages and interdependencies among firms and markets that could threaten the financial system in a crisis, complements the current microprudential orientation of bank supervision and regulation."[20]

The primary basis for the Fed's macroprudential regulation is section 165 of Dodd-Frank.[21] It requires the Fed to craft

15. *See* Saule T. Omarova & Margaret E. Tahyar, *That Which We Call a Bank: Revisiting the History of Bank Holding Company Regulation in the United States*, 31 REV. BANKING & FIN. L. 113, 118 (2012).

16. *See* 12 U.S.C. § 1844.

17. *See* Mark Van Der Weide, *Implementing Dodd–Frank: Identifying and Mitigating Systemic Risk*, 36 ECON. PERSPS. 108 (2012).

18. Exceptions to this general rule include the "Volcker Rule" prohibition against BHCs engaging in proprietary trading and private fund sponsorship and revisions to section 23A of the Federal Reserve Act, which governs banks' transactions with affiliates. *See infra* notes 115, 117 and accompanying text.

19. S. REP. NO. 111-176, at 2 (2010).

20. *See Systemic Risk Regulation Hearing*, *supra* note 13, at 76 (prepared statement of Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System). Macroprudential regulation also seeks to address the cyclical nature of systemic risk. *See* Daniel K. Tarullo, *Time-Varying Measures in Financial Regulation*, 83 LAW & CONTEMP. PROBS. 1, 3 (2020).

21. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 165(a)(1), 124 Stat. 1376, 1423 (2010) (codified as amended at 12 U.S.C. § 5365(a)(1)).

"enhanced prudential standards" for the largest BHCs, which at the time of the law's passage applied to those with $50 billion or more in total consolidated assets.[22] The Fed is authorized to establish these macroprudential standards in order to "prevent or mitigate risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected financial institutions."[23] The law does not explicitly define the parameters encompassing the state of "financial stability."[24] Rather, section 165 strengthens the resilience of large BHCs so that they can "continue serving as financial intermediaries for the U.S. financial system and sources of credit to households, businesses, state governments, and low-income, minority, or underserved communities during times of stress."[25] The financial stability objective is implicit, but nonetheless apparent, within the Dodd-Frank scheme.

This authority occupies an ambiguous legal space, somewhere between a mandate for the Fed to promote financial stability through BHC regulation and an additional statutory basis for the Fed's prudential regulations.[26] In one sense, section 165 was meant by some of Dodd-Frank's architects to act as a mechanism *constraining* the Fed's discretion by requiring it to act on

22. *Id.*

23. 12 U.S.C. § 5365(a)(1).

24. *See* Daniel K. Tarullo, Member, Bd. of Governors of the Fed. Rsrv. Sys., Financial Stability Regulation 8 (Oct. 10, 2012), https://www.federalreserve.gov/newsevents/speech/files/tarullo20121010a.pdf [https://perma.cc/5LFF-X997] ("[Dodd-Frank] provides only limited guidance to regulators on how to implement financial stability where it is established as a standard."); *see also id.* at 9 ("[O]ne does not really find in the statute or in its legislative history an implicit theory of financial stability from which to infer" how regulators should pursue financial stability policy.).

25. Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17,240, 17,243 (Mar. 27, 2014) (to be codified at 12 C.F.R. pt. 252).

26. *See id.* at 17,264, https://www.govinfo.gov/content/pkg/FR-2014-03-27/pdf/2014-05699.pdf [https://perma.cc/XFY5-6FSR] (referring to section 165 as the "financial stability mandate of the Dodd-Frank Act"); *see also* Omarova & Tahyar, *supra* note 15, at 129 ("[T]he post-crisis reform is reinventing the [Bank Holding Company Act] . . . as the basic infrastructure for systemic risk regulation across the entire financial services sector."); *see also* Tarullo, *supra* note 24, at 4–5 (citing section 165 as a provision where "financial stability is used as a stated goal motivating a new regulatory or supervisory authority without itself being the standard used in the realization of that authority").

regulatory responsibilities that it had neglected in the past.[27] In another sense, section 165 is an extremely broad provision, giving the Fed considerable discretion in its implementation,[28] including the power to issue *any* prudential standards that it "determines are appropriate."[29]

With these new authorities, the Fed set about the task of increasing the resilience of the BHC system. The Fed imposed new standards for loss-absorbing capital funding, limits on the use of leverage, and requirements to hold liquid assets. Large BHCs were also required to make forward-looking projections of their losses under stressed conditions and formulate plans for how they could be unwound in an orderly manner. The Fed's macroprudential standards sought to both reduce the likelihood that BHCs with $50 billion or more in total assets would experience failure and lower the potential economic costs to society in the event of a bank failure.

A. *Risk-Based Capital Regulation*

Capital regulation is a central component of post-GFC macroprudential policy[30] and is the first standard required by section 165 of Dodd-Frank.[31] Capital is generally a measure of a bank's loss-absorbing liabilities relative to the assets funded by those liabilities; the more capital a bank has, the more it can invest or assume losses, while less capital means fewer available resources to absorb losses or make further investments.[32]

27. *See* Cheyenne Hopkins, *'New' Powers in Reg Reform Feel Familiar*, AM. BANKER (Apr. 5, 2010, 5:24 PM), https://www.americanbanker.com/news/new-powers-in-reg-reform-feel-familiar [https://perma.cc/W76K-6RQT] (quoting a former Treasury official who stated that the Dodd-Frank Act "would not merely authorize, but require, regulators to take stronger actions with respect to constraining risk-taking by the largest firms," because "[w]e learned painfully in the last crisis that authority, while necessary, is insufficient").

28. *See* Van Der Weide, *supra* note 17, at 110. Indeed, one financial industry lobbyist described the law's passage as "halftime," reflecting the view that regulators' implementation of the law was "when the real work began." Gary Rivlin, *How Wall Street Defanged Dodd-Frank*, NATION (Apr. 30, 2013), https://www.thenation.com/article/archive/how-wall-street-defanged-dodd-frank [https://perma.cc/V4GN-VUHA].

29. 12 U.S.C. § 5365(b)(1)(B)(iv).

30. *See* Samuel G. Hanson et al., *A Macroprudential Approach to Financial Regulation*, 25 J. ECON. PERSPS. 3, 7–12 (2011).

31. *See* 12 U.S.C. § 5365(b)(1)(A)(i).

32. *See* Hanson et al., *supra* note 30, at 4–6.

The banking capital framework, known as prompt corrective action (PCA), requires federal banking agencies to establish minimum capital standards, including restrictions on capital distributions and growth as regulatory capital minimums are breached, in order to ensure the least possible loss to the Federal Deposit Insurance Corporation's (FDIC's) Deposit Insurance Fund.[33] This framework treats capital distribution as a secondary concern behind institutional solvency. As such, it places private shareholders, who profit from a bank's public powers and privileges, in a first-loss position, ahead of the public that guarantees a bank's activities. These rules are known as "risk-based capital" (RBC) because the measurement of a bank's assets is adjusted based upon perceived risk, a process known as "risk weighting."

The Fed's macroprudential capital and leverage rules were constructed with a series of buffers that were "intended to allow banks to build up capital in good times and draw it down in bad times," with restrictions on capital distributions and bonus payouts when global systemically important banks (GSIBs) dip below their regulatory minimums.[34] The new regime of capital regulation was meant to "reflect the large negative externalities associated with the financial distress, rapid deleveraging, or disorderly failure of each firm and should, therefore, be strict enough to be effective under extremely stressful economic and financial conditions."[35]

In 2013, bank regulators began strengthening U.S. capital rules by both increasing the quantity of banks' capital requirements as well as the quality of the capital that banks used to fund themselves.[36] First, regulators instituted a revised PCA

33. *See* 12 U.S.C. § 1831o.

34. Alice Abboud et al., *COVID-19 as a Stress Test: Assessing the Bank Regulatory Framework* 15 (Bd. of Governors of the Fed. Rsrv. Sys., Finance and Economics Discussion Series Working Paper No. 2021-024, 2021).

35. U.S. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION 24 (2009).

36. *See* Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-Weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 Fed. Reg. 62,018, 62,020 (Oct. 11, 2013) (to be codified at 12 C.F.R. pts. 218, 217, 225). While these were domestic U.S. rules, they were based upon the Basel III International Capital Accords, developed by the Basel Committee for Bank Supervision to fill glaring weaknesses in the pre-crisis capital regulatory framework. *See id.* at 62,020.

framework that included a new minimum 4.5 percent ratio of Common Equity Tier 1 (CET1) to risk-weighted assets, a measure of core shareholder equity and retained earnings. It also included an additional capital-conservation buffer of 2.5 percent, applicable to the largest BHCs.[37] As a result, banks with less than 7 percent CET1 to risk-weighted assets were subject to progressive restrictions on capital distributions, such as stock buybacks, dividends, and bonus payouts.[38] There was also an optional countercyclical capital buffer (CCyB), which regulators could use to prevent the excessive buildup of risky credit during a peak of the business cycle and preserve lending capacity during a downturn.[39]

The Fed also instituted a framework requiring an additional layer of loss absorbency, specifically applicable to GSIBs, "calibrated to take into account the disproportionate impact the failure of one of these firms would have on the financial system as a whole."[40] One set of GSIB surcharges, created pursuant to the international Basel III capital agreement, ranges from 1 to 2.5 percent of CET1 according to five factors: (1) cross-jurisdictional activity, (2) size, (3) interconnectedness, (4) substitutability, and (5) complexity—a formula know as Method 1.[41] Under an alternative calculation method known as Method 2, the Fed went beyond the Basel III requirements. By replacing the substitutability factor with a short-term funding metric, the Fed's Method 2 calculation can result in a surcharge that is up to 2 percentage points higher than Method 1, ranging from 1 to 4.5 percent. [42] Table 1 illustrates the difference in the relevant surcharges for U.S. GSIBs.

37. *See id.* at 62,029–33. So-called "advanced approaches" BHCs—then-defined as those with $250 billion or more in total assets or $10 billion or more in foreign exposures—are required to calculate their capital ratios using both the standard approach, using a set of standard regulatory-determined models, and an internal modeling approach, then apply whichever result is less favorable. *See id.* at 62,029.

38. Technically, banks have a 0.5 percent buffer, so the PCA restrictions are not effective until a bank reaches 6.5 percent. *Id.* at 62,042.

39. *See id.* at 62,037.

40. Daniel K. Tarullo, *Financial Regulation: Still Unsettled a Decade After the Crisis*, 33 J. ECON. PERSPS. 61, 74 (2019).

41. *See* Regulatory Capital Rules: Implementation of Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies, 80 Fed. Reg. 49,082, 49,082 (Aug. 14, 2015) (to be codified at 12 C.F.R. pts. 208, 217).

42. *See id.* at 49,087.

The GSIB surcharge was incorporated with the capital-conservation buffer, meaning that, in theory, were a GSIB to fall below the combined ratio of 7 percent CET1 plus the GSIB surcharge, its supervisor would require progressive limits on its discretionary distribution of capital. As with PCA, this framework was meant to preserve a GSIB's capital base so that it could continue to support the nonfinancial economy by providing liquidity through lending and other financial intermediation services. The GSIB surcharge was described as the "most important" institution-specific regulation with systemic macroprudential objectives.[43]

Table 1: Common Equity Surcharges for U.S. GSIBs[44]

Method 1 & Method 2 Surcharges, 2015

GSIB	Method 1	Method 2	Percent Difference
BNY Mellon	1%	1%	—
State Street	1%	1.5%	+ 50%
Wells Fargo	1%	2%	+ 100%
Morgan Stanley	1%	3%	+ 200%
Goldman Sachs	1.5%	3%	+ 100%
Bank of America	1.5%	3%	+ 100%
Citigroup	2%	3.5%	+ 75%
JPMorgan Chase	2.5%	4.5%	+ 80%
Mean			+ 88%

The macroprudential capital rules implemented after the GFC involved a highly complex and intricate set of regulations. Through a series of buffers, these rules increased in stringency either as a BHC's systemic footprint increased, or as general economic conditions or the financial conditions of an individual BHC began to deteriorate. The cumulative effect of these new RBC rules increased the resilience of large BHCs by improving the quantity and quality of their capital base.

43. Tarullo, *supra* note 20, at 2 n.2.

44. *See* Regulatory Capital Rules: Implementation of Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies, 80 Fed. Reg. at 49,087, 49,109. BHCs are required to compute their surcharge scores annually. *Id.* at 49,086.

B. Leverage Limits

In addition to RBC ratios, which seek to calculate the value of an asset based upon its perceived credit risk, a leverage ratio counts all assets equally, limiting the total amount that a bank can borrow relative to its equity base.[45] Leverage ratios are meant to provide an alternative measure of a bank's potential loss absorbency that does not depend on subjective projections about the riskiness of financial assets. Because they lack risk-sensitivity, leverage ratios are lower than RBC ratios.[46]

U.S. banks have been subject to a 4 percent basic leverage ratio requirement.[47] Post-GFC, large BHCs were subject to a supplementary leverage ratio (SLR) that imposed a minimum of at least 3 percent of Tier 1 Capital to "total leverage exposure"—a broader measure of non-risk-weighted assets including off-balance-sheet exposures like securitizations, derivatives, and securities financing.[48] The SLR applied only to the largest BHCs because "these banking organizations tend to have more significant amounts of off-balance sheet exposures that are not captured by the current leverage ratio."[49]

Because of their systemic footprints, GSIBs were also subject to an enhanced supplementary leverage ratio (eSLR) requirement of 6 percent Tier 1 Capital at their insured depository institutions (IDIs) and 5 percent Tier 1 Capital at their consolidated BHCs.[50] The eSLR is constructed as the benchmark for

45. *See* Tarullo, *supra* note 40, at 65.

46. *See id.* ("Most regulators here and abroad believe that the risk-weighted requirement should usually be the binding one, while the leverage ratio should help protect against big increases in the riskiness of asset classes above historic norms.").

47. *See* 12 C.F.R. §§ 6.4, 208.43, 325.103 (2021).

48. *See* Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-Weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 Fed. Reg. 62,018, 62,031 (Oct. 11, 2013) (to be codified at 12 C.F.R. pts. 218, 217, 225); *see also* Tarullo, *supra* note 40, at 65 n.2.

49. Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-Weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 Fed. Reg. at 62,031.

50. *See* Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and Their Subsidiary Insured Depository Institutions, 79 Fed. Reg. 24,528 (May 1, 2014) (to be codified at 12 C.F.R. pts. 6, 208, 217, 324). The agencies' SLR rule cites section

"well capitalized" IDIs under PCA; for the holding company, the "enhanced" portion of the SLR ratio was considered a 2 percent buffer, similar to the capital-conservation buffer. This means that GSIBs that fell below the eSLR were subject to graduated restrictions on capital distributions like dividends, stock buybacks, and discretionary bonus payments.[51] As with the GSIB surcharge, this scheme was meant to ensure that GSIBs have a minimum amount of balance sheet capacity available by preserving capital as financial conditions deteriorate.

Section 171 of Dodd-Frank, known as the "Collins Amendment," requires the Fed to apply the "generally applicable" capital and leverage requirements for IDIs to BHCs on a consolidated basis.[52] This requirement sets banks' capital rules as a floor, requiring the Fed to apply the FDIC's PCA rules to the entire enterprise at the consolidated holding company level—in effect, ensuring that nonbank affiliates that employ higher amounts of leverage are offset by additional financial resources at the holding company.

To complement the complexity of RBC regulation, enhanced leverage limits were intended to set minimum restrictions on BHCs' use of borrowed money. In combination, these two forms of solvency rules were meant to complement one another by attempting to capture the benefits of both complexity and bluntness.[53] In addition, post-GFC, capital and leverage rules were made more stringent across the board and increased in stringency for BHCs, commensurate with their size and riskiness.

C. Stress Testing

To complement these static capital requirements, the Fed created a dynamic and forward-looking process to measure

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165 of the Dodd-Frank Act as the legal basis for issuing the regulation. *Id.* at 24,529. At the time of the eSLR's implementation, it was estimated that U.S. GSIB BHCs would need to raise $63 billion in capital, while their IDI subsidiaries would have to raise about $89 billion, to meet the new requirements. *See* Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and Their Subsidiary Insured Depository Institutions, 78 Fed. Reg. 51,101, 51,107 (proposed Aug. 20, 2013) (to be codified at 12 C.F.R. pts. 6, 208, 217, 324).

51. *See* Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and Their Subsidiary Insured Depository Institutions, 78 Fed. Reg. at 51,106.

52. *See* 12 U.S.C. § 5371(b).

53. *See* Tarullo, *supra* note 40, at 65.

BHCs' resilience under crisis-like conditions. The Comprehensive Capital Analysis and Review (CCAR) rule instituted an annual "stress test" of the largest BHCs' capital adequacy under adverse economic conditions.[54] Stress testing seeks to apply predictive economic modeling to banks' balance sheets and plans for shareholder capital distributions. While companies used forms of internal stress testing as a risk-management tool prior to the GFC,[55] Dodd-Frank incorporated novel concepts involving supervisory-run stress testing and BHC capital planning practices.[56] In particular, stress testing was adopted for the first time as a method of setting BHCs' capital requirements.[57]

BHCs with total consolidated assets of $50 billion or more were required to submit annual capital plans—proposals for distributing capital to shareholders—for review and approval by the Fed.[58] To receive approval under CCAR, BHCs were to maintain the minimum 4.5 percent CET1 ratio throughout every scenario, including planned capital distributions.[59] The Fed incorporated the SLR as a post-stress leverage ratio in 2017; it also considered including some or all of the GSIB surcharge into firms' required CCAR minimums.[60] In addition to this "quantitative component," the Fed also included a "qualitative component," testing the quality of BHCs' risk management and

54. Capital Plans, 76 Fed. Reg. 74,631, 74,633 (to be codified at 12 C.F.R. pt. 225). The Fed has noted that CCAR is "not mandated by the Dodd-Frank Act, [but] the [Fed] believes that it is appropriate to hold large bank holding companies to an elevated capital planning standard because of the elevated risk posed to the financial system by large bank holding companies and the importance of capital in mitigating these risks." Capital Plans, 76 Fed. Reg. 35,351, 35,352 (proposed June 17, 2011) (to be codified at 12 C.F.R. pt. 225).

55. *See* Kathryn Judge, *The First Year: The Role of a Modern Lender of Last Resort*, 116 COLUM. L. REV. 843, 886–87 (2016).

56. *See* Capital Plans, 76 Fed. Reg. at 74,632.

57. *See* Daniel K. Tarullo, Taking the Stress Out of Stress Testing 4 (May 21, 2019), https://ourfinancialsecurity.org/wp-content/uploads/2019/05/Tarullo-AFR-Talk.pdf [https://perma.cc/JH8R-78Y3].

58. Capital Plans, 76 Fed. Reg. at 74,633–35.

59. Amendments to the Capital Plan and Stress Test Rules, 80 Fed. Reg. 75,419, 75,422 (Dec. 2, 2015) (to be codified at 12 C.F.R. pts. 225, 252). It should be noted that even state-of-the-art stress testing is an inexact science that fails to capture important real-world dynamics of financial crises, including an inability to account for the second-order effects of financial instability and a lack of precise foresight into the sources of the next crisis. *See* Tarullo, *supra* note 57, at 5. These shortcomings are particularly relevant when considering risks that arise from unexpected sources or business models or the effects of herding and contagion. *See infra* Section IV.A.2.

