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A Two-Tiered System of Regulation is Needed to Preserve the Viability of Community Banks and Reduce the Risks of Megabanks

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A TWO-TIERED SYSTEM OF REGULATION IS NEEDED TO PRESERVE THE VIABILITY OF COMMUNITY BANKS AND REDUCE THE RISKS OF MEGABANKS

*Arthur E. Wilmarth, Jr.**

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ABSTRACT

The financial crisis of 2007–2009 and its aftermath have accelerated a powerful consolidation trend in the U.S. banking industry. During the past three decades, the number of community banks and their share of the industry’s assets have fallen by more than half, and the largest banks have captured much of the industry’s assets. The federal government’s response to the financial crisis encouraged further consolidation by ensuring the survival of the biggest institutions while doing little to help community banks. Federal regulators allowed only one large depository institution (Washington Mutual) to fail, but they stood by while more than 450 community banks failed between 2008 and 2012.

In addition to the fact that community banks received very limited assistance during the financial crisis, they must now comply with costly new regulatory burdens imposed by the Dodd–Frank Act. These developments threaten the viability of community banks, which provide essential services to small businesses, consumers and local economies. At the same time, Dodd–Frank does not provide an adequate solution to the growing risks posed by megabanks to our national and global economies. Dodd–Frank has not ended the “too big to fail” (TBTF) status of megabanks. In addition, big banks and their political allies have succeeded in weakening the implementation of even the relatively mild reforms called for by Dodd–Frank.

This Article proposes a two-tiered system of regulation to correct the perverse effects of our current regulatory regime. The first tier of my proposed system would reduce regulatory burdens on community banks and encourage them to maintain their traditional business model of relationship-based intermediation. The second tier of my proposed system would seek to remove the TBTF subsidy for megabanks and other systemically important financial institutions

(SIFIs). SIFIs would be required to conduct their deposit-taking activities within “narrow banks,” which would be barred from transferring their safety net subsidies to nonbank affiliates. SIFIs would also be required to pay risk-based premiums to prefund the Orderly Liquidation Fund, in order to shield taxpayers from the future costs of resolving failed SIFIs.

By removing the TBTF subsidy, my proposal would enable financial markets and regulators to exercise more effective discipline over our largest financial institutions. In addition, SIFIs would be obliged to pay at least half of their compensation to senior executives and key employees in the form of contingent convertible bonds (CoCos). CoCos would help to align the personal incentives of executives and other key employees of SIFIs with the interests of creditors, the FDIC, and taxpayers.

My proposed two-tiered system of regulation would help to restore a more balanced, diverse, and resilient banking industry. Community banks have compiled a superior record of meeting the needs of their customers while maintaining a stable business model that serves the longer-term interests of their stakeholders and communities. In contrast, megabanks have shown a strong and persistent tendency to pursue short-term, high-risk strategies that produce boom-and-bust cycles and impose tremendous costs on our economy and taxpayers. If the TBTF subsidy for megabanks were removed, those banks would have strong incentives to spin off risky activities and adopt more conservative and transparent business policies.

TABLE OF CONTENTS

INTRODUCTION	252
I. THE GOVERNMENT’S RESPONSE TO THE FINANCIAL CRISIS ACCELERATED THE CONSOLIDATION TREND BY GIVING MASSIVE ASSISTANCE TO MEGABANKS WHILE DOING LITTLE TO HELP COMMUNITY BANKS	256
A. The Federal Government Provided Extraordinary Assistance to Large Banks but Gave Little Help to Community Banks	257
B. Federal Regulators Provided Extensive Forbearance to the Largest Banks but Applied Stringent Enforcement and Examination Policies to Community Banks	269

II. COMMUNITY BANKS WERE NOT RESPONSIBLE FOR THE FINANCIAL CRISIS, BUT THE OUTCOME OF THE CRISIS HAS RAISED DOUBTS ABOUT THEIR ABILITY TO CONTINUE PROVIDING CRUCIAL SUPPORT FOR SMALL BUSINESSES AND LOCAL COMMUNITIES.....	276
A. Community Banks Were Not Responsible for the Financial Crisis, but They Suffered Devastating Losses During the Ensuing Recession.....	277
B. Community Banks Face Costly New Compliance Burdens Under the Dodd–Frank Act and Basel III.....	282
III. THE PRESERVATION OF A VIBRANT COMMUNITY BANKING SECTOR SHOULD BE A NATIONAL PRIORITY.....	288
A. Community Banks Play Crucial Roles in Supporting Small Businesses and Local Communities.....	288
B. Recent Failures of Community Banks Have Inflicted Serious Harm on Small Businesses and Communities.....	294
C. A Further Decline in the Significance of the Community Banking Sector Would Seriously Harm Small Businesses, Consumers, and Local Communities.....	298
IV. DODD–FRANK HAS NOT ENDED TBTF TREATMENT FOR MEGABANKS.....	303
A. Dodd–Frank Establishes a Special Resolution Regime for Systemically Important Financial Institutions but Allows the FDIC and Other Agencies to Protect Creditors of Those Institutions.....	304
1. <i>Dodd–Frank’s Orderly Liquidation Authority Allows the FDIC to Provide Full Protection for Favored Creditors of SIFIs and Their Operating Subsidiaries</i>	304
2. <i>Dodd–Frank Does Not Prevent Federal Regulators from Using Other Sources of Funding to Protect Creditors of SIFIs</i>	315
3. <i>Dodd–Frank Does Not Prevent Congress from Authorizing Bailouts of SIFIs During Future Crises</i>	319
B. The Dodd–Frank Act Does Not Prevent Financial Conglomerates from Using Their Safety-Net Subsidies to Support Risky Capital Markets Activities.....	323

1. <i>The Volcker Rule Does Not Impose Strong and Enforceable Constraints on Risk-Taking by Megabanks</i>	323
2. <i>Wall Street Persuaded Congress to Repeal the Lincoln Amendment</i>	329
3. <i>Dodd–Frank Does Not Change the High-Risk Business Model of Universal Banks, and the Statute Instead Relies on Regulators Who Are Vulnerable to Industry Capture</i>	332
V. A TWO-TIERED SYSTEM OF REGULATION IS NEEDED TO MAINTAIN A HEALTHY COMMUNITY BANKING SECTOR AND ELIMINATE THE TBTF SUBSIDY FOR MEGABANKS	340
A. Congress and Federal Regulators Should Reduce Compliance Burdens for Community Banks and Should Encourage the Formation of De Novo Community Banks	340
B. A Two-Tiered Regulatory System Would Encourage the Relationship-Based Business Model of Community Banks and Reduce the Speculative Risks Created by Megabanks.....	342
1. <i>The First Tier of Banking Organizations Would Engage in Relationship-Based Intermediation</i>	344
2. <i>The Second Tier of Nontraditional Banking Organizations Would Be Barred from Exploiting Federal Safety-Net Subsidies</i>	345
3. <i>Two Supplemental Rules Would Prevent Second-Tier Banking Organizations from Engaging in Speculative Activities in the Commercial Sector</i>	353
4. <i>Second-Tier Banking Organizations and Other SIFIs Should Pay Risk-Based Premiums to Prefund the OLF</i>	358
5. <i>Top Executives and Key Employees of Second-Tier Banking Organizations Should Receive at Least Half of Their Total Compensation in the Form of Contingent Convertible Debt</i>	363
CONCLUSION	368

INTRODUCTION

The financial crisis of 2007–2009 and its aftermath have accelerated a consolidation trend that has transformed the U.S. banking system during the past three decades. During that period, the

number of community banks and their share of the banking industry's assets have fallen by more than half, while the largest banks have succeeded in capturing much of the industry's assets.¹ In responding to the financial crisis, the federal government encouraged further consolidation by adopting extraordinary assistance programs and forbearance measures designed to help the biggest institutions. In contrast, federal officials gave relatively little help to community banks and subjected them to strict supervision and enforcement policies. Similarly, the monetary policy followed by the Federal

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1. See *infra* notes 10-12, 30-31 and accompanying text (discussing the impact of consolidation within the banking industry on community banks and megabanks). Two definitions of "community bank" are generally used in banking studies. Some studies define community banks as including all banks with assets under \$10 billion. See, e.g., Jeffrey W. Gunther & Kelly Klemme, *Community Banks Withstand the Storm*, in FED. RESERVE BANK OF DALLAS, SPECIAL REPORT—FINANCIAL STABILITY: TRADITIONAL BANKS PAVE THE WAY, DALLAS FED 2012 ANNUAL REPORT 19, 19 (2012) [hereinafter DALLAS FED. 2012 REPORT], available at <http://www.dallasfed.org/microsites/fed/annual/2012/documents/ar12.pdf>; CONFERENCE OF STATE BANK SUPERVISORS, COMMUNITY BANKING IN THE 21ST CENTURY: OPPORTUNITIES, CHALLENGES AND PERSPECTIVES 12 (2013) [hereinafter CSBS COMMUNITY BANKING STUDY], available at <http://www.csbs.org/news/csbswhitepapers/Documents/FINALPUBLICATION.pdf>. In contrast, the Federal Deposit Insurance Corporation (FDIC) defines community banks to encompass most banks with assets under \$1 billion as well as some larger banks that meet criteria designed to identify a strong orientation toward traditional banking activities (e.g., high loan-to-asset and deposit-to-asset ratios) and limited geographic scope (e.g., operations in not more than three states). FDIC, FDIC COMMUNITY BANKING STUDY 1-1 to 1-2 (2012) [hereinafter FDIC COMMUNITY BANKING STUDY], available at <https://www.fdic.gov/regulations/resources/cbi/report/cbi-full.pdf>. Under the FDIC's criteria, 330 banks with assets between \$1 billion and \$10 billion were classified as "community banks" at the end of 2010, while 206 banks in that size range were classified as "noncommunity banks." *Id.* at 1-4. For purposes of this Article, the term "community banks" generally refers to banks with assets under \$10 billion unless the supporting citations are drawn from or rely on FDIC studies.

Reserve (Fed) in response to the crisis benefited megabanks while suppressing the earnings of community banks.²

Federal regulators stood by while more than 450 community banks failed between 2008 and 2012. In contrast, regulators allowed only one depository institution larger than \$100 billion—Washington Mutual (Wamu)—to fail during that period. In that one case, the FDIC arranged for the immediate transfer of Wamu's assets and deposits to JPMorgan Chase (Chase), the largest U.S. bank, which later received a \$25 billion capital infusion from the Treasury Department.³ In February 2009, federal regulators announced that the Treasury Department would provide any capital assistance needed to ensure the survival of the nineteen largest banking organizations, each with assets of more than \$100 billion.⁴ No such guarantees were provided to smaller banks.

In July 2010, Congress responded to the financial crisis by enacting the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank).⁵ Community banks must comply with many of Dodd–Frank's regulatory burdens, even though community banks did not play any substantial role in causing the financial crisis. In addition, the Basel III international capital accord, as implemented by federal bank regulators, will impose costly new requirements on community banks.⁶

The foregoing developments threaten the viability of community banks, which provide essential services to small businesses, consumers, and local economies.⁷ At the same time, Dodd–Frank does not provide an adequate solution for the growing

2. See *infra* Part I (describing how the federal government's response to the financial crisis helped megabanks and hurt community banks).

3. See *infra* notes 65-69, 85 and accompanying text (discussing bank failures between 2008 and 2012); see also DAVID WESSEL, IN FED WE TRUST: BEN BERNANKE'S WAR ON THE GREAT PANIC 218-19, 236-40 (2009) (discussing Chase's acquisition of Wamu and receipt of a \$25 billion capital infusion from the Treasury Department).

4. See *infra* notes 22-23 and accompanying text (describing the public announcement by federal banking agencies in February 2009 that they would ensure the survival of the nineteen largest banking organizations).

5. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

6. See *infra* Part II (discussing community banks' lack of responsibility for the financial crisis and the new compliance burdens they face under Dodd–Frank and Basel III).

7. See *infra* Section III.A (discussing growing doubts about the ability of community banks to maintain their crucial role in supporting small businesses and local communities).

risks posed by megabanks to our national and global economies. Dodd–Frank does not require large financial conglomerates to change their fundamental business model, which promotes conflicts of interest, excessive complexity, and speculative risk-taking. Nor has Dodd–Frank ended the “too big to fail” (TBTF) status of megabanks. Instead, big banks and their political allies have succeeded in weakening even the relatively mild reforms called for by Dodd–Frank.⁸

A two-tiered system of regulation is urgently needed to correct the perverse effects of our current regulatory regime. The first tier of my proposed system would reduce regulatory burdens on community banks and would encourage them to maintain their traditional business model of relationship-based intermediation. The second tier of my proposed system would seek to remove the TBTF subsidy for megabanks and other systemically important financial institutions (SIFIs). SIFIs would be required to conduct their deposit-taking activities within “narrow banks” that would be barred from transferring their safety-net subsidies to nonbank affiliates. SIFIs would also be required to pay risk-based premiums to prefund the Orderly Liquidation Fund in order to shield taxpayers from the future costs of resolving failed SIFIs. By removing the TBTF subsidy, my proposal would enable financial markets and regulators to exercise more effective discipline over our largest financial institutions. In addition, SIFIs would be obliged to pay at least half of their total compensation for top executives and key employees in the form of contingent convertible bonds (CoCos). CoCos would help to align the personal incentives of executives and key employees of SIFIs with the long-term interests of creditors, the FDIC, and taxpayers.⁹

My proposed two-tiered system of regulation would help to restore a more balanced, diverse, and resilient banking industry. Community banks have compiled a superior record of meeting the needs of their customers while maintaining a stable business model that serves the long-term interests of their stakeholders and communities. In contrast, megabanks have shown a strong and persistent tendency to pursue short-term, high-risk strategies, which produce boom-and-bust cycles and impose tremendous costs on our

8. *See infra* Part IV (explaining why Dodd–Frank does not end TBTF treatment for megabanks, and discussing successful efforts by megabanks and their supporters to weaken Dodd–Frank’s reforms).

9. *See infra* Part V (describing my proposal for a two-tiered system of regulation).

economy and taxpayers. If their TBTF subsidy were removed, megabanks would have strong incentives to spin off risky activities and adopt more conservative and transparent business policies.

I. THE GOVERNMENT'S RESPONSE TO THE FINANCIAL CRISIS
ACCELERATED THE CONSOLIDATION TREND BY GIVING MASSIVE
ASSISTANCE TO MEGABANKS WHILE DOING LITTLE TO HELP
COMMUNITY BANKS

The U.S. banking industry has experienced far-reaching consolidation during the past thirty years. Between 1984 and 2011, the number of community banks fell by more than one-half,¹⁰ and the share of commercial banking assets held by community banks declined by almost two-thirds.¹¹ During the same period, the share of banking assets held by the four largest U.S. banks mushroomed from 6.2% to 44.2%.¹² Many factors have driven this consolidation trend, including federal deregulation of geographic and product markets for banks, relaxation of federal antitrust standards governing bank mergers, transformative changes in banking technologies, and the large numbers of bank failures that occurred between 1984 and 1991 and again between 2008 and 2012.¹³

The federal government's response to the recent financial crisis has given further impetus for the consolidation trend. The federal

10. FDIC COMMUNITY BANKING STUDY, *supra* note 1, at 2-6 (showing that the number of community banking organizations, as defined by the FDIC, declined from 14,408 in 1984 to 6,356 in 2011, while the number of community bank charters fell from 15,663 to 6,799 during the same period); *see also* CSBS COMMUNITY BANKING STUDY, *supra* note 1, at 12 (stating that the number of banks smaller than \$10 billion declined from 10,300 in 1994 to about 6,000 in 2012).

11. FDIC COMMUNITY BANKING STUDY, *supra* note 1, at 2-7 (showing that the percentage of banking industry assets held by community banks, as defined by the FDIC, declined from 38% in 1984 to 14% in 2011); *see also* Jeffrey W. Gunther & Kelly Klemme, *Small Banks Squeezed*, in DALLAS FED. 2012 REPORT, *supra* note 1, at 31, 33 (showing that banks smaller than \$10 billion held less than 17% of commercial banking assets in 2011 and 2012).

12. FDIC COMMUNITY BANKING STUDY, *supra* note 1, at 2-4.

13. *Id.* at 2-1 to 2-12; *see also* Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 250-57, 312-15 [hereinafter Wilmarth, *Transformation*] (describing factors encouraging consolidation during the 1980s and 1990s); Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 CONN. L. REV. 963, 975-81, 1011-15 (2009) [hereinafter Wilmarth, *Dark Side*] (discussing factors encouraging further consolidation during the 2000s).

government provided extraordinary assistance to ensure the survival of the biggest banks while doing relatively little to help community banks. In addition, the Fed's monetary policy since 2008 has benefited big banks while hurting community banks.

The federal government pursued a similarly lopsided approach to supervision and enforcement during the financial crisis and its aftermath. As described below in Sections I.A and I.B, federal agencies adopted a policy of leniency and forbearance with regard to big banks, and only one depository institution larger than \$100 billion failed during the crisis. In contrast, federal regulators issued hundreds of capital directives and other enforcement orders against community banks, and allowed more than 450 community banks to fail. Little wonder that the largest banks have achieved even greater dominance within the banking industry since the outbreak of the crisis in 2007 while the position of community banks has deteriorated.

A. The Federal Government Provided Extraordinary Assistance to Large Banks but Gave Little Help to Community Banks

The federal government responded to the financial crisis by providing massive and disproportionate financial help to the largest financial institutions. Federal agencies provided more than \$850 billion of financial assistance to ensure the survival of Citigroup and Bank of America (BofA)—two of the three largest U.S. banks. The bailout packages for Citigroup and BofA included capital infusions, asset guarantees, emergency short-term loans, debt guarantees, and commercial paper funding.¹⁴

14. The federal government provided \$543 billion of financial assistance to Citigroup and \$315 billion of financial aid to BofA. See Arthur E. Wilmarth, Jr., *Citigroup: A Case Study in Managerial and Regulatory Failures*, 47 *IND. L. REV.* 69, 71, 110-14 (2014) [hereinafter Wilmarth, *Citigroup*] (explaining that the federal government gave Citigroup \$45 billion of capital infusions, \$300 billion of asset guarantees, \$100 billion of emergency loans (measured by the peak amount outstanding), \$65 billion of FDIC-guaranteed debt, and \$33 billion of commercial paper funding); *id.* at 109 n.326, 114 n.362 (stating that the federal government gave BofA \$45 billion of capital infusions, \$120 billion of asset guarantees, \$91 billion of emergency loans (measured by the peak amount outstanding), and \$44 billion of FDIC-guaranteed debt); Linus Wilson & Yan Wendy Wu, Does Receiving TARP Funds Make It Easier to Roll Your Commercial Paper onto the Fed? 29 (Aug. 22, 2011) (unpublished manuscript), available at <http://ssrn.com/abstract=1911454> (showing that the Fed gave BofA \$15 billion of commercial paper funding).

The federal government's bailout of BofA enabled that institution to absorb Countrywide, the second-largest thrift, and Merrill Lynch (Merrill), the third-largest securities firm. Regulators also provided financial assistance to support (1) emergency takeovers of two other failing megabanks (Wells Fargo's purchase of Wachovia and PNC's acquisition of National City); (2) Chase's emergency acquisition of Wamu, the largest thrift, and Bear Stearns (Bear), the fifth-largest securities firm; and (3) emergency conversions of the two largest securities firms—Goldman Sachs (Goldman) and Morgan Stanley—into bank-holding companies.¹⁵ Meanwhile, U.S. Bancorp became the fifth-largest bank by acquiring a large failed thrift (Downey Federal) and more than a dozen smaller failed institutions with support provided by a capital infusion from the Treasury Department and loss-sharing agreements with the FDIC.¹⁶

15. 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, 958 & n.15, 959, 978-79, 984-85 (2011) [hereinafter Wilmarth, *Dodd–Frank*] (discussing how the federal government assisted the takeovers cited above); see also Bob Ivry, Bradley Keoun & Philip Kuntz, *Secret Fed Loans Gave Banks \$13 Billion Undisclosed to Congress*, BLOOMBERG BUS. (Nov. 27, 2011, 7:01 PM), <http://www.bloomberg.com/news/articles/2011-11-28/secret-fed-loans-undisclosed-to-congress-gave-banks-13-billion-in-income> (describing how the Fed's emergency loans helped JPMorgan Chase to acquire Bear, BofA to acquire Merrill, and Wells Fargo to acquire Wachovia).