60. *See* Amendments to the Capital Plan and Stress Test Rules, 80 Fed. Reg. at 75,421.

compliance systems with a "level of detail and analysis expected in a capital plan [that would] vary based on the large bank holding company's size, complexity, risk profile, and scope of operations."[61]

In addition to the macroprudential capital and leverage regulations, stress testing increased large BHCs' capital requirements by assessing their financial conditions under hypothetical stressed conditions. In addition, the Fed's stress testing rule gave government supervisory agencies a new role in evaluating BHCs' plans to distribute capital to shareholders.

D. Liquidity Regulation

Liquidity regulation was another important component of the post-GFC framework. Liquidity rules seek to match banks' asset portfolios against their volatile funding sources, requiring BHCs to maintain a pool of "safe" and liquid assets that they can monetize in the event that they experience a sudden need for rapid deleveraging,[62] effectively self-insuring against their most volatile funding sources. Liquidity regulations were another novel undertaking post-GFC. Owing to this novelty as a macroprudential tool, liquidity rules have the potential to interact in complicated ways with, and implicate, capital regulations, banks' incentives during panics, and the idiosyncrasies of modern money markets.[63]

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61. Capital Plans, 76 Fed. Reg. at 74,635 (Dec. 1, 2011) (to be codified at 12 C.F.R. pt. 225) ("Thus, for example, a large bank holding company that has extensive credit exposures to commercial real estate but very limited trading activities [would] be expected to have robust systems in place to identify and monitor its commercial real estate exposures, but its systems related to trading activities [would] not need to be as sophisticated or extensive."); *see also* BD. OF GOVERNORS OF THE FED. RSRV. SYS., CAPITAL PLANNING AT LARGE BANK HOLDING COMPANIES: SUPERVISORY EXPECTATIONS AND RANGE OF CURRENT PRACTICE 3 (2013) ("The Federal Reserve tailored [supervisory] expectations for BHCs of different sizes, scope of operations, activities, and systemic importance in various aspects of capital planning. For example, the Federal Reserve has significantly heightened supervisory expectations for the largest and most complex BHCs—in all aspects of capital planning—and expects these BHCs to have capital planning practices that are widely considered to be leading practices.").

62. *See* U.S. DEP'T OF THE TREASURY, *supra* note 35, at 24 ("[R]igorous liquidity risk requirements . . . recognize the potential negative impact that the financial distress, rapid deleveraging, or disorderly failure of each firm would have on the financial system.").

63. For a discussion of liquidity regulation and all of its challenges and implications, see Daniel K. Tarullo, Liquidity Regulation (Nov. 20, 2014),

The basic contours of the liquidity coverage ratio (LCR) rule require large BHCs to maintain a minimum amount of high-quality liquid assets (HQLA) that could be converted easily into cash to meet anticipated funding outflows during a thirty-day period of financial and economic stress.[64] An asset qualifies as a HQLA if it is a strong credit risk, has a high likelihood of remaining liquid during a crisis, is actively traded in secondary markets, is not subject to excessive price volatility, can be easily valued, and is accepted by the Fed as collateral for loans.[65] HQLAs were subject to so-called "haircuts" based upon their risk profiles, and then sorted into categories.[66] The Fed required BHCs with more than $50 billion in assets to meet a modified LCR, subjecting them to a twenty-one-day stress period and requiring them to calculate their LCR monthly beginning in 2016.[67]

In addition to increasing BHCs' funding resilience, the Fed required banks to maintain minimum pools of "safe" assets. While these assets could be sold to meet funding demands under stressed conditions, they are also less profitable for banks to hold since investment yields are determined by their risk. Thus,

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https://www.federalreserve.gov/newsevents/speech/tarullo20141120a.pdf [https://perma.cc/9PKY-QSLF].

64. Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, 79 Fed. Reg. 61,440, 61,442 (Oct. 10, 2014) (to be codified at 12 C.F.R. pts. 50, 249, 329).

65. *Id.* at 61,450–52. The "liquid and readily marketable" standard is described as "traded in an active secondary market with more than two committed market makers, a large number of committed non-market maker participants on both the buying and selling sides of transactions, timely and observable market prices, and high trading volumes." *Id.* at 61,451.

66. *See id.* at 61,444. "Haircuts" establish the value of various types of collateral, with smaller haircuts applying to safer assets and larger haircuts for assets with greater credit risk, see Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, 79 Fed. Reg. at 61,450.

The agencies divided HQLA into two levels: Level 1 assets and Level 2 assets. *Id.* Level 1 assets include central bank reserves and Treasury securities. Level 2 assets are then divided into 2A—for example, Government Sponsored Enterprise securities—and 2B, such as corporate bonds and equities. *Id.* Within Level 2, only 50 percent of a Level 2B HQLA's value counts toward meeting the LCR, and Level 2B assets may not exceed 15 percent of total HQLA. *Id.* Eighty-five percent of a Level 2A HQLA's value counts toward meeting the LCR, and overall, Level 2 assets may not exceed 40 percent of total HQLA. *See id.*

67. *See id.* at 61,519–20. The Fed stated that while it "believes it is important for all [BHCs] subject to section 165 of the Dodd-Frank Act . . . to be subject to a quantitative liquidity requirement as an enhanced prudential standard, it recognizes that these smaller companies would likely not have as great a systemic impact as larger, more complex companies if they experienced liquidity stress." *Id.* at 61,520.

consistent with the aims of macroprudential regulation, liquidity rules placed the societal interest in financial stability above individual BHCs' profit-seeking interests.

E. Resolution Planning

Dodd-Frank also sought to respond to the disorderly failure of the investment bank Lehman Brothers, as well as the challenges of determining the risks posed by the prospective failure of the insurer AIG, during the GFC.[68] Under a novel post-GFC regulatory innovation, large BHCs were required to report periodically to the Fed and FDIC on their plan for rapid and orderly resolution through the bankruptcy process in the event of material financial distress or failure—often referred to as a "living will."[69] A key to the effectiveness of resolution planning is its value as an exercise in breaking through potential myopia, forcing management and regulators to consider the potential scenarios under which large institutions could meet their demise.[70] If regulators determine that bankruptcy is not a viable option after examining a BHC's living will, the institution may be subject to more stringent prudential standards or forced to divest itself of assets or operations.[71]

The rule implementing this provision initially required annual submissions.[72] The rule also set out specific standards for these plans, including "a strategic analysis of the plan's components," a description of the range of specific actions to be taken in the resolution process, and analyses of the company's organization, material entities, interconnections, and interdependencies, as well as pre-positioning of liquidity for the BHC to support important subsidiaries.[73] Resolution planning held the potential to provide an impetus for structural changes to large and complex BHCs, including greater subsidiarization, as well

68. FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT 324–52 (2011) (describing the failure of Lehman Brothers and bailout of AIG).

69. *See* 12 U.S.C. 5365(d).

70. *See* Emilios Avgouleas et al., *Bank Resolution Plans as a Catalyst for Global Financial Reform*, 9 J. FIN. STABILITY 210, 211 (2013).

71. *See* 12 U.S.C. § 5365(d)(5).

72. *See* Resolution Plans Required, 76 Fed. Reg. 67,323 (Nov. 1, 2011) (to be codified at 12 C.F.R pts. 243, 381).

73. *Id.* at 67,327.

as an increase in prudential standards like equity funding for riskier business lines or legal entities.[74]

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These are not the Fed's only macroprudential regulations, but they are among the most contested and important. As the foregoing discussion demonstrates, in implementing section 165, the Fed sought to gradually apply each enhanced prudential standard to classes of BHCs according to their risk profiles.[75] This approach was established in the second paragraph of section 165, titled "tailored application," which stated that the Fed "may . . . differentiate among companies on an individual basis or by category."[76]

Prior to the GFC, most prudential regulation had been applied uniformly across the banking industry, with a few sets of rules applying specially to large, "advanced approaches" BHCs.[77] Through its Dodd-Frank authority, the Fed, at its discretion, "essentially created several categories within the universe of banking organizations with $50 billion or more in assets," and thus, the "unitary approach of the pre-crisis period [had] been abandoned."[78] While the suite of rules was highly complex, they were fundamentally targeted at raising the cost for a BHC to be large, requiring large BHCs to internalize the risks that they pose to themselves and to society, and making BHC shareholders, creditors, and executives responsible in the event that a large BHC should fail.[79]

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74. *See* Avgouleas et al., *supra* note 70, at 211–12.

75. *See* Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17,240, 17,243 (March 27, 2014) (to be codified at 12 C.F.R. pt. 252) ("The set of enhanced prudential standards for bank holding companies . . . increases in stringency based on the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company. For example, the resolution plan rule applies a tailored resolution plan regime for smaller, less complex bank holding companies and foreign banking organizations that is materially less stringent than what is required of larger organizations. Similarly, the Board has tailored the application of and its supervisory expectations regarding stress testing and capital planning based on the size and complexity of covered companies.").

76. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 165(a)(2)(A), 124 Stat. 1376, 1423 (2010).

77. *See* Tarullo, *supra* note 10, at 1–4.

78. *See id.* at 6.

79. *See* Press Release, *supra* note 2.

II. THE ERA OF REGULATORY TAILORING

The outcome of the 2016 presidential election truncated the effort to implement comprehensive macroprudential regulation. In the early days of his Administration, President Donald J. Trump issued an executive order declaring the "core principles" of financial regulation, including that such regulations be "efficient, effective, and appropriately tailored . . . ."[80] Pursuant to that order, the Treasury Department drafted a report that included 101 unique recommendations for how the regulatory and supervisory processes could be tailored.[81] The focus of macroprudential policy subsequently shifted from ensuring the stability of the financial system to evaluating whether the rules that applied to large BHCs were "tailored" to fit their business models.

As an independent agency, the Fed was under no legal obligation to follow suit, but the new administration's "deregulatory agenda"[82] supplied the Fed with vital political cover to focus on tailoring its regulations. Fed Chair Jerome Powell declared that tailoring, which he defined as "try[ing to] make sure that [the Fed's] regulation is no more burdensome than it needs to be," would now be "at the heart" of the Fed's regulatory efforts.[83] The Fed's vice chair for supervision likewise endorsed the objective of tailoring as "good public policy."[84] Congress held hearings on whether macroprudential rules had been adequately tailored,[85]

80. *See* Exec. Order 13772, 82 Fed. Reg. 9,965 (Feb. 8, 2017).

81. *See* U.S. DEP'T OF THE TREASURY, *supra* note 1, at 123–38.

82. Tarullo, *supra* note 20, at 2.

83. *Monetary Policy and the State of the Economy: Hearing Before the H. Comm. on Fin. Serv.*, 115th Cong. 21 (2018) [hereinafter *Monetary Policy Hearing*]; *see also Fostering Economic Growth: Regulator Perspective: Hearing Before the S. Comm. on Banking, Hous., and Urb. Affs.*, 115th Cong. 5 (2017) [hereinafter *Fostering Economic Growth Hearing*] (statement of Jerome H. Powell, Member, Bd. of Governors of the Fed. Rsrv. Sys.) ("[The Fed] should continue to tailor [its] requirements to the size, risk, and complexity of the firms subject to those requirements.").

84. Randal K. Quarles, Member, Bd. of Governors of the Fed. Rsrv. Sys., Getting It Right: Factors for Tailoring Supervision and Regulation of Large Financial Institutions (July 18, 2018), https://www.federalreserve.gov/newsevents/speech/files/quarles20180718a.pdf [https://perma.cc/76EH-5J48]. Dodd-Frank amended the Federal Reserve Act to create the position of Vice Chairman for Supervision to "develop policy recommendations for the Board regarding supervision and regulation of depository institution holding companies and other financial firms supervised by the Board," and to "oversee the supervision and regulation of such firms." Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1108(a)(1), 124 Stat 1376, 2126 (2010) (codified at 12 U.S.C. § 242).

85. *See Examining the Regulatory Regime for Regional Banks: Hearing Before the S. Comm. on Banking, Hous., and Urb. Affs.*, 114th Cong. (2015).

culminating in the passage of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) in 2018.[86]

EGRRCPA narrowed the applicability of section 165 to BHCs with $250 billion or more in total assets.[87] With the support of Fed policymakers, EGRRCPA also elevated the tailoring language from discretionary to mandatory.[88] The Fed then set about the task of tailoring prudential and other standards for BHCs. While some of these revisions were mandated or encouraged by EGRRCPA, critics argued that the Fed used the significant regulatory discretion that it was afforded under both Dodd-Frank and EGRRCPA to deregulate large BHCs in ways that exceeded its congressional mandate.[89]

The following Sections demonstrate how this tailoring resulted in a reduction in the stringency of a variety of prudential standards. Rules that were tailored included capital, leverage, stress testing, liquidity, resolution planning, and margin requirements, as well as other activity limits. As will be discussed in greater depth below, these standards were lowered across the board for institutions of all sizes, including the GSIBs.[90]

A. *Weakened Capital Rules*

The first example of tailoring applies to capital rules, stress testing, and capital planning. In its implementation of EGRRCPA's amendment to section 165, the Fed replaced the flat $50 billion threshold with a set of "risk-based" indicators that sorted BHCs into four categories and then applied tailored prudential standards, such as capital and liquidity rules, accordingly.[91] For large BHCs, the Fed replaced the flat 2.5 percent

86. Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174, 132 Stat. 1297 (2018).

87. It could also apply to BHCs with $100 billion or more in assets. *See* DAVID W. PERKINS ET AL., CONG. RSCH. SERV., ECONOMIC GROWTH, REGULATORY RELIEF, AND CONSUMER PROTECTION ACT (P.L. 115-174) AND SELECTED POLICY ISSUES 32–35 (2018).

88. *See* Economic Growth, Regulatory Relief, and Consumer Protection Act § 401(a)(1)(B)(i); *see also* Quarles, *supra* note 84, at 1 (noting that EGRRCPA "directs [the Fed] to further tailor [its] supervision and regulation of large banks"); *Monetary Policy Hearing*, *supra* note 83, at 21. The necessity of this particular aspect of EGRRCPA was in many ways unclear, given the Fed's efforts to tailor a number of its macroprudential standards prior to EGRRCPA's passage.

89. *See infra* note 195.

90. *See infra* Section IV.A.4.

91. *See* Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements, 84 Fed. Reg. 59,230, 59,233–35 (Nov. 1, 2019). This rule also

capital-conservation buffer add-on with a floating stress capital buffer (SCB).[92] The SCB proposal was meant to "improve the efficiency and risk-sensitivity" of the capital framework,[93] ironically, by replacing a flat percentage requirement with a complex formula based upon multiple assumptions about the behavior of bank management and market participants, as well as the performance of certain assets.[94] While the SCB framework increased the *nominal* capital requirements for large BHCs, creating the appearance of greater stringency, it resulted in lowering their *effective* capital requirements.[95]

During this period, the Fed never employed its CCyB, a macroprudential policy tool meant to "increase during periods of rising vulnerabilities in the financial system and reduce when vulnerabilities recede."[96] Increasing the CCyB theoretically guards against losses to the banking system by building resilience and, at the same time, avoiding some of the broader impacts of monetary tightening.[97] The Fed has *never* raised the CCyB above 0 percent,[98] notwithstanding some Fed officials'

allowed BHCs with assets between $250 billion and $700 billion to opt out of a requirement to account for the unrealized gains and losses on certain investments, possibly allowing them to adjust their reported capital up by $5 billion, making their reported ratios 50 basis points higher. *See* Press Release, Bd. of Governors of the Fed. Rsrv. Sys., Statement on Proposals to Modify Enhanced Prudential Standards for Large Banking Organizations by Governor Lael Brainard (Oct. 31, 2018), https://www.federalreserve.gov/newsevents/pressreleases/brainard-statement-20181031.htm [https://perma.cc/Q9QD-KBUU].

92. Regulations Q, Y, and YY: Regulatory Capital, Capital Plan, and Stress Test Rules, 85 Fed. Reg. 15,576 (Mar. 18, 2020).

93. *See id.* at 15,577.

94. Examples include forward-looking projected losses, a BHC's expected dividend payouts over an arbitrary (and generally industry-friendly) time horizon, and subjective measurements of the perceived riskiness of a BHC's assets. Other examples of the rule's subjectivity and embedded value judgments include the Fed's assumption that a BHC will maintain a static balance sheet under stress, *see id.* at 15,579–80, a fact contradicted by crisis experience; arbitrary calculations concerning BHCs' dividend payout amounts; and determinations that limiting capital distributions to an average of distributions over prior quarters will sufficiently preserve capital during a crisis, *see id.* at 15,581.

95. *See infra* Section IV.A.4.

96. 12 C.F.R. pt. 217. app. A(1)(b) (2021).

97. *See* Lael Brainard, Member, Bd. of Governors of the Fed. Rsrv. Sys., Assessing Financial Stability Over the Cycle 13 (Dec. 7, 2018), https://www.federalreserve.gov/newsevents/speech/files/brainard20181207a.pdf [https://perma.cc/KR2Z-2QPF].

98. *See* Press Release, Bd. of Governors of the Fed. Rsrv. Sys., Federal Reserve Board Votes to Affirm the Countercyclical Capital Buffer (CCyB) at the Current Level of 0 Percent (Mar. 6, 2019), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190306c.htm [https://perma.cc/WV2G-SH4A].

statements in favor of doing so,[99] thus missing an opportunity to use countercyclical macroprudential capital policy to increase the resilience of BHCs and lessen their incentives to pull back on lending during a downturn.[100]

The net impact of the foregoing changes to capital rules has been an across-the-board lowering of large BHCs' capital requirements.[101] The tailoring project would not be limited to capital rules.

B. Relaxed Leverage Limits

The Fed also eased its leverage requirements. It began by removing the stress test's basic stress leverage ratio, as the SCB proposal initially included a "stress leverage buffer," which was then omitted from the final rule.[102] This effectively removed the binding restriction on banks' capital distributions.[103]

Fed leadership next expressed concerns that the SLR and eSLR could "reduce participation in or increase costs for lower-risk, lower-return businesses, such as secured repurchase agreement financing, central clearing services for market participants, and taking custody deposits, notwithstanding client demand for those services."[104] It therefore proposed lowering the eSLR add-on from a flat 2 percent above the 3 percent SLR to an amount equal to 50 percent of the GSIB surcharge.[105] Reducing the eSLR, Fed leadership argued, was "critical to mitigating any perverse incentives and preventing distortions in money

99. *See* Brainard, *supra* note 97, at 13 (noting that a number of other central banks have elected to impose some type of CCyB); *see also* Eric S. Rosengren, President & CEO, Fed. Rsrv. Bank of Boston, Ethics and Economics: Making Cyclical Downturns Less Severe 9 (June 27, 2018), https://www.piie.com/system/files/documents/2018-06-27-rosengren-prepared-remarks.pdf [https://perma.cc/DQZ8-C6YS].

100. *See* Brainard, *supra* note 97, at 12–13.

101. *See infra* Section IV.A.4.

102. *See* Regulations Q, Y, and YY: Regulatory Capital, Capital Plan, and Stress Test Rules, 85 Fed. Reg. 15,576, 15,582 (Mar. 18, 2020).

103. *See* Tarullo, *supra* note 40, at 72.

104. Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards and Total Loss-Absorbing Capacity Requirements for U.S. Global Systemically Important Bank Holding Companies, 83 Fed. Reg. 17,317, 17,319–20 (proposed Apr. 19, 2018) (to be codified at 12 C.F.R. pts. 6, 208, 217, 252).

105. *See id.* at 17,320.

markets and other safe asset markets"—an argument that would continue during and after the COVID-19 crisis.[106]

Like the Fed, banks that specialize in custody services criticized the SLR and eSLR's inclusion of central bank deposits in its asset calculation, arguing that they are merely engaged in low-risk administrative services.[107] To address their needs, EGRRCPA statutorily excluded deposits at the Fed and certain other foreign central banks that are "linked to fiduciary or custodial and safekeeping accounts" from the denominator of the SLR and eSLR, a change that especially benefitted the two U.S. GSIB custody banks.[108] The trend in leverage regulation, before and during the COVID-19 crisis, was both to exempt the safest assets and, counterintuitively, to attempt to lower the topline ratio from binding BHCs in any way, rather than increasing the ratio for the remaining riskier assets.

C. *Less Rigorous Stress Testing*

As with other enhanced prudential standards, the Fed's upward adjustment of the applicability threshold exempted a number of large BHCs from CCAR altogether.[109] For the stress tests, the Fed eliminated its ability to register a "quantitative

106. *Fostering Economic Growth Hearing*, *supra* note 83, at 39 (statement of Jerome H. Powell, Member, Bd. of Governors of the Fed. Rsrv. Sys.); *see also Monetary Policy Hearing*, *supra* note 83, at 27 (Jerome H. Powell testifying that the eSLR "seem[ed] to be deterring some low-risk wholesale-type activities that we really want financial institutions to engage in").

107. *See* Stefan M. Gavell, Exec. Vice President & Head of Regul., Indus. & Gov't Affs., State St. Corp., Comment Letter on Proposed Joint Rule to Enhance Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and Their Subsidiary Insured Depositary Institutions 13 (Oct. 21, 2013), https://www.federalreserve.gov/SECRS/2013/October/20131030/R-1460/R-1460_102113_111418_579521830781_1.pdf [https://perma.cc/5PQ4-QLN4]; *see also* John W. Ryan, President & CEO, Conf. of State Bank Supervisors, Comment Letter on Rule to Revise Supplementary Leverage Ratio 4–8 (June 13, 2014), https://www.fdic.gov/resources/regulations/federal-register-publications/2014/2014-supplementary_leverage_ratio-3064-ae12-c_06.pdf [https://perma.cc/BB5U-Y6QF].

108. Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174, § 402(b)(2)(B), 132 Stat. 1297, 1359 (2018) (codified as amended at 12 U.S.C. § 1831o note) (Supplementary Leverage Ratio for Custodial Banks).

109. In addition to its impact on CCAR supervisory stress testing, EGRRCPA also lifted the threshold for applicability for company-run stress testing from $10 billion in total assets to $250 billion in total assets. *See id.* at § 401(a)(5)(B).

objection" contained in the original CCAR regime.[110] It also relieved BHCs from seeking prior approval to distribute capital in excess of the amounts outlined in their capital plans, except in the most egregious of circumstances.[111] Examples of such circumstances include when a BHC has been required to resubmit its capital plan or the Fed has issued a "qualitative objection" to its stress test results.[112] Importantly, the Fed had previously narrowed the bases upon which it could offer qualitative objections for issues like risk management and control deficiencies.[113] By removing the "qualitative objection" of CCAR, the Fed excised an important supervisory component that tested BHCs' stress-testing and capital-planning compliance systems, making it largely a mathematical exercise.[114]

At the same time, the Fed revised CCAR to require publication of more information about the makeup of the stress tests, including some of the models and other assumptions embedded in the tests.[115] While arguably done in the name of greater supervisory "transparency," the modifications were analogized to essentially giving students the answer key for an exam.[116] The totality of these changes both narrowed the scope of the stress tests' applicability and reduced their rigor.

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110. Regulations Q, Y, and YY: Regulatory Capital, Capital Plan, and Stress Test Rules, 85 Fed. Reg. 15,576, 15,582 (Mar. 18, 2020) (to be codified at 12 C.F.R. pts. 217, 225, 252). A quantitative objection is where the Fed prevents a BHC from distributing its capital as planned because the BHC is unable to demonstrate the ability to maintain its minimum capital ratios on a post-stress basis. *See id.*

111. *See id.* at 15,583.

112. *Id.*

113. *Id.* at 15,582; *see also id.* at 15,578 n.8 ("[A] firm that participates in four assessments and successfully passes the qualitative evaluation in the fourth year is no longer subject to a potential qualitative objection.").

114. *See* Judge, *supra* note 55, at 887 (one of the purposes of the original stress tests was "to test banks' capacity to accurately assess how they would fare in the face of further adverse developments"). Notably, in 2018, two GSIBs had exceeded their permitted capital distributions but, rather than failing their stress tests, the Fed issued a "conditional non-objection," a first-of-its-kind dispensation allowing them to pay out $5 billion more in shareholder distributions and avoid re-taking the stress test. *See* Liz Hoffman & Lalita Clozel, *Morgan Stanley, Goldman Got Help From Fed on Stress Tests*, WALL ST. J., https://www.wsj.com/articles/wall-street-gets-the-friendlier-fed-its-been-waiting-for-1530558419 [https://perma.cc/DUK5-ZQ3V] (July 2, 2018, 9:29 PM).

115. *See* Enhanced Disclosure of the Models Used in the Federal Reserve's Supervisory Stress Test, 84 Fed. Reg. 6,784 (Feb. 28, 2019).

116. *See* Tarullo, *supra* note 57, at 9.

D. *Weakened Liquidity Rules*

In its implementation of EGRRCPA's amendment to section 165, the Fed exempted BHCs from, or otherwise weakened, several aspects of liquidity rules.[117] Some BHCs with more than $50 billion in total assets were moved down into less stringent versions of the LCR—for example, some BHCs were moved from a 100 percent requirement to an 85 percent requirement, while others were moved from an 85 percent requirement to a 70 percent requirement.[118] Some large BHCs were exempted from the LCR entirely.[119]

Even when the Fed took a more cautious approach, Congress sometimes interceded. During this period, some BHCs raised objections about the original LCR rule's failure to classify municipal securities as HQLA.[120] At the time of the final rule, the Fed stated that its staff would continue to analyze the treatment of municipal securities under the LCR.[121] In April 2016, the Fed finalized a rule that would have allowed BHCs to count certain categories of municipal debt as Level 2B HQLA for purposes of the LCR.[122] However, EGRRCPA then broadened this classification, statutorily amending the LCR rule to require a

117. Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements, 84 Fed. Reg. 59,230, 59,232–33 (Nov. 1, 2019) (to be codifed at 12 C.F.R. pts. 3, 50, 217, 249, 324, 329).

118. *Id.* at 59,252–55.

119. *Id.* at 59,254–55.

120. *See* Citigroup Glob. Mkts. Inc., Comment Letter on Proposed Rule to Implement a Liquidity Coverage Ratio (Dec. 27, 2013), http://www.federalreserve.gov/SECRS/2014/February/20140226/R-1466/R-1466_123013_111758_374238415736_1.pdf [https://perma.cc/8TLA-93BB]; *see also* Citigroup Glob. Mkts. Inc., Comment Letter on Proposed Rule to Implement a Liquidity Coverage Ratio (Apr. 9, 2014), http://www.federalreserve.gov/SECRS/2014/May/20140506/R-1466/R-1466_040914_115071_570402890178_1.pdf [https://perma.cc/66X3-Q7TT].

121. Press Release, Daniel K. Tarullo, Member, Bd. of Governors of the Fed. Rsrv. Sys., Opening Statement: Federal Banking Regulators Finalize Liquidity Coverage Ratio (Sept. 3, 2014), https://www.federalreserve.gov/newsevents/press/bcreg/tarullo-statement-20140903.htm [https://perma.cc/7PPB-W2M2].

122. Liquidity Coverage Ratio: Treatment of U.S. Municipal Securities as High-Quality Liquid Assets, 81 Fed. Reg. 21,223, 21,228 (Apr. 1, 2016) (to be codified at 12 C.F.R. pt. 49). Qualifying municipal securities consisted of those that were general obligation, met the same general criteria as corporate bonds, and were limited to 5 percent of overall HQLA. *Id.*

more permissive standard for categorizing municipal debt as HQLA.[123]

By changing the applicability thresholds and broadening the categories of eligible assets, the tailoring of liquidity rules resulted in many large BHCs being permitted to invest in higher yielding and less liquid assets. This allows them to achieve greater returns on their investments, but also creates greater risks because they are unable to sufficiently monetize their assets amidst either a run on their funding or a "fire sale" in certain asset classes.

E. Reduced Resolution Planning

In addition to capital, leverage, and liquidity rules, the Fed also tailored its living will rules.[124] Rather than requiring BHCs to submit annual plans, it created a two-year submission cycle for GSIBs and a three-year cycle for other large BHCs.[125] This latter requirement also permits BHCs to submit shorter plans during every other submission cycle, meaning that the vast majority of large BHCs are now only required to file full resolution plans every sixth year. This is concerning because, prior to the GFC, banks experienced rapid growth over relatively short time horizons.[126] It is doubtful that such organic growth would trigger the submission requirement in the event of a "material change."[127]

123. *See* Economic Growth, Regulator Relief and Consumer Protection Act, Pub. L. No. 115-174, § 403, 132 Stat. 1296, 1360–61 (2008) (codified as amended at 12 U.S.C. § 1828).

124. Resolution Plans Required, 84 Fed. Reg. 59,194, 59,195 (Nov. 1, 2019) (to be codified at 12 C.F.R. pt. 381).

125. *Id.* at 59,217.

126. FIN. CRISIS INQUIRY COMM'N, *supra* note 68, at 65 ("The largest firms became considerably larger. JP Morgan's assets increased from $667 billion in 1999 to $2.2 trillion in 2008, a compound annual growth rate of 16%. Bank of America and Citigroup grew by 14% and 12% a year, respectively, with Citigroup reaching $1.9 trillion in assets in 2008 (down from $2.2 trillion in 2007) and Bank of America $1.8 trillion. The investment banks also grew significantly from 2000 to 2007, often much faster than commercial banks. Goldman's assets grew from $250 billion in 1999 to $1.1 trillion by 2007, an annual growth rate of 21%. At Lehman, assets rose from $192 billion to $691 billion, or 17%.").

127. *See* Resolution Plans Required, 84 Fed. Reg. at 59,204–05. BHCs are meant to file longer plans if they have experienced certain "material changes," *id.* at 59,207–08, but are also able to apply for waivers that allow them not to provide certain information in their filings, *id.* at 59,206–08.

Breaking through the myopia of bank management had been a key value of resolution planning. This annual exercise required a BHC and its supervisors to contemplate the myriad ways in which an institution could experience material distress or failure. The accumulation of tailoring and other revisions to the resolution planning process has effectively rendered resolution planning a rote and perfunctory exercise.

F. Lowered Margin Requirements

In another example of how "tailoring" moved beyond the requirements of EGRRCPA, the Fed relaxed the stringency of multiple other prudential protections. For example, transactions that involve securities and derivatives require institutions to post a certain amount of assets, known as "margin," to their counterparties to protect against their projected credit exposure. The purpose of margin requirements is to limit the portion of securities purchases that can be made using borrowed money, thereby limiting the amount of leverage that can build up within these financial markets.[128]

In a dilution of the firewall between banks and their nonbank affiliates, the Fed finalized a rule in the summer of 2020 exempting banks from the requirement to collect initial exposure-reducing margin in their derivatives trades with nonbank affiliates.[129] During the GFC, crisis-facilitated bank mergers and instability at nonbank affiliates within the BHC structure tested these firewalls,[130] and the banking regulators updated margin rules to safeguard publicly backed IDIs from nonbank risks.[131] While not required by EGRRCPA, in a nod to the efficiency arguments underlying the tailoring project,[132] banks

128. Hanson et al., *supra* note 30, at 15–16 (Margin requirements are a "broad-based regulation" to "impose similar capital standards on a given type of credit exposure.").

129. Margin and Capital Requirements for Covered Swap Entities, 85 Fed. Reg. 39,754 (July 1, 2020) (to be codified at 12 C.F.R. pt. 1221).

130. *See* Saule T. Omarova, *From Gramm-Leach-Bliley to Dodd-Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act*, 89 N.C. L. REV. 1683, 1729–50 (2011).

131. *See* Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74,840, 74,887–89 (Nov. 30, 2015) (to be codified at 12 C.F.R. pt. 1221).

132. *See infra* Section IV.A.1.

would have "additional flexibility for internal allocation of collateral" under the revised inter-affiliate margin rules.[133]

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The foregoing is a representative sample of the effort to tailor aspects of the risk-based capital, leverage, stress-testing, and resolution-planning rules that were meant to reduce the likelihood and costs of bank failures.[134] Other elements of Dodd-Frank that were also subject to tailoring include the "Volcker Rule" prohibition against BHCs engaging in proprietary trading and private fund sponsorship.[135]

In addition to the rules that were weakened during this period, the Fed also failed to finalize a number of proposals. The list of unfinished Dodd-Frank rules includes mandatory reforms to bank compensation practices[136] and amendments to the Fed's

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133. *See* Margin and Capital Requirements for Covered Swap Entities, 84 Fed. Reg. 59,970, 59,976 (proposed Nov. 7, 2019) (to be codified at 12 C.F.R. pt. 1221).

134. For other examples of tailored rules, see Standardized Approach for Calculating the Exposure Amount of Derivative Contracts, 85 Fed. Reg. 4,362 (Jan. 24, 2020) (to be codified at 12 C.F.R. pts. 324, 327) (permitting banks and BHCs flexibility to calculate their exposures under derivatives contracts for purposes of regulatory capital rules); Prudential Standards for Large Bank Holding Companies and Savings and Loan Holding Companies, 84 Fed. Reg. 59,032 (Nov. 1, 2019) (to be codified at 12 C.F.R. pts. 217, 225, 238, 242, 252) (making additional modifications to certain enhanced prudential standards); Amendments to the Capital Plan Rule, 84 Fed. Reg. 8,953 (Mar. 13, 2019) (to be codified at 12 C.F.R. pt. 225) (limiting the scope of the Fed's potential objections to BHCs' capital plans as part of the stress tests).

135. *See* 12 U.S.C. § 1851. EGRRCPA exempted certain BHCs from the rule's coverage altogether. Economic Growth, Regulator Relief and Consumer Protection Act, Pub. L. No. 115-174, § 203, 132 Stat. 1296, 1309 (2008) (exempting BHCs with less than $10 billion in total consolidated assets and less than 5 percent trading assets and liabilities from the Volcker Rule provisions). The Volcker Rule regulation was revised in 2019 to exempt a broader range of short-term trading holdings from the proprietary trading ban and change the metrics for measuring which trading activities are subject to the rule. *E.g.*, Lalita Clozel, *Banks Get Some Relief in Volcker-Rule Changes*, WALL ST. J., https://www.wsj.com/articles/regulators-ease-proprietary-trading-compliance-for-biggest-banks-11566311407 [https://perma.cc/G5FN-54UT] (Aug. 20, 2019, 4:51 PM). In 2020, the restrictions on investments in certain types of private funds were also relaxed. *E.g.*, Pete Schroeder, *U.S. Banking Regulators Ease Rules Around Firm Investments, Internal Trading*, REUTERS, https://www.reuters.com/article/us-usa-banks-trading/u-s-banking-regulators-ease-rules-around-firm-investments-internal-trading-idUSKBN23W2AJ [https://perma.cc/3SE9-56JT] (June 25, 2020, 8:14 AM).

136. 12 U.S.C. § 5641(b); *see also* Incentive-Based Compensation Arrangements, 81 Fed. Reg. 37,670 (proposed June 10, 2016) (to be codified at 17 C.F.R. pts. 240, 275, 303). By statute, these rules were to be finished no later than April 2011. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 956, 124 Stat. 1376, 1905 (2010) (codified as amended at 12 U.S.C. § 5341).

Regulation W to apply section 23A's restrictions on bank transactions with affiliates to include securities lending and derivatives transactions.[137] During this period, the Fed also failed to finalize discretionary proposals that would have applied more stringent standards to the largest BHCs, such as incorporating GSIBs' capital surcharges into their minimum stress test capital requirements[138] or restricting BHCs' involvement in merchant banking and physical commodities activities.[139]

Far from being improvements or even neutral changes to the regulatory regime, the cumulative impact of the foregoing tailoring revisions was deregulatory in nature.[140] While the resulting increased fragility of the banking system was not a cause of the COVID-19 financial crisis, it was a contributory factor that exacerbated economic conditions, thereby necessitating significant public financial support for the financial system and the broader economy.

III. THE COVID-19 FINANCIAL CRISIS

The onset of the COVID-19 pandemic ushered in a full-blown financial market crisis and the first test of the Dodd-Frank framework, as governments announced escalating COVID-19 case numbers and implemented stringent public health measures and business restrictions. Market participants reacted negatively to the anticipated economic impacts of the public health and policy developments in March 2020, with rates in short-term borrowing and lending markets widening.[141] This

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137. *See* § 608, 124 Stat. at 1608 (codified as amended at 12 U.S.C. § 371c); *see also* S. REP. NO. 111-176, at 86 (2010). Indeed, in addition to not amending Regulation W, which implements section 23A, and notwithstanding Dodd-Frank's amendments to section 23A to cover inter-affiliate derivatives transactions, the Fed's inter-affiliate margin rule interpreted section 23A not to require banks to collect initial margin from their affiliates—a change that was contrary to the spirit of both Regulation W and section 23A. *See* Margin and Capital Requirements for Covered Swap Entities, 85 Fed. Reg. 39,754, 39,764 (July 1, 2020) (to be codified at 12 C.F.R. pt. 1221).

138. *See* Tarullo, *supra* note 57, at 5.

139. *See* Regulations Q and Y; Risk-Based Capital and Other Regulatory Requirements for Activities of Financial Holding Companies Related to Physical Commodities and Risk-Based Capital Requirements for Merchant Banking Investments, 81 Fed. Reg. 67,220 (proposed Sept. 30, 2016) (to be codified at 12 C.F.R. pts. 217, 225).

140. *See infra* Section IV.A.4.