16. Michael Rudnick, *U.S. Bancorp Nabs First Community*, DAILY DEAL, Jan. 31, 2011, available at 2011 WLNR 3459001 (reporting that “U.S. Bancorp ha[d] added about \$36.6 billion in assets since late 2008 via failed bank acquisitions” assisted by the FDIC); Kevin Dobbs & Bonnie McGeer, *Thrift Buys Give U.S. Bancorp California Boost*, AM. BANKER (Nov. 25, 2008, 2:00 AM), http://www.americanbanker.com/issues/173_241/-367510-1.html (reporting that U.S. Bancorp acquired two failed California thrifts, including Downey Financial with nearly \$13 billion of assets, and noting that “[w]hen U.S. Bancorp announced . . . that it would receive \$6.6 billion under the Treasury Department’s Capital Purchase Program, Mr. Davis said the infusion would give his company new flexibility to ‘invest in future growth’”); Heather Landy, *Davis Comes into His Own as U.S. Bancorp’s Chief*, AM. BANKER (Dec. 1, 2010, 3:17 PM), http://www.americanbanker.com/special-reports/175_22/davis-banker-of-the-year-1029285-1.html (explaining how Richard Davis, the chief executive of U.S. Bancorp, built the bank into “the fifth-largest U.S. commercial bank”); Trefis Team, *U.S. Bancorp’s Appetite for Failed Banks Shows Its Strength*, FORBES (Mar. 14, 2012, 4:19 PM), <http://www.forbes.com/sites/greatspeculations/2012/03/14/u-s-bancorps-appetite-for-failed-banks-shows-its-strength/> (reporting that U.S. Bancorp had acquired 14 failed banks from the FDIC since 2008, “more . . . than any [other] competitor”).

Moreover, the federal government injected more than \$70 billion of capital and provided \$110 billion of further assistance to bail out American International Group (AIG), the world's largest insurance company.¹⁷ The federal government's rescue of AIG provided a conduit for funneling large payments to the world's leading financial institutions. With federal approval and encouragement, AIG used federal bailout funds to pay about \$90 billion to major U.S. and foreign banks and securities firms, thereby satisfying 100% of the obligations that AIG owed to those counterparties under credit default swaps (CDS) and securities lending agreements.¹⁸ Goldman received the largest total payment from AIG while Merrill, BofA, and Citigroup also received substantial payments.¹⁹

Thus, federal agencies ensured that AIG could pay all of the obligations it owed to large, complex financial institutions (LCFIs).

17. Hester Peirce, *Securities Lending and the Untold Story in the Collapse of AIG* 39-45 (George Mason Univ. Mercatus Ctr., Working Paper No. 14-12, 2014), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2435161; CONG. OVERSIGHT PANEL, JUNE OVERSIGHT REPORT: THE AIG RESCUE, ITS IMPACT ON MARKETS, AND THE GOVERNMENT'S EXIT STRATEGY 19-20, 84-99 (2010) [hereinafter COP AIG REPORT], available at <http://www.gpo.gov/fdsys/pkg/CPRT-111JPRT56698/pdf/CPRT-111JPRT56698.pdf>; see also U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-11-716, TROUBLED ASSET RELIEF PROGRAM: THE GOVERNMENT'S EXPOSURE TO AIG FOLLOWING THE COMPANY'S RECAPITALIZATION 8-11 (2011).

18. Peirce, *supra* note 17, at 44 (citing an AIG report showing that AIG paid \$93.4 billion to counterparties after receiving federal assistance). A report by the Congressional Oversight Panel (COP) indicated a somewhat smaller amount for such payments. According to the COP, after AIG received federal assistance, it paid \$43.8 billion to counterparties to discharge securities lending obligations and \$43.7 billion to counterparties to discharge CDS obligations. See COP AIG REPORT, *supra* note 17, at 71-72, 90. The COP stated that AIG had previously used its own funds to post \$18.5 billion of collateral under its CDS deals. *Id.* at 76. There is no dispute that, with the approval of federal officials, AIG used federal assistance to pay its counterparties 100% of the amounts owed under its CDS and securities lending deals and that AIG did not demand concessions from those counterparties. *Id.* at 87-88, 92-93, 147-52; FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 376-79 (2011) [hereinafter FCIC REPORT], available at <http://fcic.law.stanford.edu/report>.

19. Peirce, *supra* note 17, at 44 (citing an AIG report showing that AIG paid Goldman \$12.9 billion after receiving federal assistance, while other recipients of the largest AIG payments included Société Générale (\$11.9 billion), Deutsche Bank (\$11.8 billion), Barclays (\$8.5 billion), Merrill (\$6.8 billion), BofA (\$5.2 billion), UBS (\$5.0 billion), BNP Paribas (\$4.9 billion), HSBC (\$3.5 billion), and Citigroup (\$2.3 billion)).

The federal government adopted a much harsher policy for smaller investors (including community banks) when the Treasury Department (Treasury) seized control of Fannie Mae (Fannie) and Freddie Mac (Freddie) in September 2008. After establishing conservatorships for both government-sponsored enterprises (GSEs), Treasury declared that the GSEs would no longer pay dividends to existing preferred stockholders. That decision destroyed the value of the GSEs' outstanding preferred stock, much of which Fannie and Freddie had issued at the urging of federal officials in late 2007 and early 2008. Many community banks purchased that preferred stock with the approval (and, allegedly, the encouragement) of federal bank regulators.²⁰ The sudden collapse in value of the GSEs' preferred stock inflicted \$2 billion of losses on community banks and led to the failures or forced sales of more than a dozen community banks.²¹ The federal government thus made a deliberate decision *not* to provide AIG-type protection for community banks when it seized Fannie and Freddie.

20. Tara Rice & Jonathan Rose, *When Good Investments Go Bad: The Contraction in Community Bank Lending After the 2008 GSE Takeover* 5-10, 37-38 (Mar. 2014) (unpublished manuscript), *available at* <http://ssrn.com/abstract=2409328> (explaining that Fannie and Freddie had \$36 billion of outstanding preferred stock in September 2008, of which \$22 billion had been sold in late 2007 and early 2008). For allegations that federal regulators encouraged banks to buy the GSEs' preferred stock, see *Housing Finance—What Should the New System Be Able to Do?: Part II—Government & Stakeholder Perspectives: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 39 (2010) (statement of Jack E. Hopkins, President & Chief Executive Officer, CorTrust Bank, N.A.); Donna Block, *FDIC Grilled on Community Bank Seizures*, *DAILY DEAL*, Jan. 21, 2010, *available at* 2010 WLNR 1681342.

21. Rice & Rose, *supra* note 20 (manuscript at 3-4, 20); *see also id.* (manuscript at 3, 13-14) (reporting that 483 community banks owned \$2.3 billion of the \$8 billion of GSE preferred stock held by all banks); *id.* (manuscript at 8, 10) (“[A] belief in the low risk of these securities was widespread among investors (including banks and other financial institutions) and regulators. . . . [T]he decision to wipe out the preferred shareholders was not an obvious one and while considerable uncertainty surrounded the fate of the GSEs, most parties assumed up until the [federal] takeover that the preferred shareholders would be made whole.”); FCIC REPORT, *supra* note 18, at 320-21 (discussing bank failures that were caused by the Treasury's decision to cut off dividend payments on Fannie's and Freddie's preferred stock); *see also* Julie Andersen Hill, *Shifting Losses: The Impact of Fannie's and Freddie's Conservatorships on Commercial Banks*, 35 *HAMLIN L. REV.* 343, 362-68 (2012) (explaining how the collapse in value of the GSEs' preferred stock caused significant investment losses, triggered bank failures, and forced bank sales within the community banking sector).

In February 2009, as federal regulators prepared to conduct the first “stress test” for the nineteen largest banks, the agencies announced that they would provide any additional capital needed to ensure the survival of those companies. The announcement proclaimed the “determination” of federal regulators “to preserve the viability of systemically important financial institutions so that they are able to meet their commitments.”²² The federal government thereby made clear to investors and the general public that the nineteen largest banks (each holding more than \$100 billion of assets) “were . . . TBTF, at least for the duration of the financial crisis.”²³

The nineteen largest banks and AIG received \$290 billion of federal capital infusions and issued \$235 billion of FDIC-guaranteed debt. In contrast, banks smaller than \$100 billion received only \$41 billion of capital infusions and “issued only \$11 billion of FDIC-guaranteed debt.”²⁴ Within the latter group, banks smaller than \$10 billion received just \$16 billion of capital infusions and issued very little FDIC-guaranteed debt.²⁵

22. Press Release, Bd. of Governors of the Fed. Reserve Sys., Joint Statement by the Treasury, FDIC, OCC, OTS, and the Federal Reserve (Feb. 23, 2009), <http://www.federalreserve.gov/newsevents/press/bcreg/20090223a.htm>.

23. Arthur E. Wilmarth, Jr., *Reforming Financial Regulation to Address the Too-Big-to-Fail Problem*, 35 BROOK. J. INT’L L. 707, 713 & n.12, 737, 743 (2010) [hereinafter Wilmarth, *Reforming Financial Regulation*]; see also Joe Adler, *In Focus: Stress Tests Complicate ‘Too Big to Fail’ Debate; There’s a Number, \$100B, but It’s Not Just a Matter of Size*, AM. BANKER (May 18, 2009), <http://www.highbeam.com/doc/1G1-199879300.html> (“By drawing a line at \$100 billion in assets, and promising to give the 19 institutions over that mark enough capital to weather an economic downturn, the government appears to have defined which banks are indeed ‘too big to fail.’”).

24. Wilmarth, *Reforming Financial Regulation*, *supra* note 23, at 737-38 (discussing the capital infusions and debt guarantees provided to the largest banks under the Troubled Asset Relief Program (TARP) and other federal programs); see also *id.* at 738 n.122 (stating that the nineteen largest banks received \$220 billion of capital infusions from the Treasury, while AIG received \$70 billion of capital assistance); *supra* note 18 and accompanying text (explaining that much of the financial assistance provided to AIG was used to pay off AIG’s obligations to large United States and European financial institutions).

25. CONG. OVERSIGHT PANEL, JULY OVERSIGHT REPORT: SMALL BANKS IN THE CAPITAL PURCHASE PROGRAM 13 (2010), available at <http://www.gpo.gov/fdsys/pkg/CPRT-111JPRT57212/pdf/CPRT-111JPRT57212.pdf>. The FDIC’s debt guarantee program was “geared towards aiding the larger banks by guaranteeing newly issued senior unsecured debt through 2012,” and the program provided “a windfall for the largest financial institutions.” HOVDE, HOVDE FINANCIAL INSTITUTIONS MONTHLY OVERVIEW 2-3 (2009), available at <http://www.hovdecapital.com/re/documents/HovdeMonthlyOverviewAugust2009.p>

The Fed also took unprecedented actions as lender of last resort (LOLR) by establishing a series of emergency lending programs that provided huge amounts of credit to LCFIs. The Fed's emergency lending programs reached a single-day peak of \$1.2 trillion in December 2008. More than half of that peak amount was extended to the ten largest U.S. banks and securities firms, and most of the remainder was lent to large U.S. and foreign banks.²⁶ If one adds up all the individual transactions included in the Fed's emergency lending programs, the Fed provided a cumulative total of \$19.5 trillion of emergency credit to banks between 2007 and 2010.²⁷ Almost 90% of that cumulative total—\$16.4 trillion—was extended to a group of fourteen large U.S. and foreign LCFIs.²⁸

The federal government provided the foregoing capital infusions, asset guarantees, debt guarantees, and emergency loans to

df. The nineteen largest banks issued \$235 billion of FDIC-guaranteed debt, and GE Capital issued an additional \$55 billion of FDIC-guaranteed debt, while other financial institutions issued only \$11 billion of such debt. CONG. OVERSIGHT PANEL, NOVEMBER OVERSIGHT REPORT: GUARANTEES AND CONTINGENT PAYMENTS IN TARP AND RELATED PROGRAMS 35-38, 58, 65 (2009), available at <http://www.gpo.gov/fdsys/pkg/CPRT-111JPRT53348/pdf/CPRT-111JPRT53348.pdf>. Most small and medium-sized banks did not participate in the FDIC's debt guarantee program because those banks generally do not issue publicly traded debt securities. *Id.* at 30 n.156.

26. Bradley Keoun & Phil Kuntz, *Wall Street Aristocracy Got \$1.2 Trillion in Secret Loans*, BLOOMBERG BUS. (Aug. 21, 2011, 7:01 PM), <http://www.bloomberg.com/news/articles/2011-08-21/wall-street-aristocracy-got-1-2-trillion-in-fed-s-secret-loans> (reporting that the Fed's emergency lending programs reached a "\$1.2 trillion peak on Dec. 5, 2008" and \$669 billion of that amount was lent to the ten largest U.S. banks and securities firms).

27. James Felkerson, *\$29,000,000,000,000: A Detailed Look at the Fed's Bailout by Funding Facility and Recipient* 31-33 (Levy Econ. Inst. of Bard Coll., Working Paper No. 698, 2011), available at <http://ssrn.com/abstract=1970414> (finding that, in addition to the \$19.5 trillion of emergency loans provided to banks, the Fed extended \$10 trillion of credit to foreign central banks through currency swap lines).

28. *Id.* at 32-33 (showing that the top nine recipients of Fed emergency credit—Citigroup, Merrill Lynch, Morgan Stanley, AIG, Barclays, BofA, BNP Paribas, Goldman, and Bear—collectively received \$13.4 trillion, while the next five most highly ranked recipients—Credit Suisse, Deutsche Bank, RBS, Chase, and UBS—collectively received \$3.0 trillion); see also Kyle D. Allen, Scott E. Hein & Matthew D. Whitledge, *The Evolution of the Federal Reserve's Term Auction Facility and Community Bank Utilization* 3-11, 16-19, 37 (Jan. 16, 2015) (unpublished manuscript), available at <http://ssrn.com/abstract=2251021> (finding that between December 2007 and March 2010, the Fed provided \$1.75 trillion of Term Auction Facility (TAF) credit to large United States banks and made nearly 1,400 additional TAF loans to foreign banks, but the Fed provided less than \$70 billion of TAF credit to United States community banks).

LCFIs on very generous terms. As a result, those programs “represented very large transfers of wealth from taxpayers to the shareholders and creditors of the largest US LCFIs.”²⁹ The federal government’s extraordinary support for the largest banks—as well as their acquisitions of troubled institutions—produced a domestic banking system in which megabanks now possess even greater dominance than they enjoyed prior to the crisis. The four largest U.S. banks—Chase, BofA, Citigroup, and Wells Fargo (the Big Four)—increased their share of commercial banking assets from 32% in 2005 to 44.2% in 2011 and 47.7% in 2013.³⁰ In addition, the eleven

29. Arthur E. Wilmarth, Jr., *Narrow Banking: An Overdue Reform That Could Solve the Too-Big-to-Fail Problem and Align U.S. and U.K. Regulation of Financial Conglomerates*, 31 BANKING & FIN. SERVICES POL’Y REP., Mar. 2012, at 1, 3, 5, 20 n.40 [hereinafter Wilmarth, *Narrow Banking*], available at <http://ssrn.cin.abstract=2050544> (citing four studies documenting the significant gains in wealth that the largest banks received as a result of federal assistance programs during the financial crisis); Mark Gongloff, *Banks Profit from U.S. Guarantee: Lenders’ Earnings Reap the Benefit of FDIC Backing on Company Debt*, WALL ST. J., July 27, 2009, at C1 (estimating that the FDIC’s debt guarantee program provided interest savings of \$24 billion to the eight largest issuers of guaranteed debt, which included the six biggest United States banks, GE Capital, and American Express); Ivry, Keoun & Kuntz, *supra* note 15 (finding that the “Fed’s below-market rates” on its emergency lending programs generated estimated profits of \$13 billion for the recipient banks, including \$4.8 billion of profits for the six biggest United States banks); see also Nicola Matthews, *How the Fed Reanimated Wall Street: The Low and Extended Lending Rates That Revived the Big Banks* 24-25 (Levy Econ. Inst. of Bard Coll., Working Paper No. 758, 2013), available at <http://ssrn.com/abstract=2233939> (showing that the average interest rates paid by Citigroup, Merrill, Morgan Stanley, BofA, and Goldman for the emergency Fed loans they received ranged from a low of 0.7999% (for BofA) to a high of 1.412% (for Goldman)); Keoun & Kuntz, *supra* note 26 (noting that the Fed agreed to provide “28-day loans through its Term Auction Facility at a rate of 1.1 percent” on October 20, 2008, while large banks were then charging 3.8% for one-month interbank loans).

30. FDIC COMMUNITY BANKING STUDY, *supra* note 1, at 2-4 to 2-5 (providing 2005 and 2011 figures); James R. Barth & Moutusi Sau, *The Big Keep Getting Bigger: Too-Big-to-Fail Banks 30 Years Later* 4 (Sept. 24, 2014) (unpublished manuscript), available at <http://ssrn.com/abstract=2510041> (providing 2013 figure); see also Harvey Rosenblum, *Choosing the Road to Prosperity: Why We Must End Too Big to Fail—Now*, in FED. RESERVE BANK OF DALLAS, 2011 ANNUAL REPORT 3, 6-7 (2011) [hereinafter DALLAS FED. 2011 REPORT], available at <http://www.dallasfed.org/assets/documents/fed/annual/2011/ar11.pdf>. (showing that “the share of banking industry assets controlled by the five largest U.S. institutions has more than tripled to 52 percent from 17 percent” since 1970).

largest U.S. banks controlled two-thirds of commercial banking assets by the end of 2012.³¹

The federal government's massive support for the largest U.S. financial institutions helped them to expand their leading positions in broader segments of the financial markets. The Big Four and Goldman controlled total banking and nonbanking assets equal to 56% of the U.S.'s gross domestic product (GDP) in 2011, up from 43% five years earlier.³² The dominance of the Big Four is even greater when their off-balance-sheet activities are taken into account. Consider what would happen if U.S. accounting principles were changed to force the Big Four to include on their balance sheets their gross (rather than net) derivatives positions as well as the securitized mortgages they sell to GSEs with recourse, as international accounting rules would require. In that case, the Big Four's total assets would nearly double (as of 2012) from \$7.6 trillion to \$14.7 trillion, an amount equal to 93% of the U.S.'s GDP.³³

31. *Examining How the Dodd–Frank Act Could Result in More Taxpayer-Funded Bailouts: Hearing Before the H. Comm. on Fin. Servs.*, 113th Cong. 76 (2013) [hereinafter *Fisher June 2013 Testimony*], available at <http://www.gpo.gov/fdsys/pkg/CHRG-113hhrg81769/pdf/CHRG-113hhrg81769.pdf> (statement of Richard W. Fisher, President and Chief Executive Officer, Federal Reserve Bank of Dallas).

32. David J. Lynch, *Banks Seen Dangerous Defying Obama's Too-Big-to-Fail Move*, BLOOMBERG BUS. (Apr. 16, 2012, 2:02 PM), <http://www.bloomberg.com/news/articles/2012-04-16/Obama-bid-to-end-too-big-to-fail-undercut-as-banks-grow> (reporting that the Big Four and Goldman held total assets of \$8.5 trillion); see also Ivry, Keoun & Kuntz, *supra* note 15 (stating that the Big Four, Goldman, and Morgan Stanley held total banking and nonbanking assets of \$9.5 trillion in 2011, up from \$6.8 trillion in 2006).

33. Yalnan Onaran, *U.S. Banks Bigger than GDP as Accounting Rift Masks Risk*, BLOOMBERG BUS. (Feb. 19, 2013, 7:01 PM), <http://www.bloomberg.com/news/articles/2013-02-20/u-s-banks-bigger-than-gdp-accounting-rift-masks-risk> (explaining the contrasting treatment of big bank assets under United States and international accounting principles); see also Andrew Cunningham, *World's Biggest Banks 2012: The Big Get Bigger*, 26 GLOBAL FIN. MAG., Oct. 2012, at 44, 44 (showing that the Big Four had total assets of \$7.6 trillion at the end of 2011). For example, after netting their offsetting derivatives exposures with various counterparties, Chase and Citigroup recorded *less than 1%* of their total derivatives contracts as assets on their balance sheets in mid-2014. Dakin Campbell, *Citigroup Embraces Derivatives as Deals Soar After Crisis*, BLOOMBERG BUS. (Sept. 17, 2014, 12:00 AM), <http://www.bloomberg.com/news/articles/2014-09-17/citigroup-embraces-derivatives-as-deals-soar-after-crisis> (reporting that Chase and Citigroup reported \$49.1 billion and \$44.5 billion, respectively, of derivatives assets on their balance sheets as of June 30, 2014, while their gross derivatives contracts were \$68 trillion and \$62 trillion, respectively). By allowing netting treatment for derivatives, U.S. accounting principles permit U.S. banks to assume that all of their

The Fed provided additional help to the largest financial institutions by maintaining a zero-interest-rate policy (ZIRP) for short-term debt and by engaging in three rounds of quantitative easing (QE) to push down interest rates on longer-term debt, including home mortgages.³⁴ Under QE1, which lasted from November 2008 until March 2010, the Fed purchased (1) \$1.4 trillion of mortgage-backed securities (MBS) and debt obligations issued by Fannie and Freddie, and (2) \$300 billion of Treasury securities.³⁵ Under QE2, the Fed purchased \$600 billion of Treasury securities during 2010 and 2011.³⁶ Under QE3, which lasted from 2012 to 2014, the Fed purchased more than \$1.6 trillion of additional Treasury securities and MBS.³⁷ As a result of the QE programs, the

counterparties will pay their obligations. However, “netting could break down” if counterparties cannot perform during a financial crisis, as occurred with AIG in 2008. *Id.* (quoting Craig Pirrong, Finance Professor at the University of Houston). Consequently, United States accounting principles “are hiding fragilities” by permitting banks to report net rather than gross derivatives positions. Onaran, *supra* (quoting Anat Admati, Finance Professor at Stanford University).