141. Lorie K. Logan, Exec. Vice President, Fed. Rsrv. Bank of N.Y., The Federal Reserve's Recent Actions to Support the Flow of Credit to Households and

disrupted markets with normally tight spreads and caused borrowers and lenders to withdraw a number of crucial sources of financing.[142]

Amidst investors' "dash for cash," banks reached the limits of their balance sheet capacity to act as lenders and securities market makers, meaning private market participants were unable to absorb the sudden influx of a variety of assets, including many assets generally deemed "safe."[143] At the same time, needing access to credit to fill a sudden revenue gap, large Fortune 500 corporations drew down their standing revolving lines of credit at large banks.[144]

The Fed's response to the crisis-like conditions caused by the COVID-19 pandemic consisted of a combination of monetary policy actions to stabilize financial markets, quasi-fiscal measures to unfreeze credit markets, and regulatory forbearance and deregulation to ease banks' balance sheet constraints. The scale of the Fed's interventions was historic and took the central bank into fraught political terrain through direct credit provision and close coordination with the Treasury Department.[145]

At the same time, the Fed's actions were necessitated by its prior regulatory decisions that had decreased the resilience of the banking system. Indeed, as a consequence of its decisions allowing BHCs to tailor their balance sheets, the Fed put itself in the position of supporting BHCs so that they could continue providing financial intermediation services. In some cases it directly filled gaps left by BHCs' retrenchment from certain markets.

Businesses (Apr. 14, 2020), https://www.newyorkfed.org/newsevents/speeches/2020/log200414 [https://perma.cc/5FKE-YAUV].

142. *Id.*

143. FIN. STABILITY OVERSIGHT COUNCIL, 2020 ANNUAL REPORT 27–28 (2020).

144. *E.g.*, Serena Ng, *Another Problem for the Fed: Banks Pressured as Clients Scramble for Cash*, WALL ST. J. (Mar. 16, 2020, 7:55 PM), https://www.wsj.com/articles/another-problem-for-the-fed-banks-pressured-as-clients-scramble-for-cash-11584356272 [https://perma.cc/VFT7-6B8D]; *see also* Arash Massoudi et al., *AB InBev Draws Down Entire $9 Billion Loan Facility*, FIN. TIMES (Mar. 16, 2020), https://www.ft.com/content/2e7ae3b6-679b-11ea-800d-da70cff6e4d3 [https://perma.cc/TH6M-NVPM].

145. *See* Nick Timiraos & Jon Hilsenrath, *The Federal Reserve Is Changing What It Means to Be a Central Bank*, WALL ST. J. (Apr. 27, 2020, 11:06 AM), https://www.wsj.com/articles/fate-and-history-the-fed-tosses-the-rules-to-fight-coronavirus-downturn-11587999986 [https://perma.cc/ET5X-PED3].

A. *Monetary and Fiscal Policy Supports*

In response to the onset of the global pandemic, monetary and fiscal authorities sprang into action in an attempt to contain the economic fallout. While some of the policy response was directly targeted at maintaining the smooth functioning of the financial system, other aspects benefitted banks indirectly. Nonetheless, banks were the ultimate beneficiaries of much of the historic government support deployed in 2020.

Beginning in mid-March 2020, the Federal Open Market Committee (FOMC) announced that it was "prepared to use its full range of tools to support the flow of credit to households and businesses" in order to counteract any potential negative economic consequences of the COVID-19 pandemic.[146] The Fed employed its powers under section 13(3) of the Federal Reserve Act to lend to dealer banks, support the purchase of money market fund (MMF) assets, offer repurchase (repo) loans, and support the commercial paper market.[147] The Fed also created a facility to purchase exchange-traded funds that hold corporate bonds,[148] including junk bonds, purchasing about $8 billion in shares of corporate bond exchange-traded funds as of July 2020.[149]

Pursuant to the Coronavirus Aid, Relief, and Economic Security (CARES) Act, the U.S. Treasury made a $10 billion equity investment in a special-purpose vehicle (SPV) re-established to administer a facility supporting the commercial paper market.[150] Further, the Treasury made a similar $10 billion equity

146. Press Release, Bd. of Governors of the Fed. Rsrv. Sys., Federal Reserve Issues FOMC Statement (Mar. 15, 2020), https://www.federalreserve.gov/monetarypolicy/files/monetary20200315a1.pdf [https://perma.cc/7FZW-5G7M].

147. *See* Press Release, Bd. of Governors of the Fed. Rsrv. Sys., Federal Reserve Announces Extensive New Measures to Support the Economy (July. 28, 2020), https://www.federalreserve.gov/newsevents/pressreleases/monetary2020-0323b.htm [https://perma.cc/JYQ2-3G3W].

148. *See* Nick Timiraos, *Fed Unveils Major Expansion of Market Intervention*, WALL ST. J., https://www.wsj.com/articles/federal-reserve-announces-major-expansion-of-market-supports-11584964844 [https://perma.cc/5BV7-47C8] (Mar. 23, 2020, 9:20 PM).

149. *See* Matt Wirz & Tom McGinty, *Fed Discloses More Corporate Bond and ETF Purchases*, WALL ST. J., https://www.wsj.com/articles/fed-bought-about-1-3-billion-corporate-bonds-in-late-june-11594396039 [https://perma.cc/6KPV-QWGC] (July 10, 2020, 2:45 PM).

150. BD. OF GOVERNORS OF THE FED. RSRV. SYS., PERIODIC REPORT: UPDATE ON OUTSTANDING LENDING FACILITIES AUTHORIZED BY THE BOARD UNDER SECTION 13(3) OF THE FEDERAL RESERVE ACT 3 n.2 (2020),

investment in a SPV administering a program to finance the purchase of highly rated securities.[151] The CARES Act made available $454 billion for the Treasury to support, through loans, guarantees and other investments, a variety of Fed-created lending programs to financial markets, and large and medium-sized businesses.[152] These provisions cleared the way for the Treasury to invest $10 billion in credit protection into the SPV administering the fund supporting MMFs.[153]

The CARES Act also used fiscal measures to fill the gap left by the absence of bank intermediation. Congress created the publicly guaranteed Paycheck Protection Program (PPP), appropriating an initial $349 billion in the form of loan guarantees to support bank lending.[154] To ensure that banks would participate in the PPP, the Fed created a PPP Liquidity Facility (PPPLF), which accepted PPP loans as collateral in return for term loans to banks, in order to free up lending space on banks' balance sheets.[155] The Fed also created a Main Street Lending Program (MSLP) using CARES Act funds to provide liquidity support to banks providing loans to qualifying medium-sized business.[156]

Efforts like the PPP, PPPLF, and MSLP aided lending programs by transferring credit and liquidity risks from the private to the public sector. Very little of the committed funds were

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https://www.federalreserve.gov/publications/files/nonlf-noelf-pdcf-mmlf-cpff-pmccf-smccf-talf-mlf-ppplf-msnelf-mself-msplf-8-10-20.pdf [https://perma.cc/HB8V-RRCX].

151. *Id.* at 6 n.6.

152. Coronavirus Aid, Relief, and Economic Security Act, Pub. L. No. 116-136, § 4015, 134 Stat. 281, 481 (2020) (codified as amended at 12 U.S.C. § 5236 note).

153. BD. OF GOVERNORS OF THE FED. RSRV. SYS., REPORT TO CONGRESS PURSUANT TO SECTION 13(3) OF THE FEDERAL RESERVE ACT: MONEY MARKET MUTUAL FUND LIQUIDITY FACILITY 1–2 (2020), https://www.federalreserve.gov/publications/files/money-market-mutual-fund-liquidity-facility-3-25-20.pdf [https://perma.cc/XXJ4-HUF6].

154. Coronavirus Aid, Relief, and Economic Security § 1102(b); *see also* Memorandum from Philip L. Swagel, Dir., Cong. Budget Off., to Mike Enzi, Chairman, Comm. on the Budget, U.S. Senate, Preliminary Estimate of the Effects of H.R. 748, the CARES Act, Public Law 116-136, at tbl.2 (Apr. 27, 2020), https://www.cbo.gov/system/files/2020-04/hr748.pdf [https://perma.cc/F7BH-5EPN].

155. *See* Press Release, Bd. of Governors of the Fed. Rsrv. Sys., Federal Reserve Takes Additional Actions to Provide up to $2.3 Trillion in Loans to Support the Economy (Apr. 9, 2020), https://www.federalreserve.gov/newsevents/pressreleases/monetary20200409a.htm [https://perma.cc/E2TF-46FU].

156. *Main Street Lending Program*, BD. OF GOVERNORS OF THE FED. RSRV. SYS., https://www.federalreserve.gov/monetarypolicy/mainstreetlending.htm [https://perma.cc/QJG4-CAA8] (Jan. 11, 2022). The MSLP was composed of five different liquidity facilities. *Id.*

actually deployed, however, suggesting that the Fed achieved much of its objective to stabilize the financial markets simply by *committing* to provide *as much support as necessary* to stabilize the markets. In a similarly important commitment to stand behind the banking system, the CARES Act temporarily reinstated the FDIC's unlimited bank debt guarantee authority by pre-authorizing any guarantees of bank debt that the FDIC might deem necessary during the pandemic.[157]

Support for the banking system during the COVID-19 crisis was not limited to fiscal support and guarantees. Regulators also offered banks forbearance from a suite of post-GFC macroprudential regulations.

B. *Regulatory Forbearance*

The Fed also took a series of regulatory and supervisory actions in response to the COVID-19 pandemic, beginning with encouraging BHCs to dip into their capital and liquidity buffers to fund additional lending.[158] Despite an otherwise global consensus among central banks favoring a suspension of dividends and stock buybacks,[159] the Fed took no such steps in the first half of 2020. By mid-March, GSIBs collectively announced that they would *voluntarily* suspend stock buybacks,[160] which had accounted for 70 percent of big banks' capital distributions in prior years, but not dividends.[161]

During the summer of 2020, the Fed reported BHCs' CCAR results, including a special "sensitivity analysis" incorporating scenarios that could better reflect the economic impact of the COVID-19 pandemic. This analysis contained several

157. Coronavirus Aid, Relief, and Economic Security Act § 4008.

158. Press Release, Bd. of Governors of the Fed. Rsrv. Sys., Fed. Deposit Ins. Corp., Ofc. of the Comptroller of the Currency, Statement on the Use of Capital and Liquidity Buffers (Mar. 17, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20200317a1.pdf [https://perma.cc/E33C-GRQG].

159. *See* Agustín Carstens, *Bold Steps to Pump Coronavirus Rescue Funds Down the Last Mile*, FIN. TIMES (Mar. 29, 2020), https://www.ft.com/content/5a1a1e9c-6f4d-11ea-89df-41bea055720b [https://perma.cc/J9QW-ZJ83].

160. *E.g.*, David Benoit, *Biggest U.S. Banks Halt Buybacks to Free Up Capital for Coronavirus*, WALL ST. J. (Mar. 15, 2020, 7:56 PM), https://www.wsj.com/articles/biggest-u-s-banks-halt-buybacks-to-free-up-capital-for-coronavirus-response-11584315565 [https://perma.cc/9FNC-692U].

161. *See* Press Release, Bd. of Governors of the Fed. Rsrv. Sys., Statement by Vice Chair for Supervision Quarles (June 25, 2020), https://www.federalreserve.gov/newsevents/pressreleases/quarles-statement-20200625c.htm [https://perma.cc/Y52K-6JEN].

assumptions that did not reflect the reality of the situation. For example, banks were assumed to experience immediate growth in their loan portfolios, but their balance sheets were assumed to remain static thereafter.[162] In addition, the analysis did not account for the capital distributions that banks made during the first half of 2020; had it done so, BHCs would have had an estimated across-the-board reduction in capital of 50 basis points.[163] Even still, one-quarter of the thirty-three analyzed BHCs fell below the minimum 4.5 percent capital ratio in the most extreme economic scenario.[164]

In response to the sensitivity analysis, the Fed temporarily suspended BHCs' stock buybacks and imposed a cap on dividends not to exceed either the lesser of the amount paid out in prior quarters or the BHC's recent net income.[165] Following another round of stress tests in December 2020, the Fed loosened restrictions on dividends and buybacks,[166] and banks promptly announced their intent to distribute billions of dollars in capital to shareholders.[167]

At the same time the Fed was permitting BHCs to distribute their capital, it granted them regulatory forbearance from the capital restrictions embedded in the SLR and eSLR rules by amending those rules to temporarily exclude Treasury securities and central bank reserves.[168] The Fed argued that banks are

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162. BD. OF GOVERNORS OF THE FED. RSRV. SYS., ASSESSMENT OF BANK CAPITAL DURING THE RECENT CORONAVIRUS EVENT 9 (2020).

163. *Id.* at 14. A basis point (bp) is one one-hundredth of a percentage point, meaning that a 50 bps decrease equals a reduction of 0.5 percent.

164. *See id.* at 14 fig.8.

165. *Id.* at 1. Former Fed Governor Daniel Tarullo noted that this policy is based upon backward-looking measures that do not reflect current or future financial conditions. *See* Daniel K. Tarullo, *Are We Seeing the Demise of Stress Testing?*, BROOKINGS INST. (June 25, 2020), https://www.brookings.edu/blog/up-front/2020/06/25/stress-testing [https://perma.cc/XSJ6-Y55P].

166. BD. OF GOVERNORS OF THE FED. RSRV. SYS., DECEMBER 2020 STRESS TEST RESULTS app. D at 143 (2020).

167. *See* Laura Noonan et al., *Federal Reserve Frees Up U.S. Banks to Resume Share Buybacks*, FIN. TIMES (Dec. 18, 2020), https://www.ft.com/content/16ec2a4d-b39a-4ecf-b0b6-af5f4469d18b [https://perma.cc/6N6H-AGVR] (quoting Federal Reserve Board Governor Lael Brainard, who stated that the Fed's decision "nearly doubles the amount of capital permitted to be paid out relative to last quarter").

168. *See* Temporary Exclusion of U.S. Treasury Securities and Deposits at Federal Reserve Banks from the Supplementary Leverage Ratio, 85 Fed. Reg. 20,578 (Apr. 14, 2020) (to be codified at 12 C.F.R. pt. 217). Shortly thereafter, all three banking regulators instituted a rule allowing depository institutions to elect to exclude treasuries and reserves from the SLR, subject to prior approval on capital distributions. Regulatory Capital Rule: Temporary Exclusion of U.S. Treasury

essential intermediaries in the money markets, especially in their roles as securities dealers, during times of stress.[169] The Fed cited widening spreads in the Treasury markets and argued that banks had said that the leverage ratio was preventing them from serving as reliable intermediaries.[170]

These two actions put in stark relief the Fed's actions and priorities during the pandemic. Allowing forbearance to permit BHCs to dip into their capital buffers during stress periods is arguably justified—indeed, the macroprudential capital and leverage framework encourages BHCs to build capital in good times and deploy it during bad times. The Fed's lax dividend policy during the early months of the COVID-19 pandemic, however, worked at cross purposes: rather than directing BHCs to conserve and deploy their capital in support of stabilizing the nonfinancial economy, it allowed BHCs to pay capital out to their shareholders. This subtle prioritization during the depths of a potential crisis effectively gave away the game regarding the true purposes of the tailoring regime.

In March of 2021, the Fed announced that it would allow the temporary SLR relief to expire; however, it noted that its scrutiny of the leverage ratio had not concluded.[171] In its announcement, the Fed stated that it may "need to address the current design and calibration of the SLR over time to prevent strains from developing that could both constrain economic growth and undermine financial stability" and would, therefore, "soon be inviting public comment on several potential SLR

Securities and Deposits at Federal Reserve Banks from the Supplementary Leverage Ratio for Depository Institutions, 85 Fed. Reg. 32,980 (June 1, 2020) (to be codified at 12 C.F.R. pts. 3, 6, 208, 217, 324). These changes roughly coincided with the effective date of the regulations implementing the provision of EGRRCPA excluding certain central bank reserves from the denominator of the leverage ratio for GSIB custody banks, which had an effective date of April 1, 2020. *See* Regulatory Capital Rule: Revisions to the Supplementary Leverage Ratio to Exclude Certain Central Bank Deposits, 85 Fed. Reg. 4,569, 4,569 (Jan. 27, 2020).

169. Temporary Exclusion of U.S. Treasury Securities and Deposits at Federal Reserve Banks from the Supplementary Leverage Ratio, 85 Fed. Reg. at 20,579.

170. *Id.* at 20,580. The literature suggests that factors other than the leverage ratio may affect dealers' ability to provide liquidity and, as will be discussed later, that institutions subject to a leverage ratio are better able to continue intermediating during stress conditions. *See infra* Section IV.B.2.

171. Press Release, Bd. of Governors of the Fed. Rsrv. Sys., Federal Reserve Board Announces that the Temp Change to Its Supplementary Leverage Ratio (SLR) for Bank Holding Companies Will Expire as Scheduled on March 31 (Mar. 19, 2021), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20210319a.htm [https://perma.cc/C58C-JHN3].

modifications."[172] This statement foreshadowed additional, and more permanent, regulatory relief to come.[173]

While the Fed was able to reduce the leverage ratio requirements it had created by regulation, it lacked legal authority to revise the Tier 1 leverage ratios applicable to BHCs under the statutory Collins Amendment.[174] The Fed also turned to Congress to lobby for an exemption from the Collins Amendment's leverage ratio by sending a letter to the Chairman of the Senate Banking Committee[175] and speaking favorably of the idea at an FOMC press conference.[176] The Fed argued that its request was necessary due to "complications [the Collins Amendment] presents in tailoring a capital regime to a diverse financial sector and to changing risks in the financial system over time."[177]

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172. *Id.*

173. Indeed, banks mounted a lobbying effort for the leverage ratio exemption to be made permanent beyond COVID-19. *See* Colby Smith & Laura Noonan, *U.S. Banks Push Fed for Extension of COVID Capital Relief*, FIN. TIMES (Feb. 11, 2021), https://www.ft.com/content/91f43572-414c-48d1-af80-857b9fa2fb18 [https://perma.cc/6Z6B-UBPW]; *see also* Harry Terris, *JPMorgan Argues for Extension as Breather on Capital Rule Nears Expiration*, S&P GLOB.: MKT. INTEL. (Feb. 1, 2021), https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/jpmorgan-argues-for-extension-as-breather-on-capital-rule-nears-expiration-62304785 [https://perma.cc/X9TH-MZ46].

174. *See* Temporary Exclusion of U.S. Treasury Securities and Deposits at Federal Reserve Banks from the Supplementary Leverage Ratio, 85 Fed. Reg. at 20,579.

175. Letter from Randal K. Quarles, Vice Chair for Supervision, Bd. of Governors of the Fed. Rsrv. Sys. to Sen. Mike Crapo, Chairman, Comm. on Banking, Hous., & Urb. Affs. 3 (Apr. 22, 2020), https://www.banking.senate.gov/imo/media/doc/Fed%20Response%20to%20Crapo%204.8.20%20Letter.pdf [https://perma.cc/75PV-LTTY] ("Congress should consider modifying section 171 of the Dodd-Frank Act ('the Collins Amendment') to allow regulators to provide flexibility under Tier 1 leverage requirements . . . .").

176. Jerome Powell, Chair, Fed. Rsrv., Remarks at Chair Powell's Press Conference 28 (July 29, 2020) (transcript available at https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20200729.pdf [https://perma.cc/D7NH-7V7C]) (quoting Federal Reserve Chair Jerome Powell's statement that a statutory exemption from the Collins Amendment's leverage requirement "would give us the ability to allow banks to grow their balance sheet, and in doing so to serve their customers better").

177. Letter from Randal K. Quarles to Sen. Mike Crapo, *supra* note 175, at 3. This request also appears to reflect a long-running tension between its staff and other banking agencies, namely the FDIC, beginning at least during the era of the Basel II international capital accords. *See* RICH SPILLENKOTHEN, NOTES ON THE PERFORMANCE OF PRUDENTIAL SUPERVISION IN THE YEARS PRECEDING THE FINANCIAL CRISIS BY A FORMER DIRECTOR OF BANKING SUPERVISION AND REGULATION AT THE FEDERAL RESERVE BOARD (1991 to 2006), at 16 (2010), https://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2010-05-31%20FRB%20 Richard%20Spillenkothen%20Paper-

Indeed, this effort was not the first in which the Fed sought greater flexibility to "tailor" capital rules, a principle that is anathema to the Collins Amendment's goal of establishing a broadly applicable capital floor for BHCs.[178]

Finally, the Fed announced that it was prepared to offer exemptions, as it had during the GFC, from legal firewalls preventing IDIs from supporting their nonbank affiliates. Specifically, the Fed wanted to allow IDIs to support their affiliated broker-dealers and MMFs, thus underscoring the value of inter-affiliate protections like margin.[179]

%20Observations%20on%20the%20Performance%20of%20Prudential%20Supervision.pdf [https://perma.cc/9DRW-3ZKN] ("In the years preceding the crisis, efforts to establish limits on how much regulatory capital would be allowed to decline under Basel II, some proposed by the FDIC, were initially denigrated and dismissed by Basel II advocates within the Federal Reserve.").

178. In his letter, Vice Chair Quarles noted that there was precedent for Congress to amend the Collins Amendment. Letter from Randal K. Quarles to Sen. Mike Crapo, *supra* note 177, at 3. In 2014, Congress passed an amendment allowing the Fed to exempt insurance companies that own thrifts from the Collins Amendment. *See* Insurance Capital Standards Clarification Act of 2014, Pub. L. No. 113-279, 128 Stat. 3017 (2014) (codified as amended at 12 U.S.C. § 5371). It is worth noting, however, that the legislation was only necessary because of a Fed legal interpretation that a range of stakeholders found to be erroneous, as demonstrated by remarks from the Collins Amendment's original sponsor:

> While the Federal Reserve has acknowledged the important distinctions between insurance and banking, it has repeatedly suggested that it lacks authority to take those distinctions into account when implementing the consolidated capital standards required by Section 171. As I have already said, I do not agree that the Fed lacks this authority and find its disregard of my clear intent as the author of section 171 to be frustrating, to say the least. Experts testifying before the Financial Institutions and Consumer Protection subcommittee of the Senate Banking Committee . . . concur that the Federal Reserve has ample authority to draw these distinctions.

160 CONG. REC. 6,428 (2014) (Statement of Sen. Susan Collins).

179. *See* Letter from Ann E. Misback, Sec'y of the Bd., Bd. of Governors of the Fed. Rsrv. Sys. (Mar. 17, 2020), https://www.federalreserve.gov/supervisionreg/legalinterpretations/fedreserseactint20200317.pdf [https://perma.cc/B4SL-4X64]; *see also* Letter from Ann E. Misback, Sec'y of the Bd., Bd. of Governors of the Fed. Rsrv. Sys. (Mar. 18, 2020), https://www.federalreserve.gov/supervisionreg/legalinterpretations/fedreserseactint20200318.pdf [https://perma.cc/LU98-GWX3]. According to publicly available information, PNC, a large BHC, used the exemption to support its securities affiliate in March 2020, and the large asset manager Vanguard used the exemption to permit its trust bank to invest capital in an MMF in January 2021. Letter from Ann E. Misback, Sec'y of the Bd., Bd. of Governors of the Fed. Rsrv. Sys., to Joseph M. Otting, Comptroller, Off. of the Comptroller of the Currency (Mar. 25, 2020), https://www.federalreserve.gov/supervisionreg/legalinterpretations/fedreserseactint20200325.pdf [https://perma.cc/A98K-6EWP] (BHC March 2020 exemption); Letter from Ann E. Misback, Sec'y of the Bd., Bd. of Governors of the Fed. Rsrv. Sys., to Blake Paulson, Acting Comptroller, Off. of the Comptroller of the Currency (Jan. 29, 2021), https://www.federalreserve.gov/

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With banks failing to draw on the capital buffers constructed under the macroprudential framework,[180] the Fed used the CARES Act and section 13(3) to establish facilities to help banks lend to small- and medium-sized businesses,[181] essentially assuming the role of a "commercial bank of last resort for the entire economy."[182] Attempts to quantify the public sector support for the banking industry during the early months of the COVID-19 pandemic in 2020 have estimated that banks may have been protected from somewhere between $130 billion and $230 billion in potential loan losses.[183] Without the full suite of fiscal supports and forbearance, "the estimated proportion of capital-deficient bank assets would have roughly doubled."[184] The warnings about the fragility of BHCs under "tailored" rules had proved prescient during the COVID-19 crisis.[185]

IV. THE COVID-19 CRISIS PROVIDED IMPORTANT LESSONS ABOUT REGULATORY TAILORING

The experience of the financial sector during the COVID-19 crisis is an important referendum on the tailoring regime. BHCs' inability to perform both basic and critical functions in response to an exogenous shock like a public health emergency should

supervisionreg/legalinterpretations/fedreserseactint20210129.pdf [https://perma.cc/2VQL-5NX8] (Vanguard January 2021 exemption).

180. IMF, *supra* note 9, at 23–24; *see also* Abboud et al., *supra* note 34, at 16.

181. *See The Federal Reserve's Main Street Lending Program*, FED. RSRV. BANK OF BOS., https://www.bostonfed.org/supervision-and-regulation/credit/special-facilities/main-street-lending-program/main-street-lending-program-overview.aspx [https://perma.cc/VF3Q-WA9W]; *see also* Press Release, Bd. of Governors of the Fed. Rsrv. Sys., Federal Reserve Takes Additional Actions to Provide up to $2.3 Trillion in Loans to Support the Economy, (Apr. 9, 2020), https://www.federalreserve.gov/newsevents/pressreleases/monetary20200409a.htm [https://perma.cc/3DQ2-ZS4N].

182. Julia-Ambra Verlaine & Liz Hoffman, *Banks Could Prove Weak Partner in Coronavirus Recovery*, WALL ST. J., (Apr. 24, 2020, 11:46 AM), https://www.wsj.com/articles/banks-could-prove-weak-partner-in-coronavirus-recovery-11587743212 [https://perma.cc/WJQ6-CAYN] (quoting Michael Feroli, JPMorgan's chief economist).

183. *See* Feldman & Schmidt, *supra* note 9.

184. IMF, *supra* note 9, at 20.

185. *See* Tarullo, *supra* note 20, at 13 ("If non-stress period capital requirements are made less rigorous—as has arguably been the case over the last few years—the losses that accompany a crisis may, at least for a time, leave some banks technically adequately capitalized but effectively unable to intermediate new lending.").

concern financial policymakers. By tailoring rules, regulators allow banks to deplete capital, which in turn shrinks the amount of balance sheet capacity that could be used to support the credit needs of the broader economy. This diminished balance sheet capacity undermines BHCs' ability to provide financial intermediation services during normal times, with these constraints growing more acute in unusual and exigent market conditions.[186]

This experience offers several preliminary conclusions about the ways in which the tailoring project has reordered the goals of financial regulation. First, it has created an efficiency mandate that has no basis in law and yet has been prioritized above other goals. Second, in practice, tailoring has rested on a degree of overconfidence about the sources of financial risk and has misunderstood and minimized the potential risks of certain activities. Third, the tailoring project has overemphasized private costs to the banking industry while underappreciating the benefits of regulation for society and the costs of banking failures and crises. Fourth, the tailoring project, while ostensibly about lessening burdensome regulations for smaller banks, has benefitted banks of all sizes, including GSIBs. Finally, the current iteration of tailoring has failed to deliver upon its proponents' promise that deregulation would lead to more credit and by extension jobs, economic growth, and prosperity. In light of this evidence, it is worth considering a different regulatory approach—a "precautionary approach"—that better reflects the lessons learned both during the GFC as well as the COVID-19 pandemic.

A. *The Project of Tailoring Has Distorted the Aims of Financial Regulation*

As memories of the GFC faded, the objective of macroprudential regulation to ensure that systemic institutions internalize the costs that they impose on society gave way to concerns

186. *See, e.g.*, Andrew Hauser, Exec. Dir. of Mkts., Bank of Eng., From Lender of Last Resort to Market Maker of Last Resort Via the Dash for Cash: Why Central Banks Need New Tools for Dealing with Market Dysfunction 2 (Jan. 7, 2021), https://www.bankofengland.co.uk/-/media/boe/files/speech/2021/january/why-central-banks-need-new-tools-for-dealing-with-market-dysfunction-speech-by-andrew-hauser.pdf [https://perma.cc/6ZK3-HAH5] (noting that during COVID-19 there was a "growing imbalance between the size of key markets, and the balance sheet capacity of banks and dealers who have traditionally helped transfer risk smoothly between investors and borrowers").

over industry's ostensible burden. Far from being an inevitable outcome, this was the result of a combination of ideological beliefs, coupled with concrete decisions and actions, on the part of lawmakers and policymakers. This reorientation gave rise to a series of policies that appeared hyper-technical on their face but the effects of which have subordinated public interests to private ones.

1. Tailoring Has Created an Extralegal Mandate to Maximize Efficiency

Consider first the Fed's adaptation of tailoring as an exercise in reducing burden and increasing efficiency.[187] Prioritizing efficiency as a goal of law and policymaking has echoes in the law and economics school of thought, which holds out "wealth maximization" in the form of transactional efficiency as the rightful aim of legal regimes.[188] As others have pointed out, this approach eschews a number of other societal interests in favor of the narrow conception that an efficient economy will inherently lead to optimal outcomes.[189]

The Fed had at one time articulated a different view of macroprudential regulation. In the wake of Dodd-Frank's passage, policymakers described macroprudential policy as a countercyclical framework whereby regulations seek to both moderate booms and control the impact of busts.[190] Ensuring that

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187. *See supra* note 83 and accompanying text; *see also* Quarles, *supra* note 6, at 1 ("I came to the Fed in order to take on that task of making the system better: more simple, more efficient, more transparent."); Jeanna Smialek, *Meet the Man Loosening Bank Regulation, One Detail at a Time*, N.Y. TIMES (Nov. 29, 2019), https://www.nytimes.com/2019/11/29/business/economy/bank-regulations-fed.html [https://perma.cc/WBK8-RLQR] (quoting the Fed's Vice Chair for Supervision, Randal Quarles, who stated that "[o]ne of the objectives of the system should be an efficient system . . . . I think we've moved not too quickly, but quite quickly, in adjusting—again, with an eye toward efficiency—some aspects of post-crisis regulation."); Federal Deposit Insurance Corporation, 84 Fed. Reg. 21,600, 21,602 (May 14, 2019) (the proposal to reduce living will requirements was "intended to improve efficiency and balance burden").

188. *See, e.g.*, Richard A. Posner, *Utilitarianism, Economics, and Legal Theory*, 8 J. LEGAL STUD. 103, 124–27 (1979).

189. *See* Jedediah Britton-Purdy et al., *Building a Law-and-Political-Economy Framework: Beyond the Twentieth-Century Synthesis*, 129 YALE L.J. 1784, 1795–1800 (2020).

190. *See* Van Der Weide, *supra* note 17, at 109 ("[W]e have to look at the time-varying element. We have to work to mitigate threats from the buildup of excessive risk during credit booms or other types of financial booms. So we have to watch for problems on the upside. At the same time, we have to pay attention to what the

large BHCs internalize the prospective costs imposed upon society when they retrench from their role as financial intermediaries during times of financial distress was a central aim of macroprudential regulation.[191]

By contrast, during the tailoring era, the Fed's Vice Chair for Supervision dismissed the idea of invoking the CCyB and instead espoused the view that when "a healthy and profitable banking system is seeking to maintain its capital levels rather than continue to increase them, a bank will appropriately and safely tend to distribute much or all of its income in any given year."[192] This is an example of a policy choice that elevates efficiency and wealth maximization in service of the belief that (1) banks should be required to fund themselves with no more loss-absorbing equity than is absolutely necessary, and (2) bank executives are entitled to deference because they make economically rational decisions about the best way to allocate their banks' capital. This analysis has nothing to say about either the distributional concerns or political economy issues endemic to this conceptual model of modern finance.

The "strong preference for private markets over legal rules" is another hallmark of law and economics that appears in the Fed's tailored macroprudential policy.[193] For example, while the Fed has never articulated an explicit policy against suspending bank dividends, it failed to do so during the onset of the COVID-19 pandemic. The Fed's SBC rule suggests the reason for this inaction. In the SBC rule, the Fed says it will assume, for the purposes of capital rules and stress testing, that banks will continue paying dividends on *all* capital instruments—both Tier 1 and lower-rated Tier 2—because "reductions in these payments are generally viewed by market participants as a sign of material weakness, and firms are therefore likely to make them even

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right tools are on the downside. You try to mitigate threats that might build up from the deleveraging or de-maturity transforming activities of financial firms that are rushing to crouch defensively as they see an economic thunderstorm approaching.").

191. *See id.* at 110.

192. *See* Randal K. Quarles, Vice Chairman for Supervision, Bd. of Governors of the Fed. Rsrv. Sys., A New Chapter in Stress Testing 6 (Nov. 9, 2018), https://www.federalreserve.gov/newsevents/speech/files/quarles20181109a.pdf [https://perma.cc/NUH8-A56F].

193. Emma Coleman Jordan, *The Hidden Structures of Inequality: The Federal Reserve and a Cascade of Failures*, 2 U. PA. J.L. & PUB. AFFS. 107, 171 (2017).

under stressful conditions."[194] Thus, the Fed has incorporated market sentiment as a policy aim, potentially at the expense of a useful financial stability tool.[195]

Importantly, none of the foregoing objectives or outcomes are preordained by either Dodd-Frank or EGRRCPA. The Fed enjoys significant discretion in choosing these policy paths. While EGRRCPA amended the tailoring language in section 165 from discretionary to mandatory, it in no way cabined the Fed's ability to determine the substantive aims of tailoring, nor did it require many of the specific rules issued by the Fed.[196]

There is an alternative interpretation of rule tailoring that centers around *effectiveness* rather than *efficiency*.[197] Both the text of Dodd-Frank and its legislative history make clear that the original tailoring factors are meant to enumerate some specific risks that the Fed should take into account when crafting enhanced prudential standards.[198] These factors serve as the basis upon which standards should *increase* in stringency.[199] This directive is even less binding than it may appear, as the Fed can also consider "any other risk-related factors that [it] deems appropriate."[200] The Fed's discretion was further reinforced by

194. Regulations Q, Y, and YY: Regulatory Capital, Capital Plan, and Stress Test Rules, 85 Fed. Reg. 15,576, 15,579 n.10 (Mar. 18, 2020).

195. There is an underlying irony in framing the goal of politics as preserving the functioning of markets, when markets would not exist without laws enacted by governments. *See* Britton-Purdy et al., *supra* note 189, at 1799.

196. *See* Press Release, Bd. of Governors of the Fed. Rsrv. Sys., *supra* note 91 ("We voted to finalize the liquidity coverage ratio only four years ago, and I see no change in the financial environment or provision in S. 2155 that would require us to substantially weaken a rule that was backed by strong analysis and informed by extensive public comment."); *see also* Press Release, Bd. of Governors of the Fed. Rsrv. Sys., Statement by Governor Lael Brainard (Oct. 10, 2019), https://www.federalreserve.gov/newsevents/pressreleases/brainard-statement-20191010.htm [https://perma.cc/FBY8-599P] (noting that "S.2155 does not require us to weaken" liquidity rules).

197. *See* Quarles, *supra* note 84, at 3 (describing tailoring as an effort to "streamline [the Fed's] framework in a manner that more directly addresses firm-specific risks").

198. S. REP. NO. 111-176, at 50 (2010) ("[Section 165] enumerates the factors that the Board of Governors shall consider in setting [enhanced prudential] standards.").

199. *See* Van Der Weide, *supra* note 17, at 110 ("[The Fed is] required to have the framework increase in proportion to what I like to call the 'systemic footprint' of firms, that is, the size, interconnectedness, and complexity of firms in that set of BHCs above $50 billion.").

200. *See* 12 U.S.C. § 5365(a)(2)(A).

EGRRCPA's savings clause, which states that "nothing . . . shall be construed to limit . . . the authority" of the Fed.[201]

The point is that the concepts of burden and efficiency are nowhere to be found in the text of either Dodd-Frank or EGRRCPA. They have been read into the statute by policymakers and placed on an even footing with the goal of preserving financial stability. This has, in turn, narrowed the aperture of risks that can be anticipated and skewed the balancing of costs and benefits when crafting macroprudential regulations. It also signals the re-emergence of a critical cognitive vulnerability in the Fed's approach to financial regulation in the lead-up to the GFC.[202]

2. Tailoring Relies Upon Faulty Premises About the Nature of Risk

The tailoring factors themselves raise important issues of regulatory philosophy. As an outgrowth of the efficiency argument, tailoring all but excludes non-GSIBs from the focus of macroprudential regulation. The justifications for tailoring rely on a subtle rhetorical sleight of hand by reframing the need to address the existence of "too big to fail" (TBTF) financial companies and markets. Instead of considering TBTF as *one* problem to be solved by macroprudential regulation, it is often presented as the *only* problem to be solved by macroprudential regulation. Therefore, the justifiable attention that TBTF has garnered may have been opportunistically exploited by tailoring proponents.

As the practical experiences of the GFC and the COVID-19 crisis demonstrate, predicting the sources of financial risk is difficult, and anticipating potential sources of risk, as well as their impacts, is at best an inexact science.[203] Indeed, regulators,

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201. Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub L. No. 115-174, § 401(b), 132 Stat. 1296, 1357 (2018) (codified as amended at 12 U.S.C. § 5365 note (Construction of 2018 Amendment)).

202. *See* Jordan, *supra* note 193, at 171 ("Fidelity to the tenets of law and economics was perhaps the single deadliest feature of myopia during the crisis.").