34. See, e.g., Stefania D’Amico et al., *The Federal Reserve’s Large-Scale Asset Purchase Programs: Rationale and Effects* 1-3, 10-11, 29-30 (Fed. Reserve Bd., Working Paper No. 2012-85, 2012), available at <http://ssrn.com/abstract=2197519> (discussing the Fed’s QE programs, and finding that QE1 and QE2 reduced yields on longer-term Treasury securities by thirty-five basis points and forty-five basis points, respectively); John C. Williams, *Will Unconventional Policy Be the New Normal?*, FRBSF ECON. LETTER, Oct. 7, 2013, at 1-3, available at <http://www.frbsf.org/economic-research/publications/economic-letter/2013/october/federal-reserve-unconventional-monetary-policy-large-scale-asset-purchases-forward-guidance/> (describing the purpose of the Fed’s QE programs); William C. Dudley, President & Chief Exec. Officer, Fed. Reserve Bank of N.Y., Remarks at the Japan Society, New York City: Lessons at the Zero Bound: The Japanese and U.S. Experience (May 21, 2013), available at <http://www.newyorkfed.org/newsevents/speeches/2013/dud130521.html> (same).

35. Michael D. Bauer, *Fed Asset Buying and Private Borrowing Rates*, FRBSF ECON. LETTER, May 21, 2012, at 1-2, available at <http://www.frbsf.org/economic-research/publications/economic-letter/2012/may/fed-asset-buying-private-borrowing-rates/el2012-16.pdf> (describing QE1); D’Amico et al., *supra* note 34, at 10-11 (same).

36. Bauer, *supra* note 35, at 2 (describing QE2); D’Amico et al., *supra* note 34, at 11 (same).

37. John C. Williams, *The Economic Recovery and Monetary Policy: The Road Back to Ordinary*, FRBSF ECON. LETTER, June 2, 2014, at 4, available at <http://www.frbsf.org/economic-research/publications/economic-letter/2014/june/economic-recovery-monetary-policy-normalization/el2014-16.pdf> (describing QE3); Andrew Flowers, *We Still Don’t Know What \$1.6 Trillion Bought Us*, FIVETHIRTYEIGHTECON. (Sept. 17, 2014, 12:47 PM), <http://fivethirtyeight.com/features/we-still-dont-know-what-1-6-trillion-bought-us/> (stating that the Fed had purchased more than \$1.6 trillion of Treasury bonds and MBS under QE3); Robin

Fed's balance sheet "ballooned to \$4.42 trillion" in September 2014,³⁸ a dramatic increase from the \$924 billion of assets that the Fed held in September 2008.³⁹

The Fed's ZIRP and QE policies conferred major benefits on the largest banks. Unlike community banks, big banks (1) obtain much of their funding by issuing market-sensitive, short-term wholesale liabilities, and (2) earn a much higher proportion of their revenues from noninterest (fee) income as opposed to interest income from loans.⁴⁰ Big banks also held large volumes of risky mortgage-related securities on their balance sheets when the financial crisis began in 2007.⁴¹ By pushing down short-term and longer-term interest rates, ZIRP and QE lowered big banks' interest costs on their market-sensitive liabilities and also increased the market values of their mortgage-related securities.⁴² Moreover, the

Harding, *Fed Eyes First Rate Rise After End to QE*, FIN. TIMES (Oct. 29, 2014, 6:13 PM), <http://www.ft.com/cms/s/O/c778256a-5f95-11e4-988c-00144feabdc0.html#axzz3SKfA1Gne> (reporting that the Fed made its final purchase of assets under QE3 in October 2014).

38. Jeff Kearns & Steve Matthews, *Fed Keeps 'Considerable Time' Pledge as Growth 'Moderate'*, BLOOMBERG BUS. (Sept. 17, 2014, 6:29 PM), <http://www.bloomberg.com/news/articles/2014-09-17/fed-keeps-considerable-time-pledge-as-growth-is-moderate->.

39. Bob Ivry, *Fed's \$4 Trillion Rescue Helps Hedge Fund as Savers Hurt*, BLOOMBERG BUS. (Dec. 20, 2012, 12:01 AM), <http://www.bloomberg.com/news/articles/2012-12-20/fed-s-4-trillion-rescue-helps-hedge-fund-as-savers-hurt>.

40. FDIC COMMUNITY BANKING STUDY, *supra* note 1, at 4-2 to 4-5; *see also* Christine M. Bradley & Lynn Shibut, *The Liability Structure of FDIC-Insured Institutions: Changes and Implications*, 18 FDIC BANKING REV., no. 2, 2006, at 1, 18, 20; Gerald Hanweck & Lisa Ryu, *The Sensitivity of Bank Net Interest Margins and Profitability to Credit, Interest-Rate, and Term-Structure Shocks Across Bank Product Specializations* 24-25, 28 (FDIC, Working Paper No. 2005-02, 2005), available at <http://ssrn.com/abstract=886727>.

41. Wilmarth, *Dark Side*, *supra* note 13, at 1028-35 (describing the large volumes of private-label MBS and collateralized debt obligations (CDOs) held by major banks in 2007); Wilmarth, *Dodd-Frank*, *supra* note 15, at 971-75 (same). The term "private-label" refers to residential MBS that were underwritten and issued by LCFIs and did not conform to the underwriting guidelines of Fannie and Freddie. Wilmarth, *Dark Side*, *supra* note 13, at 988.

42. Andrew Huszar, *Confessions of a Quantitative Easer*, WALL ST. J., Nov. 12, 2013, at A17; Jesse Eisinger, *In U.S. Monetary Policy, a Boon to Banks*, PROPUBLICA (June 29, 2011, 2:03 PM), <http://www.propublica.org/thetrade/item/in-u.s.-monetary-policy-a-boon-to-banks>; *see also* Kearns & Matthews, *supra* note 38 (reporting that the QE programs were "intended to hold down long-term interest rates"). Andrew Huszar, a former Fed official, also argued that QE provided "fat commissions" to the big banks that acted as primary dealers for the Fed because those banks earned substantial fees for executing the Fed's QE purchases. Huszar, *supra*; Ben Eisen, *Meet Andrew Huszar, the Ex-Fed Insider Who Hates QE*,

low mortgage rates produced by QE spurred a mortgage refinancing boom in 2012, which generated big profits for four of the five largest banks.⁴³ Those four banks dominated the home mortgage market after acquiring competing lenders with federal assistance during the financial crisis.⁴⁴ Chase, BofA, and Wells Fargo earned additional profits by entering into interest-rate swaps in which they took the fixed side of the trades and successfully wagered that ZIRP and QE would keep floating rates below the fixed rates specified in the swaps.⁴⁵

While liability-sensitive big banks benefited from ZIRP and QE, community banks suffered. Community banks are less liability-sensitive and more asset-sensitive than larger banks because (1) community banks obtain most of their funding from demand deposits and other core deposits, and (2) the interest rates community banks pay on their core deposits move much more slowly in response to changes in market interest rates than the yields they earn on loans.⁴⁶

MARKETWATCH (Nov. 14, 2013, 9:50 AM), <http://blogs.marketwatch.com/capitolreport/2013/11/14/meet-andrew-huszar-the-ex-fed-insider-who-hates-qe/>.

43. Peter Eavis, *With Rates Low, Banks Increase Mortgage Profit*, N.Y. TIMES (Aug. 8, 2012, 9:03 PM), <http://dealbook.nytimes.com/2012/08/08/with-rate-twist-banks-increase-mortgage-profit/> (reporting that “[b]anks are making unusually large gains on mortgages [by] . . . taking profits far higher than the historical norm,” due in part “to the concentration of mortgage lending in the hands of a few big banks, primarily Wells Fargo, JPMorgan Chase, Bank of America and U.S. Bancorp”); Kathleen M. Howley & Dakin Campbell, *Banks Pad Profits as U.S. Prolongs Refinancing Boom: Mortgages*, BLOOMBERG BUS. (July 5, 2012, 12:54 PM), <http://www.bloomberg.com/news/articles/2012-07-05/banks-pad-profits-as-u-s-prolongs-refinancing-boom-mortgages>; Jody Shenn, *Fed Helps Lenders’ Profit More than Homebuyers: Mortgages*, BLOOMBERG BUS. (Sept. 26, 2012, 9:50 AM), <http://www.bloomberg.com/news/articles/2012-09-25/fed-helps-lenders-profit-more-than-homebuyers-mortgages>.

44. Kathleen Pender, *Red Flags as Wells Fargo Mortgages Grow*, S.F. CHRON., Sept. 2, 2012, at G1 (showing that Wells Fargo, Chase, U.S. Bancorp, and BofA controlled 54% of the mortgage origination market during the first half of 2012); *supra* notes 3, 14-16 and accompanying text (discussing how federal agencies provided assistance during the crisis that enabled those big banks to acquire competing lenders).

45. Dakin Campbell, *Rising Rates Seen Squeezing Swaps Income at Biggest Banks*, BLOOMBERG BUS. (Sept. 26, 2013, 12:00 AM), <http://www.bloomberg.com/news/articles/2013-09-26/rising-rates-seen-squeezing-swaps-income-at-biggest-banks> (reporting that the three big banks had earned \$42 billion on interest-rate swaps since 2008 by taking the fixed side of those trades).

46. Charles S. Morris & Kristen Regehr, *What Explains Low Net Interest Income at Community Banks?*, in FED. RESERVE BANK OF KAN. CITY, ECONOMIC REVIEW 59, 62, 65 (2014), available at www.kc.frb.org/publicat/econrev/pdf/14q2Morris-Regehr.pdf; see also William Bednar & Mahmoud Elamin, *Rising*

Community banks are also more asset-sensitive because they earn most of their profits from the net interest margin (NIM) between their loan yields and their deposit costs.⁴⁷ ZIRP and QE significantly reduced the NIM for community banks, and the decline in NIM has been the most important factor behind the deterioration in the relative performance of community banks compared to larger banks.⁴⁸

When the federal government finally did promise to help community banks, it failed to deliver. In September 2010, President Obama signed the Small Business Jobs Act of 2010 (Jobs Act).⁴⁹ The Jobs Act required the Treasury Department to establish the Small Business Lending Fund (SBLF), which would invest up to \$30 billion in community banks and thereby enhance their ability to make small business loans.⁵⁰ Treasury received applications for SBLF funding from 935 community banks.⁵¹

However, Treasury shut down the SBLF program in September 2011, after investing only \$4.2 billion (just 14% of the authorized capital funds) in 332 community banks.⁵² Thus, Treasury approved

Interest Rate Risk at US Banks, in FED. RESERVE BANK OF CLEVELAND, ECONOMIC COMMENTARY (2014), available at <https://www.clevelandfed.org/~media/Files/Commentary%20PDFs/2014/2014-12-economic-commentary-rising-interest-rate-risk-at-us-banks.pdf?la=en> (showing that changes in interest rates would have different impacts on big banks and smaller banks, as rising interest rates would primarily affect the liabilities of the fifty largest banks but would affect both the liabilities and assets of smaller banks).

47. FDIC COMMUNITY BANKING STUDY, *supra* note 1, at 4-2 to 4-4; Morris & Regehr, *supra* note 46, at 59, 62, 65.

48. FDIC COMMUNITY BANKING STUDY, *supra* note 1, at 4-3 to 4-4, 4-9; Benjamin R. Backup, *Community Bank Developments in 2012*, 7 FDIC Q., no. 4, 2013, at 27, 34-35, available at https://www.fdic.gov/bank/analytical/quarterly/2013_vol7_4/FDIC_Quarterly_Vol7No4.pdf.

49. Small Business Jobs Act of 2010, Pub. L. No. 111-240, 124 Stat. 2504.

50. *Id.* § 4103, 124 Stat. 2585; see OFFICE OF THE SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, QUARTERLY REPORT TO CONGRESS 80, 157 (2012) [hereinafter 2012 SIGTARP REPORT], available at http://www.sigtarp.gov/Quarterly%20Reports/April_25_2012_Report_to_Congress.pdf (describing the Jobs Act and the SBLF); see also Kate Davidson, *SBLF Left Weak Banks Behind in Tarp*, *Watchdog Agency Says*, AM. BANKER (Apr. 25, 2012, 12:03 AM), http://www.americanbanker.com/issues/177_79/SBLF-Tarp-repayment-weak-banks-SIGTarp-Christy-Romero-1048710-1.html. (reporting that the Jobs Act authorized SBLF to “provide[] \$30 billion to institutions with less than \$10 billion of assets”).

51. 2012 SIGTARP REPORT, *supra* note 50, at 80, 157.

52. Kevin Wack, *Lending Fund Puts Geithner on the Defensive*, AM. BANKER, Oct. 19, 2011.

only about one-third of the applications it received from community banks for SBLF funding.⁵³ Members of Congress sharply criticized Treasury for the onerous conditions it imposed on community bank applicants and for its long delays in approving SBLF applications.⁵⁴ Treasury Secretary Timothy Geithner asserted that the Treasury did not have authority to help community banks under the Jobs Act unless they were “viable.”⁵⁵ He therefore claimed that Treasury “had to be careful to make sure that taxpayer resources were going to banks that were viable.”⁵⁶

However, the Jobs Act did *not* require community banks to demonstrate that they were “viable” in order to receive SBLF funding. Rather, the Jobs Act specified that banks were barred from receiving SBLF investments if they were seriously troubled banks included on the FDIC’s “problem bank list.”⁵⁷ Treasury’s insistence on a more exacting standard of “viability” for community banks, as a precondition for giving them SBLF aid, stood in sharp contrast to Treasury’s approach in February 2009, when Treasury and other federal agencies promised to provide all capital assistance necessary to *ensure the viability* of the nineteen largest banks.⁵⁸

B. Federal Regulators Provided Extensive Forbearance to the Largest Banks but Applied Stringent Enforcement and Examination Policies to Community Banks

In addition to providing extraordinary assistance to the biggest banks, federal regulators followed a policy of leniency and

53. 2012 SIGTARP REPORT, *supra* note 50, at 157-58 (stating that Treasury approved SBLF funding for only 332 of the 935 community banks that submitted applications).

54. Kate Davidson, *Geithner: Regulators at Fault in SBLF Delays*, AM. BANKER, June 23, 2011, at 1 (reporting that Treasury did not approve a single application for SBLF funding during the first nine months of the program’s existence); Wack, *supra* note 52.

55. Davidson, *supra* note 54 (quoting Secretary Geithner’s testimony during a congressional hearing in June 2011, where he said that community banks must be “viable” to receive SBLF funding under the Jobs Act).

56. Wack, *supra* note 52 (quoting Secretary Geithner’s statement during a congressional hearing in October 2011).

57. Small Business Jobs Act of 2010, Pub. L. No. 111-240, § 4103(d)(4), 124 Stat. 2504, 2588 (internal quotation marks omitted) (defining the FDIC’s “problem bank list” to include “the list of depository institutions having a current rating of 4 or 5” based on the federal regulators’ examination rating system).

58. *See supra* notes 22-23 and accompanying text (discussing the federal agencies’ announcement on Feb. 23, 2009).

forbearance with respect to those banks. During a Senate committee hearing on February 24, 2009—the day after regulators pledged to ensure the survival of the nineteen largest banks—Fed Chairman Ben Bernanke told committee members that “regulators would not employ ‘prompt-corrective-action’ tools” against any of those banks, even if the first stress test revealed that they were undercapitalized.⁵⁹ Senator Corker responded by questioning whether it was a good policy to send a “signal to the markets . . . that there are institutions in this country that absolutely will not fail and we will go to whatever lengths necessary” to prevent their failure.⁶⁰ Chairman Bernanke replied that “[w]e are committed to ensuring the viability of all of the major financial institutions.”⁶¹

The “prompt-corrective-action” (PCA) regime, to which Chairman Bernanke referred, was enacted in 1991. The PCA regime is *not* discretionary. It mandates that federal regulators *must* impose an escalating series of sanctions (including capital directives and other enforcement orders) against *all* undercapitalized banks.⁶² Nevertheless, consistent with Chairman Bernanke’s statement, federal regulators did not issue PCA orders or other formal capital enforcement orders against any of the largest banks, even though (1) emergency acquisitions were needed to prevent the disorderly failures of Wamu and Wachovia, and (2) Citigroup and BofA required extraordinary assistance to survive.⁶³ Instead of issuing public enforcement orders against Citigroup and BofA, federal

59. Steven Sloan, *Bernanke: ‘Don’t Need’ to Nationalize Weak Banks*, AM BANKER, Feb. 25, 2009, at 1 (paraphrasing and quoting Chairman Bernanke).

60. *Id.* (quoting Senator Corker).

61. *Id.* (quoting Chairman Bernanke).

62. See Richard Scott Carnell, *A Partial Antidote to Perverse Incentives: The FDIC Improvement Act of 1991*, 12 ANN. REV. BANKING L. 317, 325-48 (1993) (explaining that the PCA regime “requires regulators to impose increasingly stringent restrictions and requirements on an institution as its capital declines below required levels”).

63. Julie Andersen Hill, *Bank Capital Regulation by Enforcement: An Empirical Study*, 87 IND. L.J. 645, 690-93 (2012); Arthur E. Wilmarth, Jr., *Turning a Blind Eye: Why Washington Keeps Giving in to Wall Street*, 81 U. CIN. L. REV. 1283, 1346-47 (2013) [hereinafter Wilmarth, *Blind Eye*]. Citigroup’s tangible common equity (TCE) ratio fell to 1.5% or less in early 2009, indicating that it was seriously undercapitalized, while BoA’s TCE ratio declined to 2.8% at the end of 2008. Wilmarth, *Blind Eye*, *supra*, at 1346-47 n.289; Wilmarth, *Citigroup*, *supra* note 14, at 112-13; see also *supra* notes 14-15 and accompanying text (explaining that the federal government provided \$850 billion of assistance to ensure the survival of Citigroup and BofA and also provided support for Chase’s takeover of Wamu and Wells Fargo’s acquisition of Wachovia).

“regulators entered into confidential memoranda of understanding” (MOUs) with those banks, as regulators had also done when the same banks were in deep trouble during the banking crisis of the late 1980s and the early 1990s, *before* the PCA regime took effect.⁶⁴

The federal government allowed only one depository institution larger than \$100 billion—Wamu—to fail between 2008 and 2012.⁶⁵ Most regulators viewed Wamu with disdain as a poorly managed thrift that acted recklessly in originating large volumes of risky subprime mortgages and option adjustable-rate mortgages (option ARMs). Regulators decided to let Wamu fail in September 2008, after the FDIC arranged for Chase to acquire Wamu’s assets and to assume all of Wamu’s deposits (including its uninsured deposits).⁶⁶

Wamu was clearly an outlier in terms of the regulators’ willingness to tolerate a large failure that imposed any losses on creditors.⁶⁷ After Wamu failed, federal agencies (1) took all necessary measures in late 2008 to prevent the failures of Wachovia, Citigroup, and BofA, even though all three megabanks engaged in

64. Wilmarth, *Reforming Financial Regulation*, *supra* note 23, at 744 (discussing the MOUs that regulators arranged with Citigroup and BofA in 2008 and 2009); Wilmarth, *Transformation*, *supra* note 13, at 304-05 (discussing the MOUs that regulators arranged with BofA and Citicorp during the late 1980s and early 1990s).

65. *See infra* note 85 and accompanying text (explaining that Wamu, with \$307 billion of assets, was the only depository institution larger than \$100 billion that failed between 2008 and 2012).

66. FCIC REPORT, *supra* note 18, at 20, 107-08, 117-18, 172, 305-07, 365-66 (describing Wamu’s reckless lending practices and the decision to allow Wamu to fail in September 2008); WESSEL, *supra* note 3, at 218-21 (same). Only one agency—the Office of Thrift Supervision (OTS), the primary regulator of Wamu—criticized the decision to let Wamu fail. *See* FCIC REPORT, *supra* note 18, at 382 (quoting a statement by OTS Director John Reich in November 2008, in which he questioned the decisions by federal regulators to allow IndyMac and Wamu to fail). In 2010, OTS Acting Director John Bowman similarly criticized the decisions to permit IndyMac and Wamu to fail. Mr. Bowman declared: “Institutions much larger than Washington Mutual—for example, Citigroup and Bank of America—collapsed . . . [T]he OTS did not regulate the largest banks that failed; the OTS regulated the largest banks that were allowed to fail.” Cheyenne Hopkins, *On Foreign Soil, Acting OTS Head Attacks Dodd-Frank Act*, AM. BANKER, Nov. 18, 2010, at 7 (quoting John Bowman, Acting Director, Office of Thrift Supervision).