203. *See* Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies Related to Physical Commodities, 79 Fed. Reg. 3,329, 3,335 (proposed Jan. 21, 2014) ("[R]ecent events (including the financial crisis) demonstrate that low probability events can pose a danger to large organizations as well as to the financial stability of the United States."). Indeed, former Treasury Secretary Tim Geithner has argued that every financial crisis is "largely a failure of imagination." TIMOTHY F. GEITHNER, STRESS TEST 513–14 (2014).

including some of the architects of the Fed's tailoring regime, held overly optimistic views of the state of the financial system before the GFC.[204] Predicting systemic events and their impacts is difficult because "a determination must be based on an assessment of whether the firm's failure would likely have systemic effects during a future stress event, the precise parameters of which cannot be fully known."[205]

An institution's size can play a role in relation to financial stability, but there are other relevant factors like interconnectedness, substitutability, and underlying economic conditions.[206] The shifting nature of risk and panic is consistent with the idea of the "too many to fail" problem, wherein "panics can be caused by herding and by contagion, as well as big banks getting into trouble," as experienced during the savings and loan crises of the

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204. *See* Fin. Crisis Inquiry Comm'n, *supra* note 68, at 13–18 (describing academics, community groups, and state attorneys general relaying warning signs in the subprime mortgage market and the lack of a response by federal regulators); *see also* Randal K. Quarles, Treasury Under Sec'y for Domestic Fin., U.S. Dept. of Treasury, Remarks to the Money Marketeers of New York University, Inc. (May 10, 2006), https://www.treasury.gov/press-center/press-releases/Pages/js4248.aspx [https://perma.cc/64DT-TGUS] ("Regardless of where one falls out in this debate, a broad-based decline in house prices would almost certainly exert a noticeable drag on economic activity . . . . I have to say that I do not think this is a likely scenario . . . . [T]he potential tail risks I've talked about today are just that—possibilities but not likely outcomes. Fundamentally, the economy is strong, the financial sector is healthy, and our future looks bright.").

205. *Systemic Risk Regulation Hearing*, *supra* note 13, at 75 (prepared statement of Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System).

206. *Id.* ("The impact of a firm's financial distress depends also on the degree to which it is interconnected, either receiving funding from, or providing funding to, other potentially systemic firms, as well as on whether it performs crucial services that cannot easily or quickly be executed by other financial institutions. In addition, the impact varies over time: the more fragile the overall financial backdrop and the condition of other financial institutions, the more likely a given firm is to be judged systemically important. If the ability for the financial system to absorb adverse shocks is low, the threshold for systemic importance will more easily be reached."); *see also* FED. RSRV. SYS., ORD. NO. 2012-2, CAPITAL ONE FINANCIAL CORPORATION: ORDER APPROVING THE ACQUISITION OF A SAVINGS ASSOCIATION AND NONBANKING SUBSIDIARIES 32 (2012), https://www.federalreserve.gov/newsevents/pressreleases/files/order20120214.pdf [https://perma.cc/M22W-R8V4] ("Measures of a financial institution's size on a pro forma basis could either understate or overstate risks to financial stability posed by the financial institution. For instance, a relatively small institution that operates in a critical market for which there is no substitute provider, or that could transmit its financial distress to other financial organizations through multiple channels, could present significant risks to the stability of the [U.S. financial system].").

1980s and 1990s.[207] These dynamics lead to spillover risks, where "the failure of one firm may lead to deposit or liability runs at other firms that are seen by investors as similarly situated or that have exposures to such firms."[208] While Lehman Brothers is often held out as the example of interconnectedness and contagion during the GFC, traditional lenders exhibited these dynamics as well.[209]

To illustrate this point, on July 11, 2008, the Office of Thrift Supervision (OTS) closed the Pasadena, California-based IndyMac Bank.[210] A thrift with $32 billion in assets, IndyMac was not a complex investment bank dealing in derivatives; instead, its distress was caused by an "aggressive growth strategy, use of . . . nontraditional loan products, insufficient underwriting, credit concentrations in residential real estate . . . markets, and heavy reliance on . . . brokered deposits."[211] Its failure cost the Deposit Insurance Fund in excess of $10 billion, the costliest failure in the FDIC's history.[212] IndyMac would set off a cascade of distress at other regional banks and thrifts with similar business profiles, a contagion that would largely be contained by bailouts, emergency mergers, or some combination thereof.[213]

Also consider the custody banks that were largely tailored out of the eSLR by EGRRCPA. Their core custody and payment

207. Stanley Fischer, Vice Chairman, Bd. of Governors of the Fed. Rsrv. Sys., Financial Reform: How Far Are We? 20 (July 10, 2014), http://www.federalreserve.gov/newsevents/speech/fischer20140710a.pdf [https://perma.cc/JK2P-P5RJ]. Indeed, there is some evidence suggesting the existence of "too many to fail" guarantees, in the same way that there are TBTF guarantees, whereby "lending firms"—depository institutions, savings and loans firms, mortgage lenders, and credit card companies—construct portfolios that are "significantly more concentrated" than the financial market as a whole in the expectation that this correlation could result in a bailout. *See* Sharon Blei & Bakhodir Ergashev, *Asset Commonality and Systemic Risk Among Large Banks in the United States* 11 (Off. of the Comptroller of the Currency Economics Working Paper No. 2014-3, 2014). For an extensive discussion of the "too many to fail" phenomenon in the community banking context, see Jeremy C. Kress & Matthew C. Turk, *Too Many to Fail: Against Community Bank Deregulation*, 115 NW. U. L. REV. 647 (2020).

208. *Systemic Risk Regulation Hearing*, *supra* note 13, at 77 (prepared statement of Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System).

209. *See id.* at 10.

210. OFF. OF INSPECTOR GEN., U.S. DEP'T OF THE TREASURY, OIG-09-032, SAFETY AND SOUNDNESS: MATERIAL LOSS REVIEW OF INDYMAC BANK, FSB 1 (2009).

211. *Id.* at 2.

212. *See id.* at 1.

213. *See infra* notes 278–279 and accompanying text.

activities are important services for clients and increase the banks' interconnectedness with other financial institutions.[214] Nonetheless, the GSIB surcharge underestimates the risks created by the highly concentrated nature of these and other critical payment services by capping the "substitutability" indicator that applies to such activities.[215] In addition, like any other GSIB, custody banks are BHCs that engage in "shadow banking" functions that experienced stress during the GFC, requiring public support. For example, BNY Mellon was required to support at least five of its MMFs, resulting in a $425 million after-tax loss.[216] State Street's off-balance-sheet SPVs that held asset-backed commercial paper deteriorated during the GFC, leading to a 60 percent drop in the bank's stock price and requiring the bank to transfer the conduits back onto its balance sheet for support.[217] Indeed, custody banks received significant assistance from GFC-era support programs, including the FDIC's Temporary Liquidity Guarantee Program.[218] During the early onset of the COVID-19 crisis, BNY Mellon again purchased $1.2 billion in assets from one of the MMFs that it sponsors, in order to ensure that the fund had sufficient liquidity to meet $6 billion in customer redemptions.[219]

Even before the GFC, experience has shown that handling "safe" assets can be vulnerable to operational risk, a particularly

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214. *See* MERAJ ALLAHRAKHA ET AL., DEP'T OF THE TREASURY, OFF. OF FIN. RSCH., OFR BRIEF SERIES NO. 15-01, SYSTEMIC IMPORTANCE INDICATORS FOR 33 U.S. BANK HOLDING COMPANIES: AN OVERVIEW OF RECENT DATA (2015).

215. *See* Regulatory Capital Rules: Implementation of Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies, 80 Fed. Reg. 49,082, 49,084 (Aug. 14, 2015) (to be codified at 12 C.F.R. pts. 208, 217).

216. *See* FIN. CRISIS INQUIRY COMM'N, *supra* note 68, at 357.

217. *See* Raj Date, Cambridge Winter Ctr. on Fin. Inst. Pol'y, Test Case on the Charles: State Street and the Volcker Rule 7–9, (June 12, 2010) (unpublished manuscript) (on file with author). It is important to note that State Street "did not face a liquidity run, however, in major part because of pre-existing funding backstops provided by the Fed's Commercial Paper Funding Facility (CPFF) and the FDIC's Term Liquidity Guarantee Program (TLGP), coupled with taxpayer-supplied capital through the [Troubled Asset Relief Program] and a post- 'stress test' private market equity raise." *Id.* at 9.

218. *See* Martin J. Gruenberg, Member, Bd. of Dirs., Fed. Deposit Ins. Corp., FDIC Revisions to the Supplementary Leverage Ratio Capital Rule for Custody Banks (Mar. 29, 2019), https://www.fdic.gov/news/speeches/2019/spmar2919c.html [https://perma.cc/DXB2-MSH5].

219. *See* Richard Henderson & Robert Armstrong, *BNY Mellon Steps in to Support Money Market Fund After Outflows*, FIN. TIMES (Mar. 20, 2020), https://www.ft.com/content/8222c5a2-6ad3-11ea-800d-da70cff6e4d3 [https://perma.cc/S44X-6U5U].

relevant risk for custody banks. In 1985, for example, BNY Mellon "received a $23 billion discount-window loan from the Federal Reserve after an operational failure left the firm unable to redeliver securities it had received as an intermediary from other institutions."[220] All these risks could potentially come into play again in the future, for example, with the growing footprint of BNY Mellon as a clearing bank in the triparty Treasury repo market.[221] Specifically, the risks of custody activities may become even more apparent with the growth in popularity and proliferation of cryptocurrency and digital asset custody services.[222]

Perhaps most vexing, tailoring proponents have adopted contradictory narratives regarding the sources of financial risks. In arguing against more stringent enhanced prudential standards, tailoring advocates frame traditional lending, deposit taking, and the like as plain vanilla banking activities unworthy of enhanced scrutiny or protection, while capital markets activities are framed as inherently risky.[223] When trading regulations are at issue, however, tailoring proponents argue that traditional banking activities like lending are in fact the greatest sources of risk.[224]

220. DEP'T OF THE TREASURY, OFF. OF FIN. RSCH., OFR VIEWPOINT SERIES NO. 17-04, SIZE ALONE IS NOT SUFFICIENT TO IDENTIFY SYSTEMICALLY IMPORTANT BANKS 8 (2017).

221. *See* FIN. STABILITY OVERSIGHT COUNCIL, 2018 ANNUAL REPORT 110 (2018) ("[A] temporary service disruption [at BNY Mellon], such as an operational failure, could impair the [Treasury repo] market, as participants may not have a ready alternative platform to clear and settle these transactions.").

222. *See generally* Saule T. Omarova, *New Tech vs. New Deal: Fintech as a Systemic Phenomenon*, 36 YALE J. ON REG. 735, 775–82 (2019).

223. *See, e.g.*, *Examining the Dangers of the FSOC's Designation Process and Its Impact on the U.S. Financial System: Hearing Before the H. Comm. on Fin. Servs.*, 113th Cong. app. at 115–17 (2014) (prepared statement of Deron Smithy, Treasurer, Regions Bank, on behalf of the Regional Bank Coalition).

224. *See, e.g.*, Douglas Holtz-Eakin & Thomas Wade, Am. Action. F., Comment Letter on the Proposed Revisions to Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds (Sept. 4, 2018), https://www.sec.gov/comments/s7-14-18/s71418-4299960-173206.pdf [https://perma.cc/42BD-AUVN] ("[T]he crisis was caused by banks acting in their primary capacity as lenders of credit (albeit on poor risk assumptions) and not as a result of securities trading. Virtually every financial crisis in history has been a lending-related crisis."). In another irony, the illiquidity of traditional loans is cited as one reason that they are riskier than trading assets, and yet liquidity rules were tailored, reducing or otherwise exempting large BHCs that primarily hold illiquid loans from the LCR requirements. *See* Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements, 84 Fed. Reg. 59,230 (Nov. 1, 2019) (to be codified at 12 C.F.R. pt. 324, 329).

In addition, systemic events originate from all manner of endogenous and exogenous sources, very few of which are foreseeable.[225] Public support for the banking system has been required to address wars,[226] volatile oil prices,[227] foreign currency fluctuations,[228] the 9/11 terrorist attacks,[229] and now a global pandemic. We have not yet even begun to feel the full range of potential impacts of climate change.[230] Rather than deregulating most activities, as has largely been the approach under the tailoring regime, the appropriate conclusion is that many financial activities carry inherent risks and should, therefore, be subject to both stringent regulation and supervision.

3. Tailoring Distorts the Costs and Benefits of Financial Regulation

In evaluating the efficiency of financial rules, tailoring as an ideological frame prioritizes the status quo ante by treating banks' structures and business models as structures that regulations must be crafted to fit around. For example, when the banking agencies initially finalized their inter-affiliate margin rule, they acknowledged that requiring banks to collect margin from affiliates might affect market participants' incentives and behavior.[231] Rather than allowing time for banks' behavior to

225. *See* PERRY MEHRLING, THE NEW LOMBARD STREET: HOW THE FED BECAME THE DEALER OF LAST RESORT 20 (2011); *see also* Tarullo, *supra* note 24, at 4.

226. *See* Hauser, *supra* note 186, at 5 (noting that central banks intervened during World War I, World War II, and the Vietnam War).

227. *See* Brian Lamm & John O'Keefe, *Banking Problems in the Southwest*, *in* 1 FED. DEPOSIT INS. CORP., HISTORY OF THE EIGHTIES: LESSONS FOR THE FUTURE 291, 292 (1997) (describing oil as the "primary force" behind the banking crisis in Texas in the 1980s).

228. *See* Franklin R. Edwards, *Hedge Funds and the Collapse of Long-Term Capital Management*, 13 J. ECON. PERSPS. 189, 199–200 (1999) (documenting the failure of hedge funds' long-term capital management as a result of an Asian debt crisis, and the involvement of the Federal Reserve Bank of New York).

229. *See* ARTHUR E. WILMARTH, JR., TAMING THE MEGABANKS: WHY WE NEED A NEW GLASS-STEAGALL ACT 184 (2020) (noting the Fed purchased $150 billion in government bonds and extended $45 billion in discount window loans to help stabilize the U.S. banking system in the wake of the attacks of September 11, 2001).

230. *See generally* Graham S. Steele, *Confronting the "Climate Lehman Moment": The Case for Macroprudential Climate Regulation*, 30 CORNELL J. L. & PUB. POL'Y 109 (2020).

231. *See* Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74,840, 74,893 (Nov. 30, 2015) (to be codified at 12 C.F.R. pts. 45, 237, 349, 624, 1221) ("It is likely that the behavior of swap market participants, including

change in advantageous ways by potentially reducing the margin required due to fewer inter-affiliate swaps trades subject to the bank swap rules, regulators backtracked within just four years. In doing so, they argued that the initial margin requirement was driving banks to borrow "increasing amounts of cash in the debt markets to fund eligible collateral, placing additional demands on their asset-liability management structure."[232] Instead of viewing this as evidence that inter-affiliate trades had been under-margined prior to the 2015 rule and that any concerns about excessive borrowing to meet margin calls could be limited using capital and leverage rules, regulators quickly acquiesced to industry demands to reduce margin requirements.

Indeed, such activities-based regulations offer BHCs a choice: if they want to deal in derivatives, engage in proprietary trading, or sponsor private equity and hedge funds, then they are subjected to stringent prudential rules like margin and capital. At the same time, if banks want to achieve regulatory "relief," they are able do so by reducing their participation in risky activities. This provides banks with incentives to simplify or become, for lack of a better term, "boring." Rather than targeting regulations at these nominally risky activities, however, the tailoring regime exempted many BHCs from more stringent regulations altogether.

A similar dynamic can be seen in the arguments made against higher capital and leverage standards. In these cases, opponents often acknowledge that BHCs with more stable funding better serve their proper function as financial intermediaries throughout the credit cycle. However, these arguments instead begin with the interests of bank shareholders as a foundational concern and therefore exclude sacrificing banks' return-on-equity (ROE) as a *prima facie* unacceptable solution.[233] As a

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affiliate counterparties, will respond to incentives created by these swap margin requirements. Such changes could have a dramatic effect on the pattern of affiliate swap transactions which would itself have a significant impact on the amounts of initial margin that are ultimately collected on inter-affiliate transactions.").

232. Margin and Capital Requirements for Covered Swap Entities, 84 Fed. Reg. 59,970, 59,976 (proposed Nov. 7, 2019) (to be codified at 12 C.F.R. pts. 45, 237, 349, 634, 1221).

233. *See, e.g.*, Darrell Duffie, *Still the World's Safe Haven? Redesigning the U.S. Treasury Market After the COVID-19 Crisis* 3 (2020) (Hutchins Ctr. on Fiscal & Monetary Pol'y, Working Paper No. 62, 2020) ("To intermediate the large expected increases in U.S. Treasury trade volumes using the current market design, bank holding companies would need to substantially increase their capital commitments to Treasury market intermediation. Bank holding company shareholders,

descriptive matter, it is true that ROE is "deeply imbedded in the culture of banking."[234] From a normative perspective, however, even skeptics acknowledge that the social benefits of more robust capital and leverage ratios may outweigh the costs.[235] Indeed, the Federal Reserve Bank of Minneapolis weighed the potential costs to society of higher capital against the harm inflicted by financial crises and concluded that a significantly more robust capital ratio "will have paid for itself many times over if it avoids one financial crisis."[236] The logic of tailoring, therefore, centers concerns about private costs, as measured by forgone profits, above the societal benefits of a well-functioning banking system.[237]

4. Tailoring Has Resulted in the Deregulation of BHCs of *All* Sizes

While tailored regulations resulted in large BHCs using more leverage and having less capital on net, they have not been framed as deregulation. Such efforts rarely are. Financial deregulation, a generally politically unpopular undertaking after the GFC,[238] is more often presented as reducing the complexity and

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however, would not benefit from this commitment of capital unless intermediation rents rise sufficiently through a widening of bid-offer spreads. The resulting illiquidity, or episodes of illiquidity, and elevated yield volatility, would adversely impact the prices of Treasuries—not a good outcome for U.S. taxpayers.").

234. ANAT ADMATI & MARTIN HELLWIG, THE BANKERS' NEW CLOTHES: WHAT'S WRONG WITH BANKING AND WHAT TO DO ABOUT IT 115 (2013).

235. *See, e.g.*, Robin Greenwood et al., *The Federal Reserve's Balance Sheet as a Financial-Stability Tool*, *in* PROCEEDINGS FROM THE 2016 JACKSON HOLE ECONOMIC SYMPOSIUM 380 (2016), https://www.kansascityfed.org/documents/7041/steingreenwoodhanson_JH2016.pdf [https://perma.cc/X938-FHA8]; David Aikman et al., *Rethinking Financial Stability* 14 (Bank of Eng., Staff Working Paper No. 712, 2018) ("[I]t was plausibly the case that pre-crisis liquidity may have been too plentiful and too cheap in some financial markets, so some correction in the quantity and pricing of liquidity was to be expected, and indeed was potentially desirable, from a welfare perspective.").

236. FED. RSVR. BANK OF MINNEAPOLIS, THE MINNEAPOLIS PLAN TO END TOO BIG TO FAIL 50–51 (2017).

237. As Jedediah Britton-Purdy and colleagues note, cost and benefits are inherently difficult to measure outside of a pure "wealth maximizing" framework. Britton-Purdy et al., *supra* note 189, at 1797.

238. *See, e.g.*, Claire Williams, *Polling Suggests Support Among Voters for Harsher Wall Street Messaging*, MORNING CONSULT (Dec. 7, 2018, 12:01 AM), https://morningconsult.com/2018/12/07/polling-suggests-support-among-voters-for-harsher-wall-street-messaging [https://perma.cc/96WW-9RM5] (finding that 58 percent of registered voters in one poll strongly or somewhat support more government regulation and oversight of some large banks, while 20 percent of voters either

improving the efficiency of rules. Adding to potential confusion about their impacts, many of these rules are indeed complex to begin with. Ironically for an effort that is nominally meant to streamline and simplify bank regulations, the changes brought about by tailoring have been highly technical. In reality, post-EGRRCPA financial regulation has had an "apparently exclusive focus . . . on deregulatory measures,"[239] consistently weakening the standards that bind the largest BHCs.

For example, the changes to the thresholds for application of enhanced prudential standards were expected to lower the amount of capital at large BHCs by $9 billion and the amount of HQLA held by such institutions by $201 billion.[240] The latter change made it possible for banks to invest funds that were previously allocated to Treasuries, cash, and reserves into higher yielding assets or return those funds to shareholders. Similarly, the relaxation of inter-affiliate margin rules also made it possible for bank-affiliated dealers to either reallocate approximately $39.4 billion in cash and "safe" asset collateral into higher yielding assets or distribute it to shareholders.[241]

The GSIB surcharge levels, announced in the summer of 2020, also showed an average decrease of 6.7 percent from the 2015 numbers.[242] Under a favorable interpretation, the surcharge could have encouraged GSIBs to reduce their risk profiles. Research by Fed staff suggests, however, that the changes may reflect financial engineering and gaming of reporting conventions.[243] Namely, GSIBs began using tactics known as

somewhat or strongly opposed additional oversight). Of course, there is significant literature concluding that financial regulation tends to be more responsive to the interests of the regulated industry than those of the public. *See, e.g.*, Kimberly D. Krawiec, *Don't "Screw Joe the Plummer": The Sausage-Making of Financial Reform*, 55 ARIZ. L. REV. 53 (2013).

239. Tarullo, *supra* note 40, at 79.

240. *See* Press Release, Bd. of Governors of the Fed. Rsrv. Sys., *supra* note 196.

241. *See* Tara Kruse, Int'l Swaps & Derivatives Ass'n, Inc., Comment Letter on Proposed Rule Regarding Margin and Capital Requirements for Covered Swap Entities 4 (Dec. 9, 2019), https://www.fdic.gov/resources/regulations/federal-register-publications/2019/2019-margin-capital-requirements-covered-swap-entities-3064-af08-c-005.pdf [https://perma.cc/8SSU-6MKD].

242. *See infra* Table 2. This is somewhat offset by the fact that BNY Mellon's surcharge has increased; however, based on the relative size of GSIBs' balance sheets, the decreases for the largest GSIBs likely mean there was a greater impact in terms of tangible capital levels than these percentages reflect.

243. *See* Jared Berry et al., *How Do U.S. Global Systemically Important Banks Lower Their Capital Surcharges?*, BD. OF GOVERNORS OF THE FED. RSRV. SYS. (Jan. 31, 2020), https://www.federalreserve.gov/econres/notes/feds-notes/how-do-us-

"window dressing" to manage their balance sheets around reporting dates and accounting conventions in order to reduce the size of their exposure to over-the-counter (OTC) derivatives books, thereby lowering their surcharge scores, as seen in Table 2.[244]

Table 2: U.S. GSIB Surcharges Over Time[245]

GSIB	**2015**	**2020**	**Percent Change**
BNY Mellon	1%	1.5%	+ 50%
State Street	1.5%	1%	- 33%
Wells Fargo	2%	2%	—
Morgan Stanley	3%	3%	—
Goldman Sachs	3%	2.5%	- 17%
Bank of America	3%	2.5%	- 17%
Citigroup	3.5%	3%	- 14%
JPMorgan Chase	4.5%	3.5%	- 22%
Mean			**- 6.7%**

Like the reduced GSIB scores, the applicable regulatory ratios under the SCB regime reported in 2020 and 2021 superficially suggest that GSIBs are subject to substantially higher minimum capital levels, as seen in Table 3. Again, a deeper analysis of the effective impacts of the accumulation of rules changes on tangible capital demonstrates that the cumulative impact of these revisions has meant less *actual* capital across large BHCs.

global-systemically-important-banks-lower-their-capital-surcharges-20200131.htm [https://perma.cc/GZA2-T6GV].

244. *See id.* For other examples of the impacts of GSIBs' business decisions on GSIB surcharge scores, see Zach Fox & Francis Garrido, *Systemically Important Banks Increase Cross-Border Exposures*, S&P GLOB.: MKT. INTEL. (Nov. 12, 2018, 9:56 AM), https://platform.mi.spglobal.com/web/client?auth=inherit#news/article?id=47534821&cdid=A-47534821-12333 [https://perma.cc/XU58-M4E5].

245. *See* 80 Fed. Reg. at 49,087, 49,109; *see also* Press Release, Bd. of Governors of the Fed. Rsrv. Sys., Federal Reserve Board Announces Individual Large Bank Capital Requirements, Which Will Be Effective on October 1, Aug. 10, 2020, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200810a.htm [https://perma.cc/K5MW-T4L2].

Table 3: U.S. GSIB Equity Ratios Over Time[246]

GSIB	2015	2020	2021
BNY Mellon	8.0%	8.5%	8.5%
State Street	8.5%	8.0%	8.0%
Wells Fargo	9.0%	9.0%	9.6%
Morgan Stanley	10.0%	13.2%	13.2%
Goldman Sachs	10.0%	13.6%	13.4%
Bank of America	10.0%	9.5%	9.5%
Citigroup	10.5%	10.0%	10.5%
JPMorgan Chase	11.5%	11.3%	11.2%

For example, the proposal to replace the eSLR with a tailored leverage surcharge would lower the amount of capital at the GSIBs by $9 billion immediately,[247] and up to $86 billion over time.[248] Importantly, it would also lower the amount of capital at GSIBs' bank subsidiaries by $121 billion.[249] Finalizing the SCB rule proposal resulted in an approximately $100 billion reduction in Tier 1 Capital requirements for the largest BHCs and an estimated $120 billion reduction in the actual amount of CET1 at large BHCs.[250] Finally, excluding treasuries and central bank deposits from the eSLR reduced the amount of capital

246. *See* 80 Fed. Reg. at 49,087, 49,109; *see also* Press Release, Bd. of Governors of the Fed. Rsrv. Sys., *supra* note 245; Bd. of Governors of the Fed. Rsrv. Sys., Large Bank Capital Requirements, Aug. 2021, https://www.federalreserve.gov/publications/files/large-bank-capital-requirements-20210805.pdf [https://perma.cc/XRH3-HMKS]. The 2015 ratio is the sum of the CET1 ratio, the static capital buffer, and the Method 2 Surcharge. The 2020 and 2021 ratios are the sums of the CET1 ratio, the SCB, and the Method 2 Surcharge.

247. *See* Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards and Total Loss-Absorbing Capacity Requirements for U.S. Global Systemically Important Bank Holding Companies, 83 Fed. Reg. 17,317, 17,321 (proposed Apr. 19, 2018) (to be codified at 12 C.F.R. pts. 6, 208, 217, 252).

248. *See* Peter Eavis, *Washington Wants to Weaken Bank Rules. Not Every Regulator Agrees.*, N.Y. TIMES (Apr. 24, 2018), https://www.nytimes.com/2018/04/24/business/dealbook/bank-rules-leverage-ratio.html [https://perma.cc/D7ZR-FGNG] ("Capital required for eight large banks under the proposed leverage ratios is around $86 billion less than the amount demanded at the 5 percent level . . . .").

249. *See* Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards and Total Loss-Absorbing Capacity Requirements for U.S. Global Systemically Important Bank Holding Companies, 83 Fed. Reg. at 17,321.

250. *See* Press Release, Bd. of Governors of the Fed. Rsrv. Sys., Statement by Governor Brainard (Mar. 4, 2020), https://www.federalreserve.gov/newsevents/pressreleases/brainard-statement-20200304a.htm [https://perma.cc/P33D-ZKEX].

required to meet the leverage ratio by an estimated $76 billion and allowed for up $1.6 trillion in additional leverage exposure.[251]

Table 4: Estimated Cumulative Impacts of Selected Tailoring Measures[252]

Final Rules, Proposed Rules & Other Relief, 2017–20 ($ Billions)

Regulation	Holding Co.	IDI
Capital Relief		
EPS Threshold (Capital)	-$11.5	—
SCB	-$105	—
eSLR – Custody Bank	-$8	-$8
eSLR – Proposal	-$9	-$121
eSLR – COVID	-$17	-$55
TOTAL	**-$150.5**	**-$184**
Assets Exempted		
EPS Threshold (Liquidity)	$201	—
Inter-Affiliate Margin Rule	—	$40
eSLR – COVID	-$1,600	-$1,200
TOTAL	**-$1,801**	**-$1,240**

251. Temporary Exclusion of U.S. Treasury Securities and Deposits at Federal Reserve Banks from the Supplementary Leverage Ratio, 85 Fed. Reg. 20,580 & n.8 (Apr. 14, 2020) (to be codified at 12 C.F.R. pt. 217); *see also* Zach Fox & Zuhaib Gull, *Regulatory Relief Erases $1 Trillion of Exposures from 6 Banks*, S&P GLOB.: MKT. INTEL. (July 30, 2020), https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/regulatory-relief-erases-1-trillion-of-exposures-from-6-banks-59675565 [https://perma.cc/M4WR-5HLW] (reporting that a total of over $1.7 trillion in assets were excluded from the leverage ratio denominators of the thirty-four largest banks, and that those banks had an additional $125 billion in capital available).

252. *See* Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards and Total Loss-Absorbing Capacity Requirements for U.S. Global Systemically Important Bank Holding Companies, 83 Fed. Reg. at 17,321; *see also* Press Release, Bd. of Governors of the Fed. Rsrv. Sys., Statement by Governor Brainard, *supra* note 250; Temporary Exclusion of U.S. Treasury Securities and Deposits at Federal Reserve Banks from the Supplementary Leverage Ratio, 85 Fed. Reg. at 20,580; Press Release, Bd. of Governors of the Fed. Rsrv. Sys., *supra* note 194; Kruse, Comment Letter on Proposed Rule Regarding Margin and Capital Requirements for Covered Swap Entities, *supra* note 241; Regulatory Capital Rule: Revisions to the Supplementary Leverage Ratio to Exclude Certain Central Bank Deposits, 85 Fed. Reg. at 4,575.

Overall, the cumulative impact of regulatory tailoring resulted in lower minimum capital and leverage requirements and fewer assets subject to stringent risk controls. It lowered minimum capital by $150 billion and leverage requirements by $1.8 trillion at the holding company level and $184 billion and $1.24 trillion, respectively, at the IDI subsidiary.

As the figures in Table 4 demonstrate, tailoring has not been a value-neutral proposition about right-sizing regulation. Instead, tailoring efforts have resulted in substantial relaxation of the post-GFC macroprudential framework. One former Fed policymaker describes this dynamic as a "kind of low-intensity deregulation, consisting of an accumulation of non-headline-grabbing changes."[253] While ostensibly requiring an increased focus on the most systemic BHCs, GSIBs have also enjoyed the deregulatory benefits of tailoring.

5. Tailoring Has Failed to Achieve Its Stated Policy Goals

The case for tailoring also rests upon the argument that deregulation will result in more lending, thereby leading to more economic growth and, by extension, jobs for working people.[254] Leaving aside the question of whether merely increasing the supply of credit is a sound approach to economic policy,[255] tailoring proponents have failed to establish the basic premise that less regulation will inherently result in more lending.[256]

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253. Tarullo, *supra* note 57, at 3.

254. *See* U.S. DEP'T OF THE TREASURY, *supra* note 1, at 43 ("Regulatory requirements have increased the costs of providing services to consumers, steered lenders away from certain forms of lending, and otherwise impeded the efficient allocation of credit with improperly tailored regulation."); *see also* Smithy, *supra* note 223, at 5 ("[Dodd-Frank's rules] weigh on our ability to operate competitively and could force us to curtail our primary activity . . . serving retail customers and making consumer and commercial loans to small businesses and midsize firms."); Resolution Plans Required, 84 Fed. Reg. 21,600, 21,617–18 (proposed May 14, 2019) (to be codified at 12 C.F.R. pt. 243, 381) (estimating 1,137,797 person hours, potentially costing an estimated $39,922,958 in wages, required to prepare living wills and arguing that "firms could reallocate the 712,274 hours used to comply with the Rule to other activities considered to be more beneficial").

255. *See* Abbye Atkinson, *Borrowing Equality*, 120 COLUM. L. REV. 1403 (2020).

256. In fact, excessive credit is not helpful to society, and financial bubbles often lead to crisis. For more on the phenomenon of deregulation as "regulatory stimulus," see Erik F. Gerding, *Against Regulatory Stimulus*, 83 LAW & CONTEMP. PROBS. 49 (2020).

Tailoring came at a time when it had never been more profitable to be a banker. The financial sector enjoyed record earnings during 2018 and 2019,[257] which briefly declined during the early onset of the COVID-19 pandemic in 2020 before quickly recovering early in 2021.[258] These profits should have supplied banks with ample capital that they could use to support more lending; yet loan-to-deposit ratios across the banking industry remained largely level throughout 2018 and the first half of 2019, after which point loan-to-deposit ratios fell quarter-over-quarter through the fourth quarter of 2020.[259]

In addition, were it not for the PPP, banks' business lending would have declined in 2020.[260] Indeed, because the bulk of PPP loans were issued by smaller banks, GSIBs' lending did in fact decline during the second and third quarters of 2020.[261] At the same time, holdings of cash and other safe assets increased by $1.1 trillion across the twenty-five largest BHCs, comprising 35

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257. *See* Jesse Hamilton, *Banks Crushed Profit Record with $237 Billion in 2018, FDIC Says*, BLOOMBERG (Feb. 21, 2019, 12:00 PM), https://www.bloomberg.com/news/articles/2019-02-21/banks-crushed-profit-record-with-237-billion-in-2018-fdic-says [https://perma.cc/URU7-2GUW]; *see also* Ken Sweet, *Banks Made $233.1 Billion in Profits in 2019, Regulator Says*, AP NEWS (Feb. 25, 2020), https://apnews.com/article/3db9cc9c6ffcc083a5f57cb122a5e937 [https://perma.cc/HC6T-ZJ73]. While some of this record profitability is likely attributable to deregulation, other factors like the Tax Cuts and Jobs Act of 2017 likely contributed by lowering banks' effective tax rates. *See* Yalman Onaran, *Trump Tax Cut Hands $32 Billion Windfall to America's Top Banks*, BLOOMBERG (Jan. 16, 2020, 10:12 AM), https://www.bloomberg.com/news/articles/2020-01-16/trump-tax-cut-hands-32-billion-windfall-to-america-s-top-banks [https://perma.cc/XYF8-T26X].

258. *See Profits at America's Banks Are Sky-High*, ECONOMIST (Apr. 17, 2021), https://www.economist.com/finance-and-economics/2021/04/17/profits-at-americas-banks-are-sky-high [https://perma.cc/7RP9-5RWE]. Nevertheless, during his bank's first-quarter earnings call, one bank CEO reportedly "lamented how much time his bank had dedicated to discussing the alphabet soup of regulations now levied on big lenders' balance-sheets, from CECL (current expected credit losses), to the SLR (supplemental leverage ratio) and the G-SIFI surcharge (an extra capital charge for global systemically important financial institutions)." *Id.*

259. Carolyn Duren & Ali Shayan Sikander, *Loan-to-Deposit Ratios Keep Sliding at US Banks*, S&P GLOB.: MKT. INTEL. (June 14, 2021), https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/loan-to-deposit-ratios-keep-sliding-at-us-banks-64816545 [https://perma.cc/W48X-LS38].

260. BD. OF GOVERNORS OF THE FED. RSRV. SYS., SUPERVISION AND REGULATION REPORT 8 (2021).

261. Abboud et al., *supra* note 34, at 25. Although community banks make up only 15 percent of banking industry assets and 12 percent of banking industry loans, they accounted for 31 percent of PPP loans made by banks. Margaret Hanrahan & Angela Hinton, *The Importance of Community Banks in Paycheck Protection Program Lending*, 14 FDIC Q., no. 4, 2020, at 31.

percent of their combined balance sheets—the largest share dating back to 1985[262]—as their ratio of loans to deposits fell to just shy of 46 percent, the lowest point in almost thirty-six years.[263] During this period, lending through large BHCs' wealth management arms increased 17.5 percent from a year earlier to nearly $600 billion.[264]

What became of the efficiencies gained from tailoring bank regulations? One explanation is that the recent windfalls for the biggest banks translated into payouts for shareholders. In 2018 and 2019, and even during the onset of the pandemic in 2020, GSIBs' shareholder payouts exceeded 100 percent of their net income.[265] A consequence of this trend was the depletion of large banks' capital base. Again, this capital was no longer available to support more lending during ordinary times and especially during the pandemic. Indeed, the Fed's dividend cap policy implemented in June 2020 allowed large BHCs to continue distributing their capital to shareholders at a time of great uncertainty, potentially hampering their ability to support the broader

262. Shahien Nasiripour & Christopher Maloney, *Biggest U.S. Banks Keep Assets at Safest Level in 35 Years*, BLOOMBERG, https://www.bloomberg.com/news/articles/2020-10-09/biggest-u-s-banks-keep-their-assets-at-safest-level-in-35-years [https://perma.cc/TD7H-65Q4] (Oct. 9, 2020, 6:44 AM).

263. Shahien Nasiripour, *Biggest U.S. Banks Keep Lending Less and Less of Their Money*, BLOOMBERG (Feb. 8, 2021, 2:36 PM), https://www.bloomberg.com/news/articles/2021-02-08/biggest-u-s-banks-keep-lending-less-and-less-of-their-money [https://perma.cc/8LYQ-Y3PS]. This outcome is the result of both a decline in lending as well as an increase in customer deposits. *See* Duren & Sikander, *supra* note 259. Regarding the latter factor, banks began turning away or otherwise managing customer deposit movements in a remarkable statement about their financial capacity and ability to provide a basic banking service. *See* Nina Trentmann & David Benoit, *Banks to Companies: No More Deposits, Please*, WALL ST. J. (June 9, 2021, 7:30 AM), https://www.wsj.com/articles/banks-to-companies-no-more-deposits-please-11623238200 [https://perma.cc/KD7A-K7Z5].

264. Joshua Franklin & Imani Moise, *Wall Street Doubles Down on Lending 'Cheap Money' to the Rich*, FIN. TIMES (July 24, 2021), https://www.ft.com/content/8a328af4-b8f2-48c5-82a9-d7dc1c345e1c [https://perma.cc/RX35-D7LR].

265. *See* FIN. STABILITY OVERSIGHT COUNCIL, *supra* note 143, at 80 (total capital distributions at U.S. GSIBs "were close to 100 percent of the net income available to common equity in 2018 and exceeded 100 percent in 2019" and payout rates in the first quarter of 2020 "were substantially above 100 percent of net income"); *see also* Lisa Lee & Shahien Nasiripour, *Bank Dividends in Peril With Crisis Veterans Warning of Trouble*, BLOOMBERG (June 24, 2020, 5:00 AM), https://www.bloomberg.com/news/articles/2020-06-24/bank-dividends-in-peril-with-crisis-veterans-warning-of-trouble [https://perma.cc/88LR-R7NN] (indicating the four largest U.S. GSIBs made $343.1 billion in capital distributions from the beginning of 2017 through the first quarter of 2020).

economy.[266] It is therefore reasonable to question whether the real goal of tailoring was greater shareholder distributions that would increase banks' franchise values.