67. The terms for Wamu’s failure were controversial because the FDIC refused to protect Wamu’s unsecured bondholders, a decision that the Treasury Department and New York Fed President Timothy Geithner strongly opposed. After Wamu’s failure triggered an immediate run by Wachovia’s uninsured creditors, federal regulators decided that they would not permit any other large depository institution to fail without arranging a transaction that protected *all* creditors. FCIC REPORT, *supra* note 18, at 365-86; WESSEL, *supra* note 3, at 218-41, 259-63.

reckless subprime lending,⁶⁸ and (2) declared in February 2009 that regulators would ensure the survival of all banks larger than \$100 billion.⁶⁹

Federal regulators arranged additional generous forbearance measures for big banks. During the spring of 2009, regulators and members of Congress pressured the Financial Accounting Standards Board (FASB) to issue interpretations that significantly relaxed FASB's fair value accounting rules. Those interpretations allowed major banks to avoid reporting further mark-to-market losses on their holdings of risky MBS, CDOs, and other illiquid securities.⁷⁰ For example, Citigroup held \$55 billion of subprime mortgages, MBS, and CDOs in its trading accounts in the fall of 2007, and Citigroup recorded \$26 billion of losses on those assets by the fall of 2008.⁷¹ Citigroup and other major U.S. and European banks probably would have suffered further significant mark-to-market losses if FASB had not relaxed its rules for valuing illiquid securities in April 2009.⁷² Federal regulators also helped megabanks by granting a one-year postponement (until 2011) of the effective date for new FASB rules requiring banks to bring securitized assets held in off-balance-sheet conduits back onto their balance sheets.⁷³

Moreover, regulators allowed megabanks to defer taking large losses on home equity loans and other second-lien loans secured by

68. FCIC REPORT, *supra* note 18, at 19, 71-72, 113-18, 130-34, 137-39, 168-69, 260-65, 302-07, 366-71, 379-82; *see also infra* note 104 (discussing irresponsible lending by Citigroup and BofA).

69. *See supra* notes 22-23 and accompanying text.

70. Wilmarth, *Blind Eye*, *supra* note 63, at 1348-49; *see also* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-13-71, FINANCIAL INSTITUTIONS: CAUSES AND CONSEQUENCES OF RECENT BANK FAILURES 73-84, 98-102 (2013) [hereinafter GAO BANK FAILURE REPORT] (describing fair value accounting rules and discussing the impact of changes that FASB made to those rules in April 2009).

71. Wilmarth, *Citigroup*, *supra* note 14, at 99-100, 110-12 (explaining that Citigroup held \$55 billion of subprime mortgages, MBS, and CDOs related to its securitization business in the fall of 2007 and, after recording large write-downs, still held \$29 billion of such assets in November 2008).

72. Wilmarth, *Blind Eye*, *supra* note 63, at 1348-49; *see also* Michael Corkery & Al Yoon, *Crisis Plus Five: A Toxic Bond's Legacy Lives On*, WALL ST. J., Sept. 13, 2013, at A1 (reporting that the market value of an issue of subprime RBMS underwritten by Countrywide in 2006 "was down by more than half in value by the summer of 2009"); Maud Van Gaal & Corina Ruhe, *Dutch Sell ING's U.S. Mortgage Bonds for \$8.9 Billion*, BLOOMBERG BUS. (Feb. 6, 2014, 5:32 AM), <http://www.bloomberg.com/news/articles/2014-02-06/dutch-sell-ing-s-u-s-mortgage-backed-bonds-for-8-9-billion> (stating that the market value of private label MBS backed by option ARMs declined to "as low as 33 cents [on the dollar] in 2009").

73. Wilmarth, *Blind Eye*, *supra* note 63, at 1349-51.

“underwater” homes whose first mortgages exceeded their fair market value.⁷⁴ The Big Four “held \$475 billion of second-lien loans at the end of 2008,” but regulators did not require banks to begin taking substantial write-downs on those loans until 2012.⁷⁵ Regulatory forbearance for second-lien loans held by big banks evidently persisted after 2012. In March 2014, BofA, Wells Fargo, and Chase—the “three biggest home equity lenders”—still held \$250 billion of second-lien loans, and a news report warned that many of those loans were at increased risk of default because their payment terms would soon “switch from interest-only to include principal” installments.⁷⁶

Federal regulators did not grant any similar type of forbearance to community banks during the recent financial crisis and its aftermath. Regulators issued more than 1,400 PCA directives and other formal capital enforcement orders against banks smaller than \$30 billion between 2008 and 2010.⁷⁷ Federal regulators also did not allow community banks to postpone taking write-downs on impaired loans. After reviewing recent bank failures, the Government Accountability Office (GAO) determined that federal bank examiners forced many community banks to recognize losses on commercial real estate (CRE) loans after market values for the underlying real estate collateral fell below the outstanding balances of the loans. When calculating the magnitude of collateral shortfalls, some examiners reportedly challenged the validity of appraisals obtained by community bank lenders and required larger write-downs.⁷⁸ A former Comptroller of the Currency remarked that “the

74. *Id.* at 1353 (internal quotation marks omitted).

75. *Id.* at 1351-55 (observing that (1) “[i]n 2011, BofA still carried second-lien loans on its books at 93% of their face value, even though investors typically discounted such loans by 50%”; and (2) the Big Four still held \$400 billion of second-lien loans on their books in March 2012).

76. John Gittelsohn, *Default Risk Rises on 20% of Boom-Era Home-Equity Loans*, BLOOMBERG BUS. (Aug. 7, 2014, 10:09 AM), <http://www.bloomberg.com/news/articles/2014-08-07/default-risk-rises-on-20-of-boom-era-home-equity-loans>.

77. Hill, *supra* note 63, at 658-62, 668-77, 691 (stating that Colonial Bank was the largest bank that received a formal capital order between 2008 and 2010); *infra* note 85 (showing that Colonial Bank failed in August 2009 with \$25 billion of assets).

78. GAO BANK FAILURE REPORT, *supra* note 70, at 29-34. The GAO determined that, with respect to CRE loans that were not likely to be repaid by projected cash flows from the project, federal regulators “would direct the bank to write down the loan balances to the fair value of the collateral.” *Id.* at 32. Thus, “federal banking regulators required banks to use the fair value of collateral method

flexibility the regulatory community has shown vis-à-vis the ‘too-big-to-fail’ banks—roughly defined as [the nineteen] banks subject to the [first] stress test—has not been in evidence for the community banking sector.”⁷⁹

The sharp disparity in regulatory treatment for megabanks and community banks is also reflected in the very different examination practices followed by federal regulators with respect to the two categories of banks. For megabanks, regulators “focused on evaluating the risk management policies and procedures . . . as well as the banks’ ‘internal [risk] models’ and ‘credit risk metrics,’” but they “stopped doing traditional ‘full scope’ examinations.”⁸⁰ In contrast, for community banks, regulators applied “‘transaction testing’” with a vengeance, as shown by the GAO’s report on bank failures and a similar report prepared by the FDIC’s Inspector

when determining the appropriate impairment amount of a collateral-dependent loan.” *Id.* at 33. The GAO cited a report received from one state banking association, which claimed that federal bank “examiners questioned some of the appraisals banks had obtained and made adjustments to them, driving larger valuation allowances, and when required, larger write-downs, than may have been warranted.” *Id.* at 31-32. For other reports of complaints by community banks about unduly harsh examination practices by federal regulators, see Thecla Fabian, *Bank Supervision: House Financial Services Panel Analyzes Complaints of Bank Examination Practices*, 97 BNA’S BANKING REP. 62 (2011); Thecla Fabian, *Small Business: Small Business Lending Return Complicated by Underwater Collateral, New Examinations*, 94 BNA’S BANKING REP. 463 (2010); see also Thecla Fabian, *Community Banks: Large Banks, Shadow Banks Caused Crisis, Community Banks Still Lend, ICBA Tells FCIC*, 94 BNA’S BANKING REP. 103 (2010) (paraphrasing testimony by C.R. “Rusty” Cloutier, a community bank president, who said that “field examiners are overzealous and unduly overreaching and are, in some cases, second guessing bankers and professional independent appraisers and demanding overly aggressive write downs and reclassification of [CRE] loans and other assets”).

79. Eugene A. Ludwig, *Viewpoint: Time to Help Community Banks in Crisis*, AM. BANKER, Sept. 18, 2009, at 9.

80. Wilmarth, *Citigroup*, *supra* note 14, at 130 (quoting Memorandum from Richard Spillenkothen, Former Dir., Banking Supervision & Regulation, Fed. Reserve Bd. 10-11 (May 31, 2010), available at http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2010-05-31%20FRB%20Richard%20Spillenkothen%20Paper-%20Observations%20on%20the%20Performance%20of%20Prudential%20Supervision.pdf); see also *id.* at 131 (quoting testimony at a congressional hearing in May 1997 by Fed Chairman Alan Greenspan, where he stated that the Fed was seeking to avoid “‘unduly intrusive’ supervision” and was “following ‘a more risk-focused/less transaction-testing approach’” to examinations by giving primary attention to “‘risk management and control systems’” within large banking companies).

General.⁸¹ Both reports documented the exacting scrutiny that bank examiners gave to individual CRE loans made by community banks.⁸²

FDIC Vice Chairman Thomas Hoenig recently criticized federal regulators for abandoning “full-scope examinations” of major banks, and he proposed “that bank examiners should ‘spend more time studying individual [transaction] files to verify the quality of a [large] bank’s internal reports about its risk management capability.’”⁸³ However, federal banking agencies evidently have not adopted Mr. Hoenig’s proposal to apply rigorous “transaction-testing” to big banks.⁸⁴

The ultimate divergence in regulatory treatment for megabanks and community banks is shown by the fact that federal regulators guaranteed the survival of the nineteen largest banks but stood by while more than 450 community banks failed between 2008 and 2012.⁸⁵ During the banking crisis of the 1980s, prior to the enactment

81. See authorities cited *infra* at note 82.

82. GAO BANK FAILURE REPORT, *supra* note 70, at 29-34; see also FDIC OFFICE OF THE INSPECTOR GEN., EVAL-13-002, REPORT TO THE CONGRESS: COMPREHENSIVE STUDY ON THE IMPACT OF THE FAILURE OF INSURED DEPOSITORY INSTITUTIONS 48-58, 68-84 (2013), available at <http://www.fdicog.gov/reports13/13-002EV.pdf>.

83. Wilmarth, *Citigroup*, *supra* note 14, at 131 (quoting Mr. Hoenig’s comments during a speech in November 2012 and a subsequent interview in February 2013).

84. *Id.* at 131 & n.493 (citing a news report indicating that “some ‘D.C. policy watchers’ were ‘skeptical’ about Hoenig’s proposal for full-scope examinations for big banks” (quoting Joe Adler, *FDIC’s Hoenig Proposes ‘Full Scope’ Big Bank Exams*, AM. BANKER, Feb. 12, 2013, at 1)); see also Tracy Ryan, *The Man Who Has Wall Street Banks on Edge*, WALL ST. J., Sept. 26, 2014, at C1 (describing opposition by Wall Street banks against Mr. Hoenig’s proposals for other measures that would impose stronger controls on megabanks).

85. See *supra* notes 22-23 and accompanying text (describing the federal agencies’ guarantee of survival for the nineteen largest banks in February 2009). According to FDIC records, 465 banks failed between January 2008 and December 2012. FDIC, *Quarterly Banking Profile: Fourth Quarter 2012: Highlights from the 2012 Summary of Deposits*, 7 FDIC Q., no. 1, 2013, at 17, available at https://www.fdic.gov/bank/analytical/quarterly/2013_vol7_1/FDIC_Quarterly_Vol7_No1.pdf. Of those failed banks, only nine institutions had assets of more than \$10 billion and only two institutions had assets of more than \$30 billion. See *Bank Failures in Brief: 2010*, FDIC, <https://www.fdic.gov/bank/historical/bank/2010/index.html> (last updated Jan. 5, 2015) (showing that Westernbank failed in April 2010 with \$11.9 billion of assets); *Bank Failures in Brief: 2009*, FDIC, <https://www.fdic.gov/bank/historical/bank/2009/index.html> (last updated Jan. 5, 2015) (showing that AmTrust Bank failed in December 2009 with \$12 billion of assets; United Commercial Bank failed in November 2009 with \$11.2 billion of

of PCA, federal regulators acted much differently and adopted a policy of forbearance for small agricultural banks. Regulators sought to avoid unnecessary write-downs on restructured agricultural loans and also provided “capital forbearance” to 301 community banks.⁸⁶ More than three-quarters of the banks that received forbearance either survived the crisis or entered into mergers without FDIC assistance.⁸⁷ The FDIC later determined that (1) the various bank forbearance programs of the 1980s (including those for agricultural banks and savings banks) would not have been consistent with the subsequently enacted PCA regime, and (2) a strict application of the PCA regime during the banking crisis of the 1980s would have forced regulators to close more than 200 banks that ultimately survived that crisis.⁸⁸ During the recent financial crisis, as shown above, federal regulators rigorously followed PCA’s no-forgiveness regime with respect to community banks but suspended PCA treatment for the largest banks (even though regulators lacked statutory authority for that suspension).⁸⁹

II. COMMUNITY BANKS WERE NOT RESPONSIBLE FOR THE FINANCIAL CRISIS, BUT THE OUTCOME OF THE CRISIS HAS RAISED DOUBTS ABOUT THEIR ABILITY TO CONTINUE PROVIDING CRUCIAL SUPPORT FOR SMALL BUSINESSES AND LOCAL COMMUNITIES

As shown below, there is wide agreement that large, complex financial institutions (LCFIs) and credit ratings agencies (CRAs) bear primary responsibility within the private sector for the financial crisis of 2007–2009. However, the crisis triggered a severe and

assets; Guaranty Bank and Colonial Bank failed in August 2009 with \$13 billion and \$25 billion of assets, respectively; and BankUnited failed in May 2009 with \$12.8 billion of assets); *Bank Failures in Brief: 2008*, FDIC, <https://www.fdic.gov/bank/historical/bank/2008/index.html> (last updated Jan. 5, 2015) (showing that Downey Savings failed in November 2008 with \$12.8 billion of assets; Wamu failed in September 2008 with \$307 billion of assets; and IndyMac Bank failed in June 2008 with \$32 billion of assets).

86. FDIC, HISTORY OF THE EIGHTIES—LESSONS FOR THE FUTURE 49 (1997) [hereinafter FDIC BANKING HISTORY], available at <https://www.fdic.gov/bank/historical/history/>.

87. *Id.* at 49-50, 117-18 (describing the regulatory forbearance program for agricultural banks and explaining that, of the 301 banks granted forbearance under that program, 201 banks survived the crisis and another thirty-five merged without FDIC assistance, while sixty-five failed).

88. *Id.* at 51-55 (estimating that the PCA regime would have required the FDIC to close 209 banks that ultimately survived the crisis).

89. See *supra* notes 59-64, 77-79 and accompanying text.

prolonged recession that caused hundreds of failures among community banks. In turn, those failures have raised doubts about the continued ability of community banks to fulfill their central role in supporting small businesses and local communities. The future viability of community banks has also been called into question because of (1) the highly preferential TBTF treatment that megabanks received during the financial crisis, and (2) the costly new compliance requirements that Dodd–Frank and the Basel III capital accord have imposed on community banks.

A. Community Banks Were Not Responsible for the Financial Crisis, but They Suffered Devastating Losses During the Ensuing Recession

Most analysts and policymakers agree that LCFIs—including the biggest banks, the largest securities firms, and AIG—were the most important private-sector catalysts for the financial crisis of 2007–2009. With the active assistance of CRAs, LCFIs created the marketing, funding, and securitization programs that financed trillions of dollars of subprime mortgages and option ARMs, and thereby precipitated an unsustainable and catastrophic housing boom.⁹⁰ Megabanks used securitization, along with highly automated marketing and loan approval techniques, to become the unchallenged leaders in residential mortgage lending and other forms of retail lending by 2007, and they further increased their dominance by acquiring troubled lenders (with the federal government’s help) during the crisis.⁹¹

90. Wilmarth, *Dark Side*, *supra* note 13, at 1002-46; Wilmarth, *Dodd–Frank*, *supra* note 15, at 963-79; accord SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN 5-6, 10-12, 120-74 (2010); Tanya D. Marsh & Joseph W. Norman, *The Impact of Dodd–Frank on Community Banks* 22-26 (Wake Forest Univ., Legal Studies Paper No. 2,302,392, 2013), available at <http://ssrn.com/abstract=2302392>; see also DALLAS FED. 2011 REPORT, *supra* note 30, at 3, 7, 11 (“TBTF institutions were at the center of the financial crisis”); *id.* at 14 (“TBTF banks remain at the epicenter of the foreclosure mess and the backlog of toxic assets standing in the way of a housing revival”); THOMAS M. HOENIG, PRESIDENT, FED. RESERVE BANK OF KAN. CITY, REGULATORY REFORM AND THE ECONOMY: WE CAN DO BETTER 8 (2009), available at <http://www.kansascityfed.org/SpeechBio/HoenigPDF/Denver.Forums.10.06.09.pdf> (stating that the “largest [financial] firms . . . were central to this crisis as it expanded and became a global recession”).

91. Wilmarth, *Dark Side*, *supra* note 13, at 988-91, 1008-24; Wilmarth, *Dodd–Frank*, *supra* note 15, at 958-59, 984-85; see also FDIC COMMUNITY BANKING STUDY, *supra* note 1, at 5-1 to 5-2; GAO BANK FAILURE REPORT, *supra*

In contrast, community banks had very little involvement in subprime lending or other forms of securitized lending.⁹² Unlike big banks, community banks typically did not sell substantial percentages of their residential mortgages for securitization and instead held most of those loans in their portfolios.⁹³ In addition, most community banks originated home mortgages through their own loan officers and did not rely on mortgage brokers.⁹⁴

This personalized, portfolio-based lending approach gave community banks strong incentives and a superior ability to screen and monitor their home mortgage loans carefully.⁹⁵ As a result, their residential mortgages had a much lower default rate between 2009 and 2012, compared with mortgages made by larger banks.⁹⁶ A recent study found that (1) counties in which community banks had a

note 70, at 9. Between 1984 and 2011, retail loans (including residential mortgages and other consumer loans) declined from 61% to 36% of all loans held by community banks. FDIC COMMUNITY BANKING STUDY, *supra* note 1, at 5-1. During the same period, retail loans rose from 35% to 54% of all loans held by noncommunity banks. *Id.*

92. Marsh & Norman, *supra* note 90, at 23-25 (stating that “community banks were very minor players in the subprime lending market” and “participated in only 0.07 percent of residential mortgage securitization activities between 2003 and 2010”); *see also* Daniel K. Tarullo, Governor, Fed. Reserve Sys., Address at the North Carolina Bankers Association Annual Convention: Large Banks and Small Banks in an Era of Systemic Risk Regulation (June 15, 2009), *available at* <http://www.federalreserve.gov/newsevents/speech/tarullo20090615a.htm> (“The financial crisis did not originate in smaller banks . . .”).

93. Marsh & Norman, *supra* note 90, at 14; Elizabeth A. Duke, Governor, Fed. Reserve Sys., Remarks at the Community Bankers Symposium: Community Banks and Mortgage Lending (Nov. 9, 2012) [hereinafter Duke Nov. 9, 2012 Speech], *available at* <http://www.federalreserve.gov/newsevents/speech/duke20121109a.pdf>. A recent survey of community banks by the Independent Community Bankers of America (ICBA) determined that “50 percent of respondents . . . hold all of their mortgage loans in portfolio, and 72 percent of respondents hold at least half of their mortgage loans in portfolio.” INDEP. CMTY. BANKERS OF AM., COMMUNITY BANK REGULATORY RELIEF WILL GROW ECONOMY AND CREATE JOBS 4 (2014) [hereinafter ICBA REGULATORY RELIEF PROPOSALS], *available at* <http://www.icba.org/files/ICBASites/PDFs/test040814a.pdf> (citing results of Sept. 2012 survey).

94. Kathy Fogel, Raja Kali & Tim Yeager, *Have Community Banks Reduced Home Foreclosure Rates?*, 35 J. BANKING & FIN. 2498, 2500 (2011).

95. *Id.* at 2498, 2500.

96. Marsh & Norman, *supra* note 90, at 24-25 (“Since 2009, portfolio default rates [for residential mortgages] have averaged 0.23 percent at community banks versus 3.62 percent at all [banking] institutions”); *see also* Gunther & Klemme, *supra* note 1, at 3, 7 (showing that “within the beleaguered residential real estate category, . . . community banks exhibited performance far superior to the nation’s largest financial institutions”).

larger than average presence experienced significantly lower rates of home foreclosures from 2005 to 2008, and (2) the foreclosure-reducing impact of greater community bank presence became even more significant as the mortgage crisis deepened after 2006.⁹⁷

As the highly automated systems of big banks captured a steadily increasing share of retail lending markets (including home mortgages) after the mid-1980s, community banks were forced to shift more of their lending activities to the CRE market. Community banks significantly expanded their holdings of CRE loans between 1984 and 2011.⁹⁸ Applications by borrowers for CRE loans increased as the housing boom and a stronger economy created rising demand by tenants for retail and office space during the 1990s and 2000s. However, the sudden collapse of the housing market in 2007 had disastrous spillover effects on the CRE market. The housing bust plunged the U.S. economy into a deep recession, causing many retail stores and business offices to close. Widespread closures of stores and offices bankrupted CRE owners and triggered a cascade of falling market values for shopping malls and office buildings.⁹⁹

CRE loans made by community banks during the 1990s and 2000s were typically secured by smaller, less glamorous commercial properties located in towns, smaller cities, and suburbs of larger cities. Most insurance companies, real estate investment trusts, and other institutional investors (including investors in commercial MBS) did not invest in the types of properties that served as collateral for CRE loans made by community banks. Consequently, when owners of those commercial properties fell behind in their

97. Fogel, Kali & Yeager, *supra* note 94, at 2498-99, 2503-09.

98. CONG. OVERSIGHT PANEL, FEBRUARY OVERSIGHT REPORT: COMMERCIAL REAL ESTATE LOSSES AND THE RISK TO FINANCIAL STABILITY 19 (2010) [hereinafter COP CRE REPORT], available at <http://cybercemetery.unt.edu/archive/cop/20110402035627/http://cop.senate.gov/documents/cop-021110-report.pdf>; FDIC COMMUNITY BANKING STUDY, *supra* note 1, at 5-1 (stating that between 1984 and 2011, CRE loans doubled from 21% to 42% as a share of total loans held by community banks).

99. Tanya D. Marsh, *Too Big to Fail vs. Too Small to Notice: Addressing the Commercial Real Estate Debt Crisis*, 63 ALA. L. REV. 321, 322-24, 328-31, 344-48 (2012); COP CRE REPORT, *supra* note 98, at 18-36, 80-81; see also Ari Levy & Daniel Taub, *Defaulting Commercial Properties Hit Banks on Vacancy-Rate Rise*, BLOOMBERG (Mar. 23, 2009, 8:01 PM), <http://www.bloomberg.com/apps/news?sid=aR72TKlxCQ7A&pid=newsarchive> (reporting that "U.S. banks, battered by record losses from the worst housing slump since the Great Depression, now must weather increasing loan delinquencies from owners of skyscrapers and shopping malls" because the severe recession was forcing many retail outlets and business offices to close).

payments on loans from community banks, there were very few, if any, options for refinancing or selling those properties.¹⁰⁰ Community banks incurred large losses as growing numbers of their CRE loans defaulted, and losses on CRE loans proved to be a leading cause for many community bank failures.¹⁰¹

As Tanya Marsh has pointed out, “[t]here was no systemic fraud” and “no subprime aspect” in the CRE loans originated by community banks during the period leading up to the financial crisis.¹⁰² The CRE crisis was the direct result of the bursting of a catastrophic housing bubble—a bubble that LCFIs generated without any meaningful involvement from community banks. In January 2010, FDIC Chairman Sheila Bair observed that “traditional [banking] institutions . . . suffered . . . collateral damage from the . . . economic undertow created by the collapse of the housing bubble.”¹⁰³ Professor Marsh has criticized federal agencies—justifiably, in my view—for “allow[ing] community banks to fail due to circumstances that were ultimately beyond their control, particularly after stepping in to stabilize ‘systemically important’ financial institutions like Citigroup and Bank of America,” which were deeply implicated in the irresponsible lending practices that fueled the housing boom.¹⁰⁴

100. Marsh, *supra* note 99, at 348-57, 373-79; COP CRE REPORT, *supra* note 98, at 38, 42-44, 62-64, 78-80.

101. Marsh, *supra* note 99, at 371-72 (noting that 86% of the 322 banks that failed between January 2008 and December 2010 had high concentrations in CRE lending); see also GAO BANK FAILURE REPORT, *supra* note 70, at 29-31 (discussing evidence that “declining collateral values of impaired collateral-dependent loans—particularly CRE and [acquisition, development, and construction] loans—drove both credit losses and charge-offs” that led to the failures of many community banks).

102. Marsh, *supra* note 99, at 375.

103. Sheila C. Bair, Chairman, FDIC, Statement Before the Financial Crisis Inquiry Commission: The Causes and Current State of the Financial Crisis (Jan. 14, 2010) [hereinafter Bair FCIC Testimony] (emphasis added), available at <https://www.fdic.gov/news/news/speeches/archives/2010/spjan1410.html>.

104. Marsh, *supra* note 99, at 375 & n.252 (quoting a comment during a 2010 congressional hearing by Rep. Spencer Bachus (R-AL), who stated that “our larger institutions . . . have been protected and insulated, when, really, a lot of the risk-taking and what happened was a direct result of some of their activities, [while] our smaller banks and our businesses and commercial real estate is [sic] more of a victim of what they did[, a]nd it is really not a fair approach that has been taken” (quoting *Alternatives for Promoting Liquidity in the Commercial Real Estate Markets, Supporting Small Businesses, and Increasing Job Growth: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 26 (2010) (statement of Rep. Spencer Bachus))); Wilmarth, *Citigroup*, *supra* note 14, at 90-105 (describing Citigroup’s

As explained above, federal regulators allowed more than 450 community banks to fail, but they aggressively intervened to ensure the survival or assisted acquisition of all but one institution that was larger than \$100 billion.¹⁰⁵ Community banks did not deserve their much harsher fate because their overall performance during the financial crisis was significantly better than the performance of larger banks. In fact, community banks recorded substantially lower levels of noncurrent loans and charged-off loans throughout the crisis, compared with bigger banks.¹⁰⁶ Decisions by federal officials to rescue big banks but not community banks were ultimately driven by regulators' concerns about maintaining financial stability, and regulators gave no weight to the relative performance of larger and smaller banks.¹⁰⁷

reckless subprime lending and securitization practices); Victoria Finkle & Joe Adler, *Three Takeaways from Citi's \$7B Mortgage Settlement*, AM. BANKER (July 14, 2014, 3:22 PM), http://www.americanbanker.com/ArticlePreview?client_id=americanbanker_ab&story_id=1068646 (reporting on Citigroup's agreement to pay \$7 billion to "resolve a whole host of state and federal claims over how the bank packaged and sold mortgage-related assets that soured during the crisis" and defrauded investors); Tom Schoenberg, Hugh Son & David McLaughlin, *BofA to Pay \$16.7 Billion to End U.S. Mortgage Probes*, BLOOMBERG BUS. (Aug. 21, 2014, 9:11 AM), <http://www.bloomberg.com/news/articles/2014-08-21/bofa-agrees-to-pay-16-65-billion-to-end-u-s-mortgage-probes> (reporting on BofA's \$16.7 billion agreement with federal and state agencies to settle claims that "Bank of America and its Merrill Lynch and Countrywide Financial units sold billions of dollars of mortgage securities backed by toxic loans and misrepresented the risks to investors"); Bonnie Sinnock, *What Bank of America Actually Did Wrong*, NAT'L MORTGAGE NEWS (Aug. 28, 2014, 3:42 PM), <http://www.nationalmortgagenews.com/blogs/hearing/what-bank-of-america-actually-did-wrong-1042482-1.html> (reporting that the "30-page statement of facts" issued by the United States Department of Justice in connection with BofA's settlement "shows how Countrywide and Merrill Lynch, both of which B of A acquired—as well as B of A itself—removed an increasing number of [mortgage] underwriting requirements over time without clear disclosure to investors").

105. See *supra* notes 22-23, 65-69, 85 and accompanying text.

106. FDIC COMMUNITY BANKING STUDY, *supra* note 1, at 4-5 to 4-6; Gunther & Klemme, *supra* note 1, at 3, 6; see also FDIC, *Quarterly Banking Profile: Fourth Quarter 2014*, 9 FDIC Q., no. 1, 2014, at 11 [hereinafter *FDIC Fourth Quarter 2014 Report*], available at https://www.fdic.gov/bank/analytical/quarterly/2015_vol9_1/FDIC_4Q2014_v9n1.pdf (showing that, at the end of 2014, banks larger than \$10 billion still reported the highest percentages of "Total loans and leases" that were delinquent (thirty to eighty-nine days past due) or noncurrent or charged-off, compared with banks in the smaller size categories, except that banks with assets under \$100 million reported the highest percentage of delinquent loans).

107. See *supra* Part I. As economist James Barth has noted, "Many [community] banks were too small to save. . . . Other banks were too big to allow to

B. Community Banks Face Costly New Compliance Burdens Under the Dodd–Frank Act and Basel III

Some provisions of Dodd–Frank help community banks either by granting exemptions from particular statutory requirements or by giving more favorable treatment to smaller banks. For example, the provisions of Titles I and II dealing with systemically significant financial institutions (SIFIs) apply only to bank holding companies larger than \$50 billion.¹⁰⁸ Title X exempts banks smaller than \$10 billion from direct supervision and enforcement by the Consumer Financial Protection Bureau (CFPB), although Title X still requires smaller banks to comply with the CFPB’s rules.¹⁰⁹

Two provisions of Title III assist community banks by raising the per-account deposit insurance ceiling from \$100,000 to \$250,000 and by requiring the FDIC to amend its deposit insurance assessment formula so that larger banks pay a higher (and fairer) percentage of deposit insurance assessments.¹¹⁰ Two other sections of Dodd–Frank benefit smaller banks by (1) removing a requirement that previously compelled small publicly traded banks to include in their annual audits a report on the effectiveness of their internal controls over financial reporting,¹¹¹ and (2) exempting banks smaller than \$10

fail. There is an inequity there.” Steve Matthews, *‘Ring of Death’ Throttles Georgia as Small Banks Close: Economy*, BLOOMBERG BUS. (Mar. 19, 2014, 9:04 AM), <http://www.bloomberg.com/news/articles/2014-03-19/-ring-of-death-throttles-georgia-as-banks-too-small-to-save> (quoting James Barth, Finance Professor at Auburn University).

108. Marsh & Norman, *supra* note 90, at 29-30; Wilmarth, *Dodd–Frank*, *supra* note 15, at 993-98, 1006-09.

109. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1026, 124 Stat. 1376, 1993-95 (2010); U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-12-881, COMMUNITY BANKS AND CREDIT UNIONS: IMPACT OF THE DODD–FRANK ACT DEPENDS LARGELY ON FUTURE RULE MAKINGS 30-35 (2012) [hereinafter GAO DODD–FRANK IMPACT STUDY] (discussing § 1026 and other provisions of Title X that apply to community banks); *see also* Marsh & Norman, *supra* note 90, at 32-33 (same).

110. Dodd–Frank §§ 331, 335; *see also* GAO DODD–FRANK IMPACT STUDY, *supra* note 109, at 22-25 (discussing §§ 331 and 335, and noting the FDIC’s views that (1) the new deposit insurance assessment formula mandated by § 331 has “shifted some of the overall assessment burden from community banks to the largest institutions” and “has resulted in a sharing of the [deposit insurance fund] assessment burden that better reflects each group’s share of industry assets,” and (2) the higher deposit insurance coverage limit of \$250,000 “should help community banks attract and retain core deposits”).

111. Dodd–Frank § 989(G); *see also* GAO DODD–FRANK IMPACT STUDY, *supra* note 109, at 25-27 (discussing § 989(G)).

billion from the Durbin Amendment's limitation on debit card interchange fees.¹¹²

The foregoing provisions of Dodd–Frank reflect a growing congressional appreciation of the need for a two-tiered approach that would establish separate regulatory regimes for community banks and larger banks.¹¹³ However, Dodd–Frank does not go far enough in establishing different standards for small and large banks. Instead, Dodd–Frank imposes complex and costly new compliance burdens on community banks.¹¹⁴

In 2013, the Mercatus Center at George Mason University conducted a survey of community bankers (the Mercatus Small Bank Survey) to determine the impact of Dodd–Frank on small banks.¹¹⁵ According to the results of that survey, (1) over four-fifths of respondents stated that Dodd–Frank had increased their banks' compliance costs by more than 5%; (2) many respondents said that their banks would need to hire additional staff members to meet their new compliance requirements; and (3) over four-fifths of respondents viewed Dodd–Frank as being even more burdensome for their banks than the Bank Secrecy Act.¹¹⁶ Other anecdotal reports indicate that growing compliance burdens and costs are major factors leading community bankers either to abandon traditional lines of business or to sell their institutions to larger banks.¹¹⁷

112. Dodd–Frank § 1075; *see also* GAO DODD–FRANK IMPACT STUDY, *supra* note 109, at 27-30 (discussing the Durbin Amendment, but noting concerns among community bankers that the two-tiered interchange fee structure established by the Durbin Amendment might not prove to be viable and therefore might not provide lasting benefits to community banks); Marsh & Norman, *supra* note 90, at 27-28 (same).

113. Jeff Bater, *Regulatory Reform: Senators Raise Questions of Two-Tiered Regulatory System for Banks Big and Small*, 100 BNA'S BANKING REP. 1071, 1071 (2013); Rob Braswell, *The Case for Tiered Regulation*, AM. BANKER (June 11, 2014, 12:00 PM), <http://www.americanbanker.com/bankthink/the-case-for-tiered-regulation-1068007-1.html>.

114. Bater, *supra* note 113, at 1071; Braswell, *supra* note 113; Marsh & Norman, *supra* note 90, at 35-40.

115. Hester Peirce, Ian Robinson & Thomas Stratmann, *How Are Small Banks Faring Under Dodd–Frank?* 16-19 (George Mason Univ. Mercatus Ctr., Working Paper No. 14-05, 2014), available at <http://mercatus.org/publication/how-are-small-banks-faring-under-dodd-frank> (describing the survey).

116. *Id.* at 34-37.

117. Marsh & Norman, *supra* note 90, at 35-38; Jackie Stewart, *Ranks of Tiny Banks Shrinking as Challenges Mount*, AM. BANKER, Feb. 21, 2014, at 2, available at 2014 WLNR 4711820; *see also* Jackie Stewart, *A Quarter of Community Banks Expect to Sell Next Year: KPMG*, AM. BANKER, Nov. 22, 2013, at 2, available at 2013 WLNR 29274403.

New residential mortgage lending rules mandated by Title XIV of Dodd–Frank create particularly difficult obstacles for community banks. Section 1411 requires residential mortgage lenders to determine that their borrowers have “a reasonable ability to repay” their loans together with associated taxes, insurance, and mortgage guarantee costs.¹¹⁸ Home mortgage lenders that fail to satisfy the “ability to repay” (ATR) requirement are subject to enforcement actions and sanctions by regulators as well as civil claims for damages by borrowers.¹¹⁹ If a residential mortgage meets the criteria for a “qualified mortgage” (QM), as specified in the CFPB’s QM regulation, § 1412 creates a presumption that the lender has satisfied the ATR requirement.¹²⁰ Unfortunately, the CFPB’s “QM regulation is so complex that an inadvertent failure to comply with the QM requirements may become a significant problem,”¹²¹ particularly for community banks that do not have large compliance staffs.¹²² Respondents to the Mercatus Small Bank Survey expressed “general confusion . . . about how the mortgage rules apply to them,” and they described the QM regulation and Dodd–Frank’s other new

118. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1411, 124 Stat. 1376, 2142-45 (2010); *see also* Marsh & Norman, *supra* note 90, at 33 (discussing § 1411).

119. Marsh & Norman, *supra* note 90, at 34; Raymond Natter, What Happens If a Mortgage Is Not a QM Loan? 2-3 (Dec. 5, 2013) (unpublished manuscript), *available at* <http://ssrn.com/abstract=2371938>.

120. Marsh & Norman, *supra* note 90, at 34. The CFPB’s QM regulation provides a conclusive presumption in favor of QMs that have an interest rate within 1.5% of the Average Prime Offer Rate (APOR) for first-lien loans, or within 3.5% of the APOR for junior-lien loans. Kevin L. Petrasic & Michael A. Hertzberg, *Complying with the CFPB’s Qualified Mortgage Rule: Issues for Implementation*, in PAUL HASTINGS, STAY CURRENT: A CLIENT ALERT FROM PAUL HASTINGS 1, 4 (2013), *available at* <http://www.paulhastings.com/publications-items/details/?id=b516de69-2334-6428-811c-ff00004cbded>. However, higher-priced QMs qualify only for a rebuttable presumption that the lender has satisfied the ATR requirement. *Id.*

121. Natter, *supra* note 119, at 1.

122. Marsh & Norman, *supra* note 90, at 34 (stating that “the consequences for failing to understand, implement, or document” the CFPB’s QM regulation “are high,” and “community banks largely lack the in-house expertise to protect themselves from mistakes that could lead to costly litigation”). The CFPB has issued a “small entity compliance guide” that seeks “to provide an easy-to-use summary of the ATR/QM rule,” but that guide has a length of fifty pages. CONSUMER FIN. PROT. BUREAU, ABILITY-TO-REPAY AND QUALIFIED MORTGAGE RULE: SMALL ENTITY COMPLIANCE GUIDE 9 (2014) [hereinafter CFPB ATR/QM COMPLIANCE GUIDE], *available at* http://files.consumerfinance.gov/f/201401_cfpb_atr-qm_small-entity-compliance-guide.pdf.

requirements for home mortgages as creating onerous and costly compliance burdens.¹²³

Dodd–Frank’s new ATR and QM standards also present a direct challenge to the traditional business model of community banks. Many community banks provide customized mortgages that are designed to meet the special needs of small business owners and farmers, and many of those mortgages do not satisfy the standard QM criteria with regard to employment, income, and collateral. In addition, community banks cannot sell most of their customized mortgages to GSEs because they do not meet the GSEs’ prescribed criteria for “conforming” mortgages.¹²⁴ Community banks must therefore retain customized mortgages for entrepreneurs and farmers in their portfolios. To mitigate the interest rate risk of retained mortgages, many community banks include balloon payment terms in their mortgages that require full repayment after three or five years.¹²⁵ The ICBA recently estimated that community banks hold more than \$400 billion in balloon payment mortgages that have been extended to over five million borrowers.¹²⁶

The CFPB’s QM regulation has a strong tendency “to homogenize the market for housing credit by incentivizing lenders to provide mortgage products that favor standard, prime borrowers, or mortgage products that conform to Fannie Mae/Freddie Mac standards.”¹²⁷ The QM regulation’s incentives for “standardized” residential mortgages conflict with the business model followed by community banks, “which emphasizes relationship banking, personalized underwriting, and customization of financial products to meet the specific needs of customers and communities.”¹²⁸ The QM regulation does include a “small creditor” exception, which provides QM treatment for mortgage loans originated by smaller

123. Peirce, Robinson & Stratmann, *supra* note 115, at 49-52. Some respondents stated that their community banks had already decided to discontinue offering home mortgages because of the new Dodd–Frank rules. *Id.* at 49.

124. ICBA REGULATORY RELIEF PROPOSALS, *supra* note 93, at 3-6; *see also* Duke Nov. 9, 2012 Speech, *supra* note 93, at 8-10.

125. ICBA REGULATORY RELIEF PROPOSALS, *supra* note 93, at 3-5.

126. *Id.* at 4-5.

127. Petrasic & Hertzberg, *supra* note 120, at 7.

128. Marsh & Norman, *supra* note 90, at 39; *see also* Peirce, Robinson & Stratmann, *supra* note 115, at 14 (“[M]any [community] bankers felt that the move toward standardized products and a “one-size-fits-all” supervisory approach were taking away one of the strongest advantages of community banks: the ability to tailor products to fit individualized needs.” (quoting CSBS COMMUNITY BANKING STUDY, *supra* note 1, at 15)).

banks that operate primarily in “rural” or “underserved” counties if their loans satisfy a number of requirements designed to protect borrowers.¹²⁹ However, the “small creditor” exception is far too narrow to accommodate the mortgage lending practices of many community banks.¹³⁰ As a result, the “QM rule poses a daunting challenge” for community banks that wish to continue making customized mortgages to entrepreneurs and farmers.¹³¹

Community bankers have also expressed great concerns about Dodd–Frank’s adverse impact on their mortgage servicing activities. Community banks typically retain mortgage servicing rights for a high percentage of the mortgages they originate. Community banks view mortgage servicing rights as an essential component of their business strategy to build long-term relationships with their customers.¹³² However, the CFPB’s new mortgage servicing rules under Dodd–Frank impose highly detailed and costly requirements.¹³³ The CFPB’s mortgage servicing rules include a “small servicer” exception, which exempts small servicers from some but not all of the prescribed requirements for mortgage servicing.¹³⁴ However, the small servicer exception applies only to companies (including all affiliates) that service 5,000 or fewer mortgages, and it therefore fails to cover many community banks that are active in making and servicing home mortgages.¹³⁵

Section 171 of Dodd–Frank requires community banks to comply with new capital standards that federal regulators have

129. CFPB ATR/QM COMPLIANCE GUIDE, *supra* note 122, at 33-36 (describing the small creditor exception, which applies to banks with less than \$2 billion of assets that originate mortgages predominantly in rural or underserved areas).

130. ICBA REGULATORY RELIEF PROPOSALS, *supra* note 93, at 6-7.

131. *Id.* at 3-10; *accord* Duke Nov. 9, 2012 Speech, *supra* note 93, at 5-14.

132. ICBA REGULATORY RELIEF PROPOSALS, *supra* note 93, at 8-9.

133. The CFPB has issued a “small entity compliance guide” that seeks “to provide an easy-to-use summary of the Mortgage Servicing Rules,” but that guide is more than 100 pages in length. CONSUMER FIN. PROT. BUREAU, 2013 REAL ESTATE SETTLEMENT PROCEDURES ACT (REGULATION X) AND TRUTH IN LENDING ACT (REGULATION Z) MORTGAGE SERVICING FINAL RULES: SMALL ENTITY COMPLIANCE GUIDE 11 (2014) [hereinafter CFPB MORTGAGE SERVICING COMPLIANCE GUIDE], *available at* http://files.consumerfinance.gov/f/201401_cfpb_small-entity-compliance-guide_tila-respa.pdf.

134. *Id.* at 16-19 (describing the small servicer exception).

135. ICBA REGULATORY RELIEF PROPOSALS, *supra* note 93, at 8-9; *see also* CFPB MORTGAGE SERVICING COMPLIANCE GUIDE, *supra* note 133, at 16-19 (explaining the small servicer exemption).

adopted to implement the Basel III capital accord.¹³⁶ In July 2013, the federal banking agencies issued a new capital regulation under Basel III,¹³⁷ and that regulation imposes much higher capital charges on mortgage servicing rights retained by banks. Under the new regulation, which takes effect in 2015, any bank (including a community bank) with mortgage servicing assets (MSAs) that exceed 10% of its “common equity tier 1 capital”¹³⁸ will be required to deduct the excess amount from its regulatory capital. In addition, MSAs below the 10% threshold will be subject to a 250% risk weight.¹³⁹ Consequently, beginning in 2015, community banks that service substantial numbers of home mortgages will be compelled to report “starkly lower capital ratios . . . or [will] be forced to raise new capital, a significant challenge for community banks in the current environment.”¹⁴⁰

Increased compliance costs under the new mortgage rules and higher capital charges under the new capital rule will probably cause many community banks to shrink or abandon their mortgage lending and servicing businesses.¹⁴¹ That outcome would be very harmful to consumers, entrepreneurs, farmers, and local communities because

136. Marsh & Norman, *supra* note 90, at 30.

137. For a detailed overview of the new capital regulation issued in July 2013, see SULLIVAN & CROMWELL LLP, BANK CAPITAL RULES: FEDERAL RESERVE APPROVES FINAL RULES ADDRESSING BASEL III IMPLEMENTATION AND, FOR ALL BANKS, SUBSTANTIAL REVISIONS TO BASEL I-BASED RULES (2013), *available at* http://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital%20Rules_Basel_III_7_3_13.pdf. The federal banking agencies have issued a guide “to help small, non-complex community banking organizations understand the sections of the capital rule . . . most relevant to their operations.” BD. OF GOVERNORS OF THE FED. RESERVE SYS., FDIC & OFFICE OF THE COMPTROLLER OF THE CURRENCY, NEW CAPITAL RULE: COMMUNITY BANK GUIDE 1 (2013) [hereinafter CAPITAL RULE COMMUNITY BANK GUIDE], *available at* http://www.federalreserve.gov/bankinforeg/basel/files/capital_rule_community_bank_guide_20130709.pdf.

138. See RICHARD SCOTT CARNELL, JONATHAN R. MACEY & GEOFFREY P. MILLER, THE LAW OF FINANCIAL INSTITUTIONS 223-24 (5th ed. 2013) (describing the calculation of “common equity tier 1 capital” under federal capital regulations implementing Basel III).

139. CAPITAL RULE COMMUNITY BANK GUIDE, *supra* note 137, at 3; *see also Examining Regulatory Relief Proposals for Community Financial Institutions, Part II: Hearing Before the Subcomm. on Fin. Insts. & Consumer Credit of the H. Comm. on Fin. Servs.*, 113th Cong. 4 (July 15, 2014) (statement of Samuel A. Vallandingham, Indep. Cmty. Bankers of Am.) [hereinafter *Vallandingham Testimony*], *available at* <http://www.icba.org/files/ICBASites/PDFs/test071514a.pdf>.

140. *Vallandingham Testimony*, *supra* note 139, at 5.

141. Peirce, Robinson & Stratmann, *supra* note 115, at 49-52.

community banks originate almost one-fifth of all new residential mortgage loans each year.¹⁴² As discussed below, federal regulators should revise their mortgage rules and their new capital regulation to reduce Dodd–Frank’s burdens on community banks.¹⁴³

III. THE PRESERVATION OF A VIBRANT COMMUNITY BANKING SECTOR SHOULD BE A NATIONAL PRIORITY

A. Community Banks Play Crucial Roles in Supporting Small Businesses and Local Communities

The small business sector is a highly important sector in our economy. The health of the small business sector depends in large part on the ability of community banks to fulfill their traditional role as relationship lenders. Small businesses (those with fewer than 500 employees) account for almost half of U.S. private-sector jobs and private-sector output.¹⁴⁴ Small firms created more than three-fifths of all net new U.S. jobs between 1993 and 2013.¹⁴⁵ Small businesses (particularly start-up and younger firms) have spurred much of the innovation and dynamism in the U.S. economy over the past three decades.¹⁴⁶

Banks are, and have long been, the most important providers of external credit to small businesses.¹⁴⁷ Within the banking industry,

142. Duke Nov. 9, 2012 Speech, *supra* note 93, at 5-14; ICBA REGULATORY RELIEF PROPOSALS, *supra* note 93, at 2-7; *Vallandingham Testimony*, *supra* note 139, at 2-6; *see also* Marsh & Norman, *supra* note 90, at 13-14, 33-39.

143. *See infra* Section V.A.

144. OFFICE OF ADVOCACY, U.S. SMALL BUS. ADMIN., FREQUENTLY ASKED QUESTIONS 1 (2014) [hereinafter SBA FAQ], *available at* http://www.sba.gov/sites/default/files/advocacy/FAQ_March_2014_0.pdf (stating that small businesses account for “48.5 percent of private-sector employment” and “46 percent of private-sector output”).

145. *Id.* (stating that small firms created “14.3 million of the 22.9 million net new jobs,” or 63% of such jobs, between 1993 and 2013); *see also* OFFICE OF ADVOCACY, U.S. SMALL BUS. ADMIN., THE SMALL BUSINESS ECONOMY: A REPORT TO THE PRESIDENT 26 (2010) [hereinafter SMALL BUSINESS ECONOMY REPORT], *available at* http://www.sba.gov/sites/default/files/sb_econ2010.pdf (stating that small firms “accounted for 64 percent of the net new jobs created between 1993 and 2008”).

146. SMALL BUSINESS ECONOMY REPORT, *supra* note 145, at 27-28 (citing studies); *see also* John Haltiwanger, Ron S. Jarmin & Javier Miranda, *Who Creates Jobs? Small Versus Large Versus Young*, 95 REV. ECON. & STAT. 347, 360-61 (2013).

147. REBEL A. COLE, HOW DID THE FINANCIAL CRISIS AFFECT SMALL BUSINESS LENDING IN THE UNITED STATES? 1 & n.1 (2012), *available at*

the community banking sector has consistently served as a dedicated and essential source of credit to small firms.¹⁴⁸ Community banks currently provide about half of all bank credit extended to small businesses, even though community banks hold less than one-fifth of the banking industry's assets.¹⁴⁹

Community banks pursue a "relationship lending" strategy that gives them significant advantages in providing credit to small firms.¹⁵⁰ Community banks are relationship lenders because they specialize in gathering and evaluating "soft" information about the reputation and creditworthiness of local entrepreneurs.¹⁵¹ Community banks have a superior ability to assess and monitor local firms because their managers and loan officers generally have long tenures in their positions and are deeply involved in the life of their communities.¹⁵² Indeed, locally owned banks and their directors,

<https://www.sba.gov/sites/default/files/files/rs399tot.pdf> (stating that "about 60 percent of all small firms use some form of bank credit"); Charles Ou & Victoria Williams, *Lending to Small Businesses by Financial Institutions in the United States*, in OFFICE OF ADVOCACY, SMALL BUS. ADMIN, SMALL BUSINESS IN FOCUS: FINANCE 9, 9-10, 11 (2009), available at http://www.sba.gov/sites/default/files/advocacy/09finfocus_0.pdf (stating that commercial banks "accounted for 58 percent of total debt owed by . . . small firms to external lenders" in the early 2000s); Wilmarth, *Transformation*, *supra* note 13, at 258 ("Banks provide more than three-fifths of the credit extended to small businesses by persons other than owners and trade creditors, and banks have maintained this dominant market share despite the significant changes that have occurred in the financial services industry [since 1980].").

148. FDIC COMMUNITY BANKING STUDY, *supra* note 1, at I, 1-1 ("Community banks have always been inextricably connected to entrepreneurship. . . . They obtain most of their core deposits locally and make many of their loans to local businesses.").

149. *Id.* at I, 5-1 (reporting that in 2011 community banks, as defined by the FDIC, "held 14 percent of banking industry assets, but 46 percent of the industry's small loans to farms and businesses"); Jeffrey W. Gunther & Kelly Klemme, *A Lender for Tough Times*, in DALLAS FED. 2012 REPORT, *supra* note 1, at 25, 25 (stating that banks with assets under \$10 billion "held 17 percent of industrywide banking assets as of June 2012—but they accounted for more than half of the amount lent to small businesses").

150. Scott E. Hein, Timothy W. Koch & S. Scott MacDonald, *On the Uniqueness of Community Banks*, 90 ECON. REV. 15, 18-20 (2005); see also FDIC COMMUNITY BANKING STUDY, *supra* note 1, at 1-1 ("The relationship lending approach used by community banks is often the only avenue small [borrowers] have to obtain loans and access other financial services.").

151. Hein, Koch & MacDonald, *supra* note 150, at 18.

152. Allen N. Berger et al., *Does Function Follow Organizational Form? Evidence from the Lending Practices of Large and Small Banks*, 76 J. FIN. ECON. 237, 239-45, 265-67 (2005); Rebel A. Cole, Lawrence G. Goldberg & Lawrence J. White, *Cookie Cutter vs. Character: The Micro Structure of Small Business Lending*

officers, and staff members typically provide generous financial support to, and fill key leadership positions for, local charitable and civic organizations.¹⁵³

Community banks play a particularly important role in supporting local economies and civic groups in rural counties as well as a number of counties included in metropolitan areas where few other banks are present. In 2012, community banks were the *only* banks operating banking offices in 615 counties, and community banks also operated offices in 642 other counties where noncommunity banks *collectively* had only one or two offices. Thus, more than one-third of U.S. counties, with a total population of over 16 million people, “would have very limited physical access to mainstream banking services without the presence of community banks.”¹⁵⁴

Community banks emphasize the importance of providing deposit and cash management services to small businesses because deposit accounts cement their relationships with local entrepreneurs. Deposit accounts enable community banks to monitor the economic performance of their businesses loan customers. In turn, small

by *Large and Small Banks*, 39 J. FIN. & QUANTITATIVE ANALYSIS 227, 228-30, 249 (2004); Hein, Koch & MacDonald, *supra* note 150, at 18-20, 22; Wilmarth, *Transformation*, *supra* note 13, at 255-57, 262, 266.

153. For discussions of the importance of locally owned banks as sources of philanthropy and civic leadership for community-based charitable and social organizations, see Richard M. Brunell, *The Social Costs of Mergers: Restoring “Local Control” as a Factor in Merger Policy*, 85 N.C. L. REV. 149, 151-55, 214-20 (2006); Peter C. Carstensen, *Public Policy Toward Interstate Bank Mergers: The Case for Concern*, 49 OHIO ST. L.J. 1397, 1425 (1989); see also Josh Adams, *Local Banks a Key Part of Community*, TENNESSEAN, Feb. 9, 2012, at 1, available at 2012 WLNR 2799130 (describing the importance of community banks and their managers and directors as supporters and leaders of local charities and community groups); Kalen Holliday, *Building Communities: One Bank at a Time*, SAVINGS & COMMUNITY BANKER, Oct. 1, 2004, at 52, available at 2004 WLNR 15911752 (reporting results of a survey showing that “[n]early all community banks donate time, money, or both to their communities,” with most community banks supporting more than ten nonprofit or community organizations).

154. Backup, *supra* note 48, at 34 (providing data and noting that the United States has a total of 3,238 counties); see also FDIC COMMUNITY BANKING STUDY, *supra* note 1, at 3-5 (explaining that, in 2011, more than 70% of the counties in which community banks either operated all banking offices, or all but one or two offices, were rural counties, while about 15% of those counties were included in metropolitan areas).

businesses frequently choose to establish deposit accounts at banks that have their main offices located nearby.¹⁵⁵

Community banks “target small businesses as their primary customers for business lending and related services, while large banks view midsized and larger corporations as their preferred customers for financial services.”¹⁵⁶ Large banks prefer to make loans to bigger firms that can provide “hard” quantitative data, including audited financial statements.¹⁵⁷ When large banks do provide credit to small businesses, they frequently do so in the form of business credit cards with “micro” lines of credit under \$100,000.¹⁵⁸ Large banks use business credit cards to make loans to small firms because they can originate those loans—based primarily on the business owner’s personal financial profile and credit history—by using the same quantitative and automated methods (including credit scoring and mass marketing) that they use for their consumer credit card programs.¹⁵⁹

A study by Allen Berger and Lamont Black confirms that large banks generally provide small business credit by using quantitative “hard” technologies, while community banks prefer to make small

155. Cole, Goldberg & White, *supra* note 152, at 247 (finding that “small banks, but not large banks, favor an applicant with which it has a pre-existing deposit relationship”); Wilmarth, *Transformation*, *supra* note 13, at 262, 268 (“The ability of local banks to observe small business deposit accounts provides those banks with a significant monitoring advantage over large banks that are headquartered outside the community and, therefore, are less likely to attract deposits from small firms within the locality.”); *see also infra* note 163 and accompanying text (describing another study that found a strong link between deposit accounts maintained by small businesses and relationship lending by community banks).

156. Wilmarth, *Transformation*, *supra* note 13, at 263; *see also* Gunther & Klemme, *supra* note 149, at 1 (reporting that community banks “have about 13 percent of [their] assets in small business loans, far above the 2 percent for the largest banks”).

157. Berger et al., *supra* note 152, at 240, 250, 252; Cole, Goldberg & White, *supra* note 152, at 236, 245. Large banks prefer to rely on “hard” information and to use standardized, “cookie cutter” criteria for approving loans because (1) it is difficult for loan officers at large banks to gather and transmit to senior executives “soft” information about small businesses, and (2) complex hierarchies within large banks create control problems that encourage senior executives to prescribe quantitative criteria that give very limited discretion to loan officers. Berger et al., *supra* note 152, at 239-40, 242-43; Cole, Goldberg & White, *supra* note 152, at 229-30, 249; Hein, Koch & MacDonald, *supra* note 150, at 19-20, 22.

158. *See* Wilmarth, *Transformation*, *supra* note 13, at 264-65, 267.

159. Ou & Williams, *supra* note 147, at 9, 14-20; Wilmarth, *Transformation*, *supra* note 13, at 264-65, 267.

business loans through a relationship-based approach that incorporates “soft” information.¹⁶⁰ Berger and Black found that large banks in the late 1990s were more likely to extend credit to the smallest size category of small businesses (presumably through business credit card loans).¹⁶¹ Large banks were also more likely to provide credit in the form of equipment leases because large banks could use “hard” technologies in approving those leases and did not have to rely on “soft” information.¹⁶² In contrast, community banks were more likely to provide credit to small businesses through commercial real estate loans (because community banks could evaluate “soft” information about local property values) or through lines of credit that were based on existing relationships between the borrowers and the lending banks. Community banks also preferred to provide lines of credit to small businesses that maintained checking accounts or had longer relationships with them.¹⁶³ Berger and Black concluded that relationship factors were more important than the size of the borrower in determining whether small businesses obtained credit from community banks instead of large banks.¹⁶⁴

In keeping with their business strategy of building strong relationships, community banks proved to be more reliable sources of credit for small businesses during the last two banking crises, compared with larger banks.¹⁶⁵ During the most recent crisis, larger banks cut back sharply on their small business lending. A study by Rebel Cole determined that banks receiving TARP capital assistance—which were primarily larger banks—reduced their small business lending by a significantly higher percentage between 2008 and 2011, compared with banks (mainly smaller institutions) that did

160. Allen N. Berger & Lamont K. Black, *Bank Size, Lending Technologies, and Small Business Finance*, 35 J. BANKING & FIN. 724, 724-25, 727, 734-35 (2011) (presenting a study based on small business lending data from the late 1990s).

161. *Id.* at 734-35.

162. *Id.* at 724, 726-29, 732-34; *see also supra* note 158 (discussing business credit card loans made by large banks to small businesses).

163. Berger & Black, *supra* note 160, at 728-29, 733-34.

164. *Id.* at 733-34.

165. Gunther & Klemme, *supra* note 149, at 26 (stating that between mid-2008 and mid-2010, “community bank loan volume held up relative to 2007 levels, while the biggest banks significantly reduced business lending”); Wilmarth, *Transformation*, *supra* note 13, at 262 (citing a study finding that “small business lending declined by a greater percentage at banks larger than \$10 billion [during the banking crisis of the late 1980s and early 1990s] compared to banks smaller than \$1 billion”).

not receive TARP assistance.¹⁶⁶ Similarly, the Small Business Administration reported that large banks cut back substantially on the amount of credit they provided to small firms through business credit cards after 2008.¹⁶⁷

In contrast, community banks slightly increased their share of the small business lending market between mid-2008 and mid-2012, even though their share of total banking industry assets declined during that period.¹⁶⁸ Moreover, small business lending grew at a significantly faster rate at community banks during 2013 and 2014, compared with the rest of the banking industry.¹⁶⁹ The lending

166. Cole, *supra* note 147, at 25-26, 31, 41, 43-44; *see also* Rebel A. Cole, How Did the Financial Crisis Affect Business Lending in the U.S.? 5 (Dec. 19, 2013) (unpublished manuscript), *available at* <http://ssrn.com/abstract=1899067> (determining that, among sixteen of the largest bank holding companies receiving TARP assistance, “small-business lending declined by more than 20%” at eleven and “by more than 10%” at thirteen, while “all 16 reduced small-business lending”); *supra* notes 24-25 and accompanying text (explaining that most TARP capital assistance was given to the largest banks, while relatively little TARP assistance was provided to community banks); Bob Ivry, *Small Business Can't Get Loans from Bailed-Out Banks*, BLOOMBERG BUS. (Sept. 16, 2010, 1:02 PM), <http://www.bloomberg.com/news/articles/2010-09-16/small-business-can-t-get-loans-from-banks-bailed-out-by-taxpayers-in-u-s-> (reporting on the experiences of small business owners who could not obtain loans from Bank of America, JPMorgan Chase, or Wells Fargo).

167. SMALL BUSINESS ECONOMY REPORT, *supra* note 145, at 86-87, 94-95.

168. OFFICE OF ADVOCACY, U.S. SMALL BUS. ADMIN., SMALL BUSINESS ECONOMY (2012) [hereinafter 2012 SBA REPORT], <http://www.sba.gov/advocacy/small-business-economy> (follow “2012 Section B Finance” hyperlink; then select “Table B.9” Tab for “Share of Business Loans and Total Assets by Size of All U.S. Depository Institutions”) (showing that, between June 2008 and June 2012, the share of small business loans held by banks with assets under \$10 billion increased from 51.73% to 51.79%, even though the share of total banking industry assets held by those banks declined from 23.46% to 22.19%).

169. FDIC, *Quarterly Banking Profile: Second Quarter 2014*, 8 FDIC Q., no. 3, 2014, at 14-15, *available at* <https://www2.fdic.gov/qbp/2014jun/qbp.pdf> (reporting that small business loans made by community banks grew at a rate of 3.1% from June 2013 to June 2014, compared with a growth rate of only 1.1% for the entire banking industry); FDIC, *Quarterly Banking Profile: Third Quarter 2014*, 8 FDIC Q., no. 4, 2014, at 16-17, *available at* <https://www2.fdic.gov/qbp/2014sep/qbp.pdf> (reporting that small business loans made by community banks grew at a rate of 3.6% from September 2013 to September 2014, compared with a growth rate of only 2% for the entire banking industry); *FDIC Fourth Quarter 2014 Report*, *supra* note 106, at 3, 17 (reporting that (1) small business loans made by community banks increased at a rate of 1.1% during the fourth quarter of 2014, compared with a growth rate of only 0.4% for the entire banking industry, and (2) total lending by community banks increased by 8.6% during 2014, compared with a growth rate of only 5.3% for the entire banking industry); *see also* Chris Cumming,

performance of community banks during the recent crisis is particularly impressive when one considers that (1) the federal government did relatively little to help community banks during the crisis while providing enormous amounts of assistance to big banks, and (2) as a result of the favoritism shown by the federal government toward large banks, only nine banks larger than \$10 billion failed while more than 450 smaller banks failed.¹⁷⁰

B. Recent Failures of Community Banks Have Inflicted Serious Harm on Small Businesses and Communities

Notwithstanding the commendable performance of the more than 6,000 community banks that survived the financial crisis,¹⁷¹ the failures of hundreds of community banks seriously damaged the small business sector as well as local communities. As Mark Gertler observed, “[t]he demise of local lenders has inflicted a disproportionate blow on small enterprises.”¹⁷² Similarly, as Mark Zandi explained, “[s]mall bank failures matter a lot to the communities in which they operate, especially in non-urban areas. Small banks are key to small businesses.”¹⁷³ A prominent Atlanta lawyer pointed out that the failures of many community banks in Georgia “sidelined the important mission of allocating capital to borrowers with legitimate needs [and] had a very damaging impact on the state.”¹⁷⁴

A recent study by John Kandrak determined that bank failures between 2008 and 2010 had significant adverse impacts on income, employment, compensation growth, and poverty in the counties

Smaller Banks Generating Solid Loan Growth as Others Ease Up, AM. BANKER, Apr. 25, 2014, available at 2014 WLNR 11028680 (reporting that loans at banks with assets under \$40 billion had grown by 12% since the first quarter of 2013, while loans at banks larger than \$50 billion had grown by less than 2% during that period).

170. See *supra* Part I.

171. See Backup, *supra* note 48, at 29, 34-37 (reporting that 6,141 community banks remained in operation at the end of 2012, and their performance improved during 2012); *FDIC Fourth Quarter 2014 Report*, *supra* note 106, at 16-17 (reporting that 6,037 community banks remained in operation at the end of 2014, and their total net income increased by 9.1% in 2014).

172. Matthews, *supra* note 107 (quoting Professor Mark Gertler).

173. *Id.* (quoting Mark Zandi, chief economist at Moody's Analytics, Inc.) (internal quotation marks omitted).

174. *Id.* (quoting Brian Olasov) (internal quotation marks omitted).

where the failures occurred.¹⁷⁵ Similarly, news reports indicate that many small businesses could not find any type of external funding—or were forced to rely on much more expensive credit from nonbank lenders—when local banks failed or were unable to continue providing loans to their established small firm customers.¹⁷⁶ Financing for small businesses from angel investors, venture capital firms, and public stock offerings declined precipitously after 2008, and those sources of funding have recovered very slowly in the past few years.¹⁷⁷ Similarly, total business lending by finance companies fell at a significantly faster rate between 2008 and 2012, compared with the decline in small business lending by banks.¹⁷⁸

In view of the close relationships that community banks build with entrepreneurs and the significant harm that the community banking sector suffered during the financial crisis, it is not surprising

175. JOHN KANDRAC, *BANK FAILURE, RELATIONSHIP LENDING, AND LOCAL ECONOMIC PERFORMANCE* 3, 10-11, 19-20 (2013), available at <http://www.federalreserve.gov/pubs/feds/2014/201441/201441pap.pdf>. Kandrac found that the effects of bank failures on local economies were less severe in cases where the FDIC entered into loss-sharing agreements with acquiring banks. *Id.* at 11, 20. As Kandrac pointed out, those loss-sharing agreements obligated the acquiring banks to maintain relationships with the failed banks' borrowers for a specified period of time. *Id.* at 12-15. The results of his study "support the view that bank failures can have important effects on local economies, and that the disruption of banking relationships is a likely channel through which these effects are transmitted." *Id.* at 16; see also Adam B. Ashcraft, *Are Banks Really Special? New Evidence from the FDIC-Induced Failure of Healthy Banks*, 95 AM. ECON. REV. 1712, 1713, 1719 (2005) (examining fifty-six bank subsidiaries of two large Texas bank holding companies that failed in 1988 and 1992, after the FDIC triggered their cross-guarantee obligations, and finding that those bank failures led to sharp declines in bank lending and significant reductions in personal incomes in the counties where the failed banks were located).

176. Zeke Faux & Max Abelson, *Trying to Be a Nice Guy in Small-Business*, BLOOMBERG BUS. (July 10, 2014), <http://www.bloomberg.com/bw/articles/2014-07-10/steven-mandis-high-rate-small-business-lendings-nice-guy> (reporting on Kalamata Capital, a nonbank lender that was charging annual interest rates to small firms ranging from 53% to 72%); Matthews, *supra* note 107 (describing the inability of small firms to find alternative financing after their local banks failed); see also Andrew Martin, *The Places They Go When Banks Say No*, N.Y. TIMES, Jan. 31, 2010, at BU1, BU6 (describing Hartsco Financial Services, another nonbank lender that was charging annual interest rates of more than 40% to small and mid-sized firms).

177. SBA FAQ, *supra* note 144, at 2; SMALL BUSINESS ECONOMY REPORT, *supra* note 145, at 98-103.

178. 2012 SBA REPORT, *supra* note 168, tbls.B.8, B.10 (showing that between 2008 and 2012, small business lending by banks declined from \$711.5 billion to \$587.8 billion, a decrease of 17.4%, while total business lending by finance companies fell from \$607.6 billion to \$467.4 billion, a reduction of 23.1%).

that small businesses also experienced severe losses during and after the financial crisis. For example, almost 60% of the net job losses recorded by all U.S. employers occurred at small businesses during the first three quarters of 2009.¹⁷⁹ The share of net U.S. job losses incurred by the smallest firms (those with fewer than fifty employees) “was nearly double their 30% share of total employment” between 2007 and 2012.¹⁸⁰ During the same five-year period, rates for new business formation and small business expansion fell sharply below their established trend lines between 1992 and 2006.¹⁸¹ An important reason for the financial crisis’ disproportionate impact on smaller firms was that small businesses have long relied on banks for external credit and had very few alternative sources for financing when bank lending declined.¹⁸²

Two Citigroup economists, Nathan Sheets and Robert A Sockin, documented the harm suffered by the small business sector as a consequence of the financial crisis and the resulting drop in bank credit.¹⁸³ Sheets and Sockin found that bank credit to both large companies and small firms declined sharply between 2008 and 2010. However, bank loans to large companies increased after 2010 and “returned to their previous peak” by 2012, while bank loans to small firms remained “15 percent off their peak” in 2012.¹⁸⁴

Sheets and Sockin also calculated that bank lending to large companies increased by \$400 billion, or 75%, between 2004 and 2012, but bank lending did not show any substantial increase for small firms during the same period.¹⁸⁵ As Sheets and Sockin observed, “[t]his is a remarkable shift in the distribution of credit over an eight-year period and may, if anything, understate the actual

179. SMALL BUSINESS ECONOMY REPORT, *supra* note 145, at 28-29.

180. Elizabeth Laderman, *Small Businesses Hit Hard by Weak Job Gains*, FRBSF ECON. LETTER, Sept. 9, 2013, at 1, available at <http://www.frbsf.org/economic-research/publications/economic-letter/2013/september/small-business-job-growth-employment-rate/el2013-26.pdf>.

181. *Id.* at 3-4; FRANÇOIS GOURIO, TODD MESSER & MICHAEL SIEMER, THE FED. RESERVE BANK OF CHI., WHAT IS THE ECONOMIC IMPACT OF THE SLOWDOWN IN NEW BUSINESS FORMATION? 1-2 (2014), available at http://www.chicagofed.org/digital_assets/publications/chicago_fed_letter/2014/cflseptember2014_326.pdf.

182. Laderman, *supra* note 180, at 1-2; see also GOURIO, MESSER & SIEMER, *supra* note 181, at 1.

183. NATHAN SHEETS & ROBERT A SOCKIN, CITI, DOES SIZE REALLY MATTER?: THE EVOLVING ROLE OF SMALL FIRMS IN THE U.S. ECONOMY 3 (2012) (on file with author).

184. *Id.* at 13.

185. *Id.*

difference in credit allocation, given that large firms have greater access to corporate debt markets.”¹⁸⁶ As they further pointed out, a Boston Fed staff study found that small firms with a high degree of dependence on external financing were “more likely to lay off workers” during the financial crisis because those small firms “absorbed a significant credit-supply shock.”¹⁸⁷

Beyond the curtailment of credit for small businesses, failures of community banks have inflicted broader injuries on local communities. As noted above, (1) community banks and their managers and staff play leading roles in supporting local charitable and civic groups through financial contributions and volunteer work,¹⁸⁸ and (2) community banks are the only banks operating physical offices in many rural counties and some counties in metropolitan areas.¹⁸⁹ Consequently, failures of community banks have caused significant funding and staffing challenges for many local charities and public service organizations.¹⁹⁰ Large, out-of-town banks that acquire failed community banks are less likely to provide comparable support to local nonprofits because those banks tend to give most of their backing either to nonprofits located in their headquarters cities or to larger statewide and national organizations.¹⁹¹ Thus, community bank failures have ripple effects that reach far beyond the banks themselves.

186. *Id.*

187. *Id.* at 15 (citing BURCU DUYGAN-BUMP, ALEXEY LEVKOV & JUDIT MONTORIOL-GARRIGA, FED. RESERVE BANK OF BOS., FINANCING CONSTRAINTS AND UNEMPLOYMENT: EVIDENCE FROM THE GREAT RECESSION 23 (2011), available at <http://www.bostonfed.org/bankinfo/qau/wp/2010/qau1006.pdf>). The Boston Fed staff study determined that “reduction in bank lending to small and financially constrained firms during the Great Recession is associated with increased layoffs of workers.” DUYGAN-BUMP, LEVKOV & MONTORIOL-GARRIGA, *supra*, at 23.

188. *See supra* note 153 and accompanying text.

189. *See supra* note 154 and accompanying text.

190. GAO BANK FAILURE REPORT, *supra* note 70, at 53 (describing views of state bank regulators and community banking associations); Tammy Joyner, *Failed Bank Honored in Henry County*, AJC.COM (May 4, 2012, 7:09 PM), <http://www.ajc.com/news/business/failed-bank-honored-in-henry-county/nQTYm/> (reporting on the extensive charitable contributions and community involvement of a failed community bank, and describing concerns among local citizens about the availability of future support for community organizations); *see also* Laura McVicker, *Bank’s Collapse Puts Local Charities in Limbo: Thousands of Dollars Pledged for Various Efforts in Jeopardy*, COLUMBIAN, Jan. 22, 2009, available at 2009 WLNR 1359469 (same).

191. GAO BANK FAILURE REPORT, *supra* note 70, at 53; *see also* Brunell, *supra* note 153, at 151-55, 214-15 (discussing the tendency of larger, nonlocal banks

C. A Further Decline in the Significance of the Community Banking Sector Would Seriously Harm Small Businesses, Consumers, and Local Communities

Domestic and international evidence confirms that small firms, consumers, and local communities suffer when community banks are unable to maintain a significant competitive presence in local markets. After reviewing the striking contrast between the rapid growth in bank credit for large firms between 1995 and 2012 and the much slower rate of growth in bank lending to small firms, Sheets and Sockin highlighted the impact of the shrinking presence of community banks.¹⁹² As they explained:

Well-established results in the empirical literature have shown a special link between small firms and small banks. As such, this sustained and sizable decline in the role of small banks as providers of credit—reflecting the ongoing consolidation of the U.S. banking system—is very likely a factor contributing to the downtrend in the share of credit provided to small firms.¹⁹³

A study by Steven Craig and Pauline Hardee concluded that small businesses were less likely to obtain access to bank credit—and also were likely to receive lower amounts of credit—in U.S. markets that were dominated by the largest banks.¹⁹⁴ Craig and Hardee also determined that nonbank lenders offset some, but not all, of the reduction in availability of small business credit in markets dominated by big banks.¹⁹⁵ Similarly, a study by Allen Berger and others found that small firms were more “credit constrained” and more likely to be late in paying off their trade credit if they borrowed from larger banks.¹⁹⁶ Berger’s study concluded that larger banks “are

to reduce contributions to local charities after acquiring local banks and to give greater support to nonlocal charities); Carstensen, *supra* note 153, at 1425.

192. SHEETS & SOCKIN, *supra* note 183, at 13-14 (noting that bank lending to large firms expanded from \$350 billion in 1995 to \$900 billion in 2012, an increase of more than 150%, while bank lending to small firms rose from \$175 billion to \$280 billion during the same period, a rise of only 60%).

193. *Id.* at 14 (footnote omitted); *see also id.* at 15 (stating that “the ongoing consolidation of the U.S. banking system, particularly the declining role of small banks, also appears to have been an important factor weighing on the supply of credit to small firms in recent years”).

194. Steven G. Craig & Pauline Hardee, *The Impact of Bank Consolidation on Small Business Credit Availability*, 31 J. BANKING & FIN. 1237, 1239-40, 1248-49, 1258-59 (2007).

195. *Id.*

196. Berger et al., *supra* note 152, at 241, 245-46, 260.

not as effective at alleviating credit constraints” for small businesses, and, consequently, “bank consolidation may raise meaningful concerns for small firms.”¹⁹⁷

Any further decline in the competitive presence of community banks would harm consumers and local communities as well as entrepreneurs. Numerous studies have concluded that large banks charge substantially higher fees for deposit account services, including automated teller machine (ATM) fees, account maintenance fees, overdraft fees, and non-sufficient funds (NSF) fees, compared with smaller banks.¹⁹⁸ Surveys show that community banks earn much higher rates of customer satisfaction and a far higher level of citizen trust, compared with big banks.¹⁹⁹ In addition,

197. *Id.* at 266.

198. See, e.g., CONSUMER FIN. PROT. BUREAU, CFPB STUDY OF OVERDRAFT PROGRAMS: A WHITE PAPER OF INITIAL DATA FINDINGS 52 (2013), available at http://files.consumerfinance.gov/f/201306_cfpb_whitepaper_overdraft-practices.pdf (stating that, in 2012, the median NSF fee and median overdraft fee among thirty-three large banks were both \$34, while the median NSF fee and median overdraft fee among 800 smaller banks and credit unions were both \$30); EDMUND MIERZWINSKI, U.S. PIRG EDUC. FUND, BIG BANKS, BIGGER FEES 2012: A NATIONAL SURVEY OF FEES AND DISCLOSURE COMPLIANCE 1-2, 9-11 (2012), available at http://www.uspirg.org/sites/pirg/files/reports/USPIRG_Big_Banks_Bigger_Fees_0.pdf (reporting results of survey showing that “small banks had lower average checking account fees, overdraft fees and foreign or off-us ATM fees, as well as lower balance requirements to avoid checking fees, than big banks”); see also U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-08-281, BANK FEES: FEDERAL BANKING REGULATORS COULD BETTER ENSURE THAT CONSUMERS HAVE REQUIRED DISCLOSURE DOCUMENTS PRIOR TO OPENING CHECKING OR SAVINGS ACCOUNTS 16 (2008) (“Large institutions on average charged between \$4.00 and \$5.00 more for insufficient funds and overdraft fees than smaller institutions.”); Wilmarth, *Transformation*, *supra* note 13, at 295 (citing earlier studies finding that “large, multistate banks charge fees on deposit accounts that are significantly higher than the fees assessed by small community banks”).

199. Kate Berry, *Small Banks Still Rule in Customer Satisfaction: J.D. Power*, AM. BANKER (Apr. 18, 2013, 4:00 AM), http://www.americanbanker.com/issues/178_74/small-banks-still-rule-in-customer-satisfaction-1058418-1.html; see also Tom Bengtson, *Community Banks Have Edge in Small Business Lending*, N.W. FIN. REV., Dec. 15, 2008, at 19, available at 2008 WLNR 24955810 (“Small banks have historically enjoyed the highest level of customer satisfaction, although medium-size banks are making gains, narrowing the gap with smaller banks. . . . [S]urveys show 72 percent of small business customers who bank at small banks are very satisfied with their banking relationship; 64 percent who bank at medium-size banks are very satisfied, and 51 percent of people who bank at large banks are very satisfied.”); Michael Ramlet & Raffy Maristela, *Poll: Governmental and Financial Institutional Trust*, MORNING CONSULT (June 24, 2014), <http://themorningconsult.com/2014/06/morning-consult-finance-poll-institutional->

as indicated above, many rural counties and some counties in metropolitan areas will be left without any banking offices (or with very few) if large numbers of community banks are forced to close.²⁰⁰

Studies of foreign banking markets have similarly found that small and medium-sized enterprises (SMEs) and consumers receive better service in markets where community banks maintain a significant presence. In contrast, SMEs and consumers fare worse in markets dominated by large banks. For example, a study of twenty-one developed countries and twenty-eight developing nations found that countries with stronger community bank sectors (i.e., countries where community banks had a larger total market share and a higher average efficiency ranking) reaped significant benefits in the form of faster growth in GDP, higher employment by SMEs, and increased availability of bank credit.²⁰¹

Additionally, the U.K. Financial Conduct Authority (FCA) and the U.K. Competition & Markets Authority (CMA) published recent studies indicating that the U.K.'s highly concentrated banking system provides inferior service to, and imposes high costs on, SMEs and consumers. The four largest U.K. banks hold over 80% of domestic "[b]usiness current accounts" (BCAs) maintained by SMEs, and those banks also provide 90% or more of business loans to SMEs.²⁰² A joint study by the FCA and CMA determined that (1) only 13% of SMEs in the U.K. "trust their bank to act in their best interests"; (2) only 25% of SMEs in the U.K. "consider that their bank supports their business"; and (3) "more SMEs would be *unwilling* to recommend their bank to a friend than would be *willing* to do so."²⁰³ The joint study also found that BCAs offered by smaller U.K. banks were less expensive than those provided by the four biggest banks, and that "satisfaction levels of SME customers at the smaller banks tend to be higher than those at the largest banks."²⁰⁴

trust/ (reporting that almost 80% of citizens trusted community banks, while less than 45% trusted investment banks and less than 40% trusted Wall Street).

200. See *supra* note 154 and accompanying text.

201. Allen N. Berger, Iftekhar Hasan & Leora F. Klapper, *Further Evidence on the Link Between Finance and Growth: An International Analysis of Community Banking and Economic Performance*, 25 J. FIN. SERVICES RES. 169, 186-92, 197-98 (2004).

202. FIN. CONDUCT AUTH. & COMPETITION & MKTS. AUTH., BANKING SERVICES TO SMALL AND MEDIUM-SIZED ENTERPRISES: A CMA AND FCA MARKET STUDY 4, 44-51 (2014), available at https://assets.digital.cabinet-office.gov.uk/media/53eb6b73ed915d188800000c/SME-report_final.pdf.

203. *Id.* at 153, 168 (emphasis added).

204. *Id.* at 161, 168.

The joint study concluded that “competition is less effective in delivering good outcomes for SMEs . . . than would be the case in a market where banks are under more competitive pressure. . . . [O]verall we believe . . . the evidence indicates that [U.K.] banks are underperforming in satisfying SME customers.”²⁰⁵

A separate study by the CMA reached similar results with regard to “personal current accounts” (PCAs) that U.K. banks provide to consumers. The four biggest U.K. banks control more than three-quarters of the consumer PCA market.²⁰⁶ The CMA’s study found that “larger [banks] have lower customer satisfaction scores and attract more complaints” and also “pay lower interest on credit balances,” compared with smaller banks.²⁰⁷ In addition, banks “with the lowest customer satisfaction rating have the highest market shares, while [smaller banks] with high customer satisfaction struggle to expand as market shares remain stable. This [evidence] suggests that there are limited competitive incentives to improve customer service.”²⁰⁸

Much like the U.S. government, the U.K. government responded to the financial crisis by encouraging mergers among troubled institutions and by propping up TBTF megabanks, thereby promoting even greater consolidation within the U.K. banking system. For example, the U.K. government arranged for Lloyds TSB to make an emergency takeover of HBOS, and the government subsequently bailed out the resulting Lloyds Banking Group as well as RBS to prevent both megabanks from failing.²⁰⁹ As Chancellor of the Exchequer George Osborne observed, ““One of the prices we’re paying for the financial crisis is that our banking sector is now dominated by a few big banks.””²¹⁰ The Parliamentary Commission on Banking Standards pointed out that the TBTF status of the largest

205. *Id.* at 5, 172.

206. COMPETITION & MKTS AUTH., PERSONAL CURRENT ACCOUNTS: MARKET STUDY UPDATE 9, 26 fig.2.2 (2014), *available at* https://assets.digital.cabinet-office.gov.uk/media/53c834c640f0b610aa000009/140717_-_PCA_Review_Full_Report.pdf.

207. *Id.* at 36.

208. *Id.* at 119.

209. HOUSE OF LORDS & HOUSE OF COMMONS, PARLIAMENTARY COMM’N ON BANKING STANDARDS, CHANGING BANKING FOR GOOD: FIRST REPORT OF SESSION 2013–14, at 233–34, 247–48, 270–71 (2013) [hereinafter U.K. PCBS REPORT], *available at* <http://www.parliament.uk/documents/banking-commission/Banking-final-report-vol-ii.pdf>.

210. *Id.* at 233 (quoting the Right Honorable George Osborne, Member of Parliament for Tatton, Cheshire (Feb. 4, 2013)).

U.K. banks gives them “access to cheaper credit than would otherwise be available” and thereby “distorts competition and raises barriers to entry. Success does not depend simply on being prudently run or on serving customers effectively, but on the implicit [TBTF] guarantee.”²¹¹

In view of the U.K.’s experience, the United States should take immediate steps to preserve the vitality of its community banking sector and to eliminate perverse incentives created by the TBTF status of megabanks. A similar warning flag appears when one considers the plainly inadequate services that SMEs receive from big banks in the highly concentrated Canadian banking system. During the past decade, the Canadian Federation of Independent Business (CFIB) has issued a series of survey reports showing that Canadian SMEs are deeply dissatisfied with the performance of the five largest Canadian banks. The “Big Five” banks control more than 70% of the SME lending market in Canada, and there is no meaningful community bank sector in Canada.²¹²

In the absence of community banks, Canadian credit unions have consistently outperformed the “Big Five” banks since 2000 in terms of satisfying SME customers.²¹³ As the CFIB observed in 2003, the superior performance of Canadian credit unions “provides further evidence that these locally based and managed institutions have an edge servicing their small business clientele.”²¹⁴ In contrast, when evaluating the performance of the big Canadian banks, the CFIB declared that “there is not a single Big Five bank that seems to be

211. *Id.* at 113.

212. DOUG BRUCE & QUEENIE WONG, CANADIAN FED’N OF INDEP. BUS., BATTLE OF THE BANKS: HOW SMEs RATE THEIR BANKS 9, 29 tbl.C1 (2013) [hereinafter 2012 CFIB REPORT], available at <http://www.cfib-fcei.ca/cfib-documents/rr3292.pdf> (providing market shares of the “Big Five” Canadian banks for loans to SMEs between 2000 and 2012); Renee Haltom, *Why Was Canada Exempt from the Financial Crisis?*, 17 ECON FOCUS, no. 4, 2013, at 22, 22, available at https://www.richmondfed.org/publications/research/econ_focus/2013/q4/pdf/full_issue.pdf (stating that “Canada has just 80 banks, six of which hold 93 percent of the market share”).

213. 2012 CFIB REPORT, *supra* note 212, at 3 (“In 2012, credit unions dominated among all the banks in serving the SME market, similar to findings in 2009.” (citation omitted)); see also DOUG BRUCE, CANADIAN FED’N OF INDEP. BUS., BANKING ON COMPETITION: RESULTS OF CFIB BANKING SURVEY 2 (2003) [hereinafter 2003 CFIB REPORT], available at <http://www.cfib-fcei.ca/cfib-documents/Banking.pdf> (reporting that “[c]redit unions rank first in terms of overall satisfaction among business clients” in 2003, and noting that “credit unions ranked first in CFIB’s 2000 survey”).

214. 2003 CFIB REPORT, *supra* note 213, at 2.

taking a leadership role in serving the SME sector. . . . Efforts must be made to encourage the development of competitive alternatives to the major chartered banks.”²¹⁵ Thus, studies, surveys, and other evidence from the highly consolidated U.K. and Canadian banking systems strongly indicate that markets dominated by big banks do not provide either good service or adequate credit to SMEs.²¹⁶ U.S. policymakers and regulators should therefore take all possible measures to preserve a vibrant community bank sector in this country.

IV. DODD–FRANK HAS NOT ENDED TBTF TREATMENT FOR MEGABANKS

Two of Dodd–Frank’s stated purposes are “to end ‘too big to fail’” and “to protect the American taxpayer by ending bailouts.”²¹⁷ When President Obama signed Dodd–Frank into law, he declared, “Because of this law, the American people will never again be asked to foot the bill for Wall Street’s mistakes. . . . There will be no more taxpayer-funded bailouts. Period.”²¹⁸

Unfortunately, as shown below, there is a very high probability that Dodd–Frank will not prevent bailouts and will not end TBTF treatment for creditors of systemically important financial institutions (SIFIs). Dodd–Frank creates a special resolution regime for dealing with failed SIFIs, but that regime allows the FDIC to give

215. *Id.* at 3, 18.

216. See Haltom, *supra* note 212, at 25 (“Critics claim that Canada’s tightly regulated [banking] system is slower to innovate and fund entrepreneurs.”); Arthur E. Wilmarth, Jr., *Too Big to Fail, Too Few to Serve? The Potential Risks of Nationwide Banks*, 77 IOWA L. REV. 957, 1054-55 (1992) (explaining that national surveys of bank lending to SMEs in 1987 showed that “the decentralized U.S. banking system [was] more competitive and responsive than the highly concentrated British and Canadian systems in providing credit to small businesses,” apparently because “most British and Canadian small businesses [were] served by large nationwide banks, while small firms in the United States [were] served primarily by local independent banks”).

217. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1376 (2010) (codified as amended in scattered sections of 12 U.S.C.).

218. Stacy Kaper, *Obama Signs Historic Regulatory Reform Bill into Law*, AM. BANKER (July 21, 2010, 11:50 AM), <http://www.americanbanker.com/news/obama-1022698-1.html> (quoting Barack Obama, U.S. President, statement upon signing the Dodd–Frank legislation at the Ronald Reagan Building, D.C. (July 21, 2010)) (internal quotation marks omitted). Portions of the analysis in this Part IV have been adapted from Wilmarth, *Dodd–Frank*, *supra* note 15, Part V.

special protection to favored classes of creditors with close connections to Wall Street. Dodd–Frank also permits the Fed and other federal agencies to provide emergency liquidity assistance to troubled SIFIs. Moreover, Dodd–Frank will not stop Congress from adopting emergency bailout measures to keep SIFIs from failing during future financial crises. Finally, Dodd–Frank does not prevent SIFI-owned banks from transferring safety-net subsidies to their nonbank affiliates engaged in risky capital markets activities. In sum, Dodd–Frank fails to address the principal causes of TBTF bailouts because it does not mandate fundamental changes in the structure and operations of megabanks and nonbank SIFIs.

A. Dodd–Frank Establishes a Special Resolution Regime for Systemically Important Financial Institutions but Allows the FDIC and Other Agencies to Protect Creditors of Those Institutions

1. *Dodd–Frank’s Orderly Liquidation Authority Allows the FDIC to Provide Full Protection for Favored Creditors of SIFIs and Their Operating Subsidiaries*

Dodd–Frank establishes an Orderly Liquidation Authority (OLA), which seeks to provide a “viable alternative to the undesirable choice” between the disorderly bankruptcy of a SIFI and a “bailout . . . that would expose taxpayers to losses and undermine market discipline.”²¹⁹ Dodd–Frank’s OLA for SIFIs is similar in many respects to the FDIC’s existing resolution regime for failed depository institutions.²²⁰ However, contrary to Dodd–Frank’s stated goals,²²¹ the OLA does not preclude future bailouts for favored creditors of TBTF institutions.

Dodd–Frank authorizes the Fed to impose enhanced prudential requirements on bank holding companies with assets of \$50 billion or more and also on nonbank financial companies that have been

219. S. REP. NO. 111-176, at 4 (2010).

220. See CARNELL, MACEY & MILLER, *supra* note 138, at 485-523 (describing the FDIC’s resolution regime for failed banks); see also Notice of Proposed Rulemaking Implementing Certain Orderly Liquidation Authority Provisions of the Dodd–Frank Wall Street Reform and Consumer Protection Act, 75 Fed. Reg. 64,173, 64,175 (Oct. 19, 2010) [hereinafter FDIC Proposed OLA Rule] (noting that “[p]arties who are familiar with the liquidation of insured depository institutions . . . will recognize many parallel provisions in Title II” of Dodd–Frank).

221. See *supra* note 217 and accompanying text (quoting the purposes stated in Dodd–Frank’s preamble).

designated by the Financial Stability Oversight Council (FSOC) as potential “threat[s] to the financial stability of the United States.”²²² Dodd–Frank does not use the term “SIFI” to describe such institutions. However, I will follow general practice by using the term “SIFI” to refer to systemically important financial institutions.²²³ I will also describe large bank holding companies as “bank SIFIs” and FSOC-designated nonbank financial companies as “nonbank SIFIs.”

In order to invoke the OLA for a “financial company” whose failure could pose a serious risk to the financial system (i.e., a SIFI), the Treasury Secretary must issue a systemic risk determination (SRD).²²⁴ The Treasury Secretary’s SRD must be based on the recommendation of the Fed, acting together with either the Securities and Exchange Commission (SEC) (if the SIFI’s largest subsidiary is a securities broker or dealer) or the Federal Insurance Office (if the SIFI’s largest subsidiary is an insurance company) or the FDIC (for any other SIFI, including one whose largest subsidiary is a bank).²²⁵ The Treasury Secretary’s SRD must find that (1) the SIFI’s failure and resolution under the federal Bankruptcy Code or another applicable insolvency law would have “serious adverse effects on financial stability in the United States”; (2) application of the OLA would “avoid or mitigate such adverse effects”; and (3) “no viable private sector alternative is available to prevent” the company’s failure.²²⁶

Dodd–Frank requires the FDIC to ensure that equity owners of a failed SIFI do not receive any payment until all creditor claims are paid, and it also mandates that executives responsible for the SIFI’s

222. Dodd–Frank § 113(a)(1) (authorizing FSOC to designate nonbank financial companies as SIFIs if FSOC determines that such companies “could pose a threat to the financial stability of the United States”); *id.* §§ 115(a), 165(a) (effectively treating bank holding companies with assets of \$50 billion or more as bank SIFIs); *id.* § 111 (establishing FSOC).

223. *See* FIN. STABILITY BD., PROGRESS AND NEXT STEPS TOWARDS ENDING “TOO-BIG-TO-FAIL” (TBTF): REPORT OF THE FINANCIAL STABILITY BOARD TO THE G-20, at 2 (2013) [hereinafter FSB 2013 TBTF REPORT], *available at* http://www.financialstabilityboard.org/wp-content/uploads/r_130902.pdf?page_moved=1 (explaining that “SIFIs are institutions of such size, market importance and interconnectedness that their distress or failure would cause significant dislocation in the financial system and adverse economic consequences”).

224. Dodd–Frank § 203(b).

225. *Id.* § 203(a).

226. *Id.* § 203(b).

failure must be removed.²²⁷ Dodd–Frank further directs the FDIC to impose losses on unsecured creditors if a failed SIFI’s assets are insufficient to pay all secured and unsecured debts.²²⁸ However, as shown below, Dodd–Frank provides the FDIC with substantial leeway to provide full protection for favored classes of unsecured creditors of failed SIFIs and their operating subsidiaries.

In its capacity as receiver for a failed SIFI, the FDIC may provide funding to transfer or pay off creditors’ claims in at least two ways. First, the FDIC can provide funding directly to the SIFI’s receivership estate by making loans, purchasing or guaranteeing assets, or assuming or guaranteeing liabilities.²²⁹ Second, the FDIC can provide funding to establish a “bridge financial company” (BFC), and the FDIC may then transfer designated assets and liabilities from the failed SIFI to the BFC.²³⁰ In either case, the FDIC (1) may adopt measures designed to reduce “the potential for serious adverse effects to the financial system,”²³¹ and (2) may provide preferential treatment to certain creditors if the FDIC determines that such treatment is necessary to “maximize” the value of a failed SIFI’s assets or to preserve “essential” operations of the SIFI or a successor BFC.²³² The FDIC can give preferential treatment to favored creditors under the foregoing conditions as long as every creditor receives at least the amount it would have recovered in a liquidation proceeding under Chapter 7 of the federal Bankruptcy Code.²³³

In 2011, the FDIC implemented its OLA authority by issuing an interim final rule,²³⁴ followed by a final rule.²³⁵ The OLA rule

227. *Id.* §§ 204(a)(1)-(2), 206(2)-(4).

228. *Id.* §§ 204(a)(1), 206(3).

229. *Id.* § 204(d).

230. *Id.* § 210(h)(1), (3), (5).

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

232. *Id.* § 210(b)(4), (h)(5)(E).

233. *Id.*; *see also* FDIC Proposed OLA Rule, *supra* note 220, at 64,175, 64,177 (explaining Dodd–Frank’s minimum guarantee for creditors of a failed SIFI).

234. Orderly Liquidation Authority Provisions of the Dodd–Frank Wall Street Reform and Consumer Protection Act, Interim Final Rule, 76 Fed. Reg. 4207-11 (proposed Jan. 25, 2011) [hereinafter FDIC Interim OLA Rule].

235. Certain Orderly Liquidation Authority Provisions Under Title II of the Dodd–Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. 41,626 (July 15, 2011) [hereinafter FDIC Final OLA Rule] (adopting regulations to be codified at 12 C.F.R. pt. 380).

permits the FDIC to provide preferential treatment to certain creditors in an OLA proceeding if such treatment would help “to continue key operations, services, and transactions that will maximize the value of the [failed SIFI’s] assets and avoid a disorderly collapse in the market place.”²³⁶ In contrast, the OLA rule bars holders of subordinated debt or unsecured senior debt with a term of more than 360 days from receiving any preferential treatment.²³⁷ Hence, the FDIC can pay 100% of the claims submitted by short-term, unsecured creditors of a failed SIFI whenever the FDIC determines that such payments are “essential for [the SIFI’s] continued operation and orderly liquidation.”²³⁸

Under the OLA rule, the FDIC is very likely to provide full protection for short-term liabilities of SIFIs that are funded by the capital markets, including commercial paper and securities repurchase agreements. Those types of short-term wholesale liabilities proved to be highly volatile and prone to creditor “runs” during the financial crisis.²³⁹ By declaring that the FDIC can give preferential treatment to short-term creditors of failed SIFIs, but will *never* provide such treatment to holders of long-term debt or subordinated debt, the OLA rule has at least two perverse effects. First, the OLA rule creates an implicit subsidy for short-term creditors of SIFIs, and it undermines market discipline by encouraging short-term creditors in the capital markets to continue providing funds to troubled SIFIs. Second, the OLA rule encourages SIFIs to rely even *more* heavily on vulnerable, short-term funding strategies that led to repeated disasters during the financial crisis.²⁴⁰

Dodd–Frank generally requires the FDIC to recover preferential payments made to creditors in an OLA proceeding if the proceeds of liquidating a failed SIFI are insufficient to repay the full amount that the FDIC has borrowed from the Treasury to finance the

236. FDIC Proposed OLA Rule, *supra* note 220, at 64,175; FDIC Interim OLA Rule, *supra* note 234, at 4211.

237. FDIC Interim OLA Rule, *supra* note 234, at 4211; FDIC Final OLA Rule, *supra* note 235, at 41,634.

238. FDIC Proposed OLA Rule, *supra* note 220, at 64,177-78; FDIC Interim OLA Rule, *supra* note 234, at 4211; *see also* FDIC Final OLA Rule, *supra* note 235, at 41,634 (reaffirming the position set forth in the interim OLA rule).

239. *See* ZOLTAN POZSAR ET AL., FED. RESERVE BANK OF N.Y., SHADOW BANKING 2-6, 46-59 (2010), *available at* http://www.newyorkfed.org/research/staff_reports/sr458.pdf.

240. Wilmarth, *Dodd–Frank*, *supra* note 15, at 998-99.

liquidation.²⁴¹ However, Dodd–Frank allows the FDIC to exercise its powers under the OLA for the purpose of preserving “the financial stability of the United States” and preventing “serious adverse effects to the financial system.”²⁴² Accordingly, the FDIC potentially could waive its right of “claw-back” against favored short-term creditors and could reaffirm its decision to give them full protection if the FDIC determines that such treatment is necessary to maintain financial stability.²⁴³

Since 2012, the FDIC has advocated a “single point of entry” (SPOE) strategy as its preferred approach for resolving failed SIFIs under the OLA.²⁴⁴ In December 2013, the FDIC formally presented its proposed SPOE strategy in a public call for comments.²⁴⁵ Under the SPOE approach, the FDIC would place only the SIFI’s top-tier holding company in receivership, and the FDIC would transfer the holding company’s most desirable assets—including its operating subsidiaries—to a BFC.²⁴⁶ The FDIC would then wipe out the equity interests of the shareholders of the SIFI’s top-tier holding company,

241. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 210(o)(1)(B), (D), 124 Stat. 1376, 1509 (2010) (codified at 12 U.S.C. § 5390(o)(1)(B), (D) (2012)).

242. *Id.* §§ 206(1), 210(a)(9)(E)(iii).

243. Wilmarth, *Dodd–Frank*, *supra* note 15, at 1000 (internal quotation marks omitted); *see also* DAVID SKEEL, *THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD–FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES* 142-45, 147-48 (2011) (describing the FDIC’s right to recover preferential payments from creditors, but concluding that Dodd–Frank gives the FDIC discretion to “bail out the most important creditors while giving little or nothing to other, theoretically comparable claims”).

244. *See* Joe Adler, *Likely Battle Ahead for FDIC’s ‘Single Point’ Resolution Plan*, AM. BANKER, Dec. 11, 2013, available at 2013 WLNR 30941803 (stating that “FDIC officials have promoted the [SPOE] methodology . . . for well over a year as it seeks to carry out Dodd[–]Frank Act powers to clean up failed behemoths”); *see also* Michael Bologna, *FDIC Unveils Resolution Strategies in the Face of Large Bank Failures*, 98 BNA’S BANKING REP. 839 (2012) (reporting on a speech given by FDIC Chairman Martin Gruenberg on May 10, 2012, in which Mr. Gruenberg proposed an OLA resolution plan “that places bank holding companies in receivership and allows for smooth continued operation by potentially hundreds of domestic and foreign subsidiary organizations” under the control of a new BFC).

245. Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76,614 (proposed Dec. 18, 2013) [hereinafter FDIC SPOE Proposal].

246. *Id.* at 76,616 (“To implement the SPOE strategy the FDIC would be appointed receiver only of the top-tier U.S. holding company The FDIC would organize a bridge financial company, into which it would transfer assets from the receivership estate, primarily the [parent] financial company’s investments in and loans to subsidiaries.”).

and the FDIC would convert the claims of the holding company's bondholders into equity interests in the BFC.²⁴⁷ Most importantly, the failed SIFI's operating subsidiaries (including banks, securities broker-dealers, and insurance companies) would continue to operate without interruption, and the rights of their creditors would remain unimpaired.²⁴⁸ In addition, the holding company's obligations to short-term creditors and service providers that are deemed "essential" to the BFC's operations "would be assumed by the [BFC] in order to keep day-to-day operations running smoothly."²⁴⁹

As a practical matter, the SPOE strategy would accomplish a "reorganization" of the failed SIFI, in sharp contrast to the "liquidation" mandated by Title II of Dodd-Frank.²⁵⁰ Indeed, the FDIC intends to use claims procedures and accounting principles that are typically used in Chapter 11 reorganizations under the Bankruptcy Code when the FDIC carries out SPOE resolutions.²⁵¹ FDIC Board Member Jeremiah Norton has acknowledged that the SPOE strategy is "not contemplated in Dodd-Frank."²⁵²

As bankruptcy scholars have pointed out, the FDIC's SPOE strategy strongly resembles the controversial "Section 363" transactions that the federal government used to restructure Chrysler

247. *Id.*

248. *Id.* ("The [holding] company's subsidiaries would remain open and operating, allowing them to continue critical operations for the financial system and avoid the disruption that would otherwise accompany their closings . . .").

249. *Id.* at 76,618.

250. See, e.g., *Fisher June 2013 Testimony*, *supra* note 31, at 9, 19 (describing the "single point of entry method" as a "simulated restructuring, as would occur in a Chapter 11 bankruptcy" rather than the "liquidation" mandated by Dodd-Frank); *Who Is Too Big to Fail: Does Title II of the Dodd-Frank Act Enshrine Taxpayer-Funded Bailouts?: Hearing Before the Subcomm. on Oversight & Investigations of the H. Comm. on Fin. Servs.*, 113th Cong. 6, 7 (2013) [hereinafter *Skeel Testimony*] (statement of David A. Skeel, S. Samuel Arsht Professor of Corporate Law, University of Pennsylvania Law School) ("[A]lthough Title II explicitly requires that its provisions be used for liquidation, [