Even taking policymakers and bankers at their word, tailoring as a project has failed according to its own terms. It has not led to more lending that, in turn, might have resulted in more economic growth, jobs, and widely shared prosperity.

B. *Preventing Panics and Crises Requires a "Precautionary Approach" to Bank Regulation*

Deregulation is not the inevitable interpretation of the meaning of tailoring. Indeed, the prior approach to macroprudential regulation raised prudential standards for larger BHCs rather than merely lowering the standards for smaller ones.[267] Instead of the current tailored approach, a more effective approach to macroprudential regulation would prioritize stable financial markets ahead of the narrow interests of private executives and shareholders. Macroprudential policymakers should pursue a "precautionary approach" to financial stability, implementing robust enhanced prudential standards rather than narrowly tailored, technocratic rules.[268] The "precautionary approach" would apply progressive macroprudential rules to a broader class of BHCs than those believed by regulators to be "systemically important,"[269] and it would impose a more robust

266. *See* Press Release, Lael Brainard, Member, Bd. of the Governors of the Fed. Rsrv. Sys., Statement by Governor Brainard (June 25, 2020), https://www.federalreserve.gov/newsevents/pressreleases/brainard-statement-20200625c.htm [https://perma.cc/WA9X-V9FZ].

267. *See supra* Table 1.

268. *See* Hilary J. Allen, *A New Philosophy for Financial Stability Regulation*, 45 LOY. U. CHI. L.J. 173, 196 (2013) (arguing for a precautionary approach that "would accept that maintaining a stable financial system greatly benefits society and that the fiscal and monetary remedies available after a crisis are costly, while acknowledging that neither of these can be accurately reflected as a dollar amount" as weighed against the "costs of the regulation, both in terms of immediate quantifiable short-term costs and long-term unquantifiable costs in the sense of foregone benefits (the latter of which should also be considered from a precautionary perspective)"); *see also id.* at 206 ("The precautionary principle, rather than strict cost-benefit analysis, is therefore more likely to overcome the cognitive biases that unduly focus regulator attention on the short-term, and thus cause financial regulators to adopt the long-term and wide-view approach necessary to the regulation of an ever-evolving financial system.").

269. *See supra* note 6 and accompanying text.

set of capital and leverage requirements than those required by the current stress testing and SCB regimes.

1. Tiering, Not Tailoring

The architect of the first iteration of the Fed's bank regulation framework has articulated a "tiering principle" for macroprudential regulation. In this approach, "prudential regulation should vary with the size and systemic importance of banking organizations, based on the magnitude of the negative externalities" resulting from their financial distress.[270] Reviving this vision of tiering—through progressively increasing standards beginning with large regional BHCs[271]—would better incorporate the important lessons learned during a variety of crisis events dating back almost four decades.

The legislative history of Dodd-Frank reflects a level of humility regarding the identification and mitigation of systemic risk, as well as the potential benefits that are conferred upon BHCs with the perception that they may be TBTF. The committee report for the Senate-passed precursor to Dodd-Frank states that it imposed a $50 billion threshold for macroprudential standards because the "graduated approach to the application of the heightened prudential standards is intended to *avoid identification of any bank holding company as systemically significant.*"[272] While "some at the higher end of this range may have

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270. Tarullo, *supra* note 40, at 64.

271. *See supra* notes 77–81 and accompanying text.

272. S. REP. NO. 111-176, at 2 (2010) (emphasis added). This view has been reinforced by Fed policymakers. *See* Daniel K. Tarullo, Member, Bd. of the Governors of the Fed. Rsrv. Sys., Regulating Systemic Risk 7 (Mar. 31, 2011), http://www.federalreserve.gov/newsevents/speech/tarullo20110331a.pdf [https://perma.cc/FJ3A-29Q3] ("During the legislative debate, a question was raised as to whether identification of institutions as systemically important would itself exacerbate moral hazard. The worry was that markets would regard such identification as confirmation that the government did indeed regard a firm as too-big-to-fail. Part of the rationale for setting the statutory standard of $50 billion in assets for bank-affiliated firms was that the failure of some of these firms, while likely to cause some noticeable disruptions in financial relationships, would not be regarded as necessarily endangering the financial system. Any link between the list of firms and TBTF is thereby attenuated."); *see also* Definitions of "Predominantly Engaged In Financial Activities" and "Significant" Nonbank Financial Company and Bank Holding Company, 78 Fed. Reg. 20,756, 20,774 (Apr. 5, 2013) (to be codified at 12 C.F.R. 242) ("Congress established $50 billion in total consolidated assets as the threshold (without an inflation adjustment) at which bank holding companies should be subject to enhanced prudential supervision *without any special*

a large enough systemic footprint that their stress or failure could have material effects on the rest of the financial system," it was also the case that "[i]f a number of these banks simultaneously came under pressure or failed, a harmful contraction of credit availability in significant regions or sectors of the economy could ensue, even if there were little chance of a financial crisis."[273] Enhanced prudential standards were therefore originally intended—and indeed may still be appropriate—for BHCs whose failure, in isolation, might not necessarily be expected to endanger the financial system.

This approach made sense in light of the widespread distress experienced by regional banking institutions during the GFC—some as a result of their own risky investments, and others as a result of the broader instability in the banking system.[274] Following the example of IndyMac mentioned above, the commercial banks Wachovia and Washington Mutual experienced significant distress and had to be subsumed into other BHCs in order to avoid the ramifications that their failures would have had upon regional economies as well as the financial markets.[275]

Indeed, during the GFC, the U.S. Treasury Department's Troubled Asset Relief Program (TARP) began by injecting capital into the nine largest U.S. financial institutions.[276] The support did not end there. Regulators next stress tested nineteen BHCs with more than $100 billion in assets in the Supervisory

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determination by the Council that the bank holding company's failure would pose a threat to financial stability." (emphasis added)).

273. Tarullo, *supra* note 10, at 8.

274. *See, e.g.*, FIN. CRISIS INQUIRY COMM'N, *supra* note 68, at 302 ("Michael Solomon, a managing director in risk management manager in the Office of Thrift Supervision (OTS), told the FCIC, 'It was hard for businesses, particularly small, midsized thrifts—to keep up with [how quickly the ratings downgrades occurred during the crisis] and change their business models and not get stuck without the chair when the music stopped . . . . They got caught. The rating downgrades started and by the time the thrift was able to do something about it, it was too late . . . . Business models . . . can't keep up with what we saw in 2008.'")

275. *See id.* at 365–70 (discussing the near-failures of Washington Mutual and Wachovia). Had Washington Mutual been allowed to fail, the FDIC's midrange estimate for the liquidation cost was $41.5 billion, an amount that would have depleted the entire balance of the DIF at the time. JOHN E. BOWMAN & SHEILA C. BAIR, OFFS. OF INSPECTOR GEN., U.S. DEP'T OF TREASURY AND FDIC, EVALUATION OF FEDERAL REGULATORY OVERSIGHT OF WASHINGTON MUTUAL BANK 35 (2010).

276. *See* OFF. OF THE SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, SIGTARP-10-001, EMERGENCY CAPITAL INJECTIONS PROVIDED TO SUPPORT THE VIABILITY OF BANK OF AMERICA, OTHER MAJOR BANKS, AND THE U.S. FINANCIAL SYSTEM 14 (2009).

Capital Assessment Program (SCAP)[277] and announced to the market that additional capital would be made available to SCAP banks through TARP.[278] The government had effectively guaranteed all U.S. banks with over $100 billion in assets.[279]

The U.S. government ultimately injected nearly $205 billion in capital into 707 banks of *all* sizes.[280] In addition to TARP, so-called "regional" BHCs—those between $100 billion and $700 billion in assets—utilized more than $125 billion in liquidity guarantees from the FDIC during the GFC.[281] In total, while GSIBs received a significant amount of government support, the entire class of BHCs with $50 billion or more in assets generally used a higher proportion of emergency lending programs during the GFC than did banking organizations with less than $50 billion in assets.[282]

277. *See* BD. OF GOVERNORS OF THE FED. RSRV. SYS., THE SUPERVISORY CAPITAL ASSESSMENT PROGRAM: OVERVIEW OF RESULTS (2009), http://www.federalreserve.gov/bankinforeg/bcreg20090507a1.pdf [https://perma.cc/2367-QXJW].

278. *See* Joint Press Release, Timothy F. Geithner, Sec'y, Dep't of the Treasury, Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Rsrv. Sys., Sheila Bair, Chairman, Fed. Deposit Ins. Corp., & John C. Dugan, Comptroller, Off. of the Comptroller of the Currency, The Treasury Capital Assistance Program and the Supervisory Capital Assessment Program (May 6, 2009), http://www.federalreserve.gov/newsevents/press/bcreg/20090506a.htm [https://perma.cc/M7LF-9VUQ].

279. The ten banks with SCAP shortfalls were required to meet the target capital ratios within thirty days, preferably by raising new capital in the market—however, as noted above, the Treasury Department also made clear that additional capital support could be made available through other TARP programs. *See id.*

280. CONG. OVERSIGHT PANEL, MARCH OVERSIGHT REPORT: THE FINAL REPORT OF THE CONGRESSIONAL OVERSIGHT PANEL 40 (2011), https://www.congress.gov/112/cprt/JPRT64832/CPRT-112JPRT64832.pdf [https://perma.cc/78H3-RP7X].

281. Press Release, Martin J. Gruenberg, Member, Fed. Deposit Ins. Corp. Bd. of Dirs., Statement on the Final Rule on Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements (Oct. 15, 2019), https://www.fdic.gov/news/speeches/2019/spoct1519a.html [https://perma.cc/D5T7-LJHM].

282. *See* U.S. GOV'T ACCOUNTABILITY OFF., GAO-14-18, GOVERNMENT SUPPORT FOR BANK HOLDING COMPANIES: STATUTORY CHANGES TO LIMIT FUTURE SUPPORT ARE NOT YET FULLY IMPLEMENTED 31 (2013).

Table 5: Regional Banks During the Global Financial Crisis[283]

SCAP Results & Government Support, 2008

Bank	Risk-Weighted Assets	Capital Needs	Total Support	Exited TARP
American Express	$104.4 billion	None	$13.8 billion	6/17/09
BB&T	$109.8 billion	None	$11.6 billion	6/17/09
Capital One	$131.8 billion	None	$3.6 billion	6/17/09
Fifth Third	$112.6 billion	$1.1 billion	$11.0 billion	2/2/11
Ally/GMAC	$172.6 billion	$11.5 billion	$37.5 billion	Auto-rescue program
KeyCorp	$106.7 billion	$1.8 billion	$13.9 billion	3/30/11
PNC	$250.9 billion	$600 million	$13.9 billion	2/10/10
Regions	$116.3 billion	$2.5 billion	$20.3 billion	4/4/12
SunTrust	$162.0 billion	$2.2 billion	$11.9 billion	3/30/11
US Bank	$230.6 billion	None	$10.5 billion	6/17/09
Total	**$1,497.7 billion**	**$19.7 billion**	**$148 billion**	

283. *See* BD. OF GOVERNORS OF THE FED. RSRV. SYS., *supra* note 277, at 9 tbl.3, app. at 19–37 (2009) (risk-weighted assets and capital needs columns); CONG. OVERSIGHT PANEL, *supra* note 280, at 23 fig.7 (total support column); SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, EXITING TARP: REPAYMENTS BY THE LARGEST FINANCIAL INSTITUTIONS 80 app. F (2011), https://www.sigtarp.gov/sites/sigtarp/files/Audit_Reports/Exiting_TARP_Repayments_by_the_Largest_Financial_Institutions.pdf [https://perma.cc/YAV9-CDY2] (exited TARP column).

Table 6: Large BHCs Required More Support During the Global Financial Crisis[284]

Public support as a percentage of total assets, by size

Total Assets	Ratio of Support to Assets
≥ $250 billion	11.24%
$50 to $250 billion	10.28%
$10 to $50 billion	5.35%
$1 to $10 billion	3.05%
$500 million to $1 billion	2.22%
< $500 million	1.54%

Thus, while the existence and distress of individual TBTF institutions were important aspects of the GFC, a financial system that is vulnerable to the "too many to fail" dynamic can also lead to problems. This situation is preventable, however, if regulators cast an appropriately wide regulatory net and act preemptively. This is essentially the notion underlying the establishment of PCA in the FDIC Improvement Act of 1991 (FDICIA), which was passed in the wake of the savings and loan crisis.[285]

2. Increasing Resilience

The most direct policy for increasing GSIBs' balance sheet resilience is through more robust capital and leverage requirements paired with interventionist capital distribution policies, both incidental to annual supervisory stress testing as well as in response to deteriorating economic conditions. In an example of one such policy proposal, GSIBs' required minimum capital and leverage ratios would be increased to a range of 23.5 to 38 percent and 15 percent, respectively.[286] This approach is consistent with the finding that GSIB capital surcharge remains

284. *See* SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, *supra* note 283, at 91–92.

285. Section 38 of the Federal Deposit Insurance Act requires the federal banking agencies to establish capital standards, including five categories of capital adequacy. Again, bank management must take various steps, such as restrictions on capital distributions and limits on asset growth, as each regulatory capital minimum is breached. *See* 12 U.S.C. § 1831o.

286. *See* FED. RSRV. BANK OF MINNEAPOLIS, *supra* note 236, at 63–64.

substantially below the optimum levels required to meet its financial stability goals, particularly for GSIBs that rely on significant amounts of short-term wholesale funding,[287] and that overall system-wide capital requirements remain below the socially optimal levels.[288] Pairing these two complementary standards is important, as recent research has shown that combining robust capital requirements with a leverage ratio can mitigate the risk-taking incentives that can occur with the leverage ratio alone.[289]

In addition, a proactive, anticipatory approach to dividend and capital raising has a demonstrated track record of reducing the likelihood and cost of bank failures dating back to the savings and loan crisis.[290] Permissive bank dividend policy prior to the GFC led to a significant depletion of bank capital, and more proactive regulatory intervention could have reduced the need for future bailout assistance.[291]

Macroprudential regulation is by no means a panacea for all of the ills plaguing the financial system,[292] but it offers a number of financial stability benefits. In the aftermath of crises, banks' inability to intermediate, absent significant public support and regulatory forbearance, functions like a "debt overhang," inhibiting them from serving their basic purpose even after markets recover.[293] Indeed, better capitalized banks were

287. *See* Wayne Passmore & Alexander H. von Hafften, *Are Basel's Capital Surcharges for Global Systemically Important Banks Too Small?* 1–2 (Bd. of Governors of the Fed. Rsrv. Sys., Finance and Economics Discussion Series Working Paper No. 2017-021, 2017) (finding that GSIB surcharges should be raised 375 to 525 bps for all GSIBs, include a short-term funding metric that further boosts capital surcharges 175 to 550 bps for certain GSIBs, and create an additional lower bucket with a capital surcharge of 225 bps for very large banks that are not currently subject to any GSIB surcharge).

288. *See* Tarullo, *supra* note 40, at 66; *see also* Simon Firestone, Amy Lorenc & Ben Ranish, *An Empirical Economic Assessment of the Costs and Benefits of Bank Capital in the United States*, 101 FED. RSRV. BANK OF ST. LOUIS REV. 203, 204 (2019) (finding an optimal RBC ratio between 13 percent and 26 percent).

289. *See* Jonathan Acosta-Smith et al., *The Leverage Ratio, Risk-taking and Bank Stability* 1 (Bank of Eng., Staff Working Paper No. 766, 2018).

290. *See* George Hanc, *The Banking Crises of the 1980s and Early 1990s: Summary and Implications*, *in* HISTORY OF THE EIGHTIES: LESSONS FOR THE FUTURE, *supra* note 227, at 3, 66–68.

291. *See* Eric S. Rosengren, President & Chief Exec. Officer, Fed. Rsrv. Bank of Bost., Dividend Policy and Capital Retention: A Systemic "First Response" (Oct. 10, 2010).

292. *See* WILMARTH, *supra* note 229, at 140 (proposing activity limits on banking organizations in the mode of a modern Glass-Steagall Act).

293. *See* ADMATI & HELLWIG, *supra* note 234, at 81.

able to keep lending during the GFC,[294] suggesting that banks with more equity funding will better serve their role as intermediators.[295]

This demonstrates that it is actually more, not less, bank capital that furthers the stated policy goal of greater bank lending and will help achieve many of the purported policy goals sought by the proponents of tailoring. These issues may reemerge as policymakers navigate an environment of diminishing COVID-19 policy accommodations and banks' corresponding capacity to support the economy.[296]

CONCLUSION

The COVID-19 financial crisis served as an important referendum on the Fed's approach to regulatory tailoring. The lessons from this episode may appear to be subtle or esoteric, but they are important. First, the tailoring project, which consisted of an assortment of highly technocratic changes, may have appeared reasonable at times in isolation but had the cumulative effect of substantial deregulation. Second, the changes outlined above may not be the end of the story, as tailoring is still a relatively new undertaking and may result in an even further relaxation of banking rules. Finally, while BHCs failed to absorb the shocks created by the COVID-19 pandemic, requiring the Fed to intervene through both emergency lending measures and widespread regulatory forbearance, this result was in many ways foreseeable. Importantly, the consequences of the actions that give rise to such shocks are often not felt until some years after

294. *See* Nada Mora, *Can Banks Provide Liquidity in a Financial Crisis?*, 95 ECON. REV., Nov. 2010, at 31, 53; *see also* Aikman et al., *supra* note 235, at 12 (finding that, on average, each additional 1 percentage point of pre-crisis capital boosted banks' lending over the subsequent decade by over 20 percent); *see also* Victoria Ivashina & David S. Scharfstein, *Bank Lending During the Financial Crisis of 2008*, 97 J. OF FIN. ECON. 319, 319–20 (2010) (finding that banks that rely less on short-term nondeposit funding are better able to lend throughout a downturn).

295. *See* ADMATI & HELLWIG, *supra* note 234, at 100–14 (detailing arguments on the economics of banks' balance sheets and the "costs" of equity funding).

296. This Article's lessons may be of particular relevance as the Fed navigates its post-COVID-19 monetary policy framework characterized by historically large deficit financing and a glut of bank reserves. *See* IMF, *supra* note 9, at 26; *see also* Duffie, *supra* note 233, at 2 ("[T]he size of the Treasury market may have outgrown the capacity of dealers to safely intermediate the market on their own balance sheets, raising questions about the future safe-haven status of U.S. Treasuries and concerns over the cost to taxpayers of financing growing federal deficits.").

they are initially taken. These lessons only serve to underscore the urgency of developing an effective framework for macroprudential regulation. Left unaddressed, the vulnerabilities exposed by the COVID-19 crisis are likely to have profound implications for the foreseen and unforeseen financial stability risks that lie ahead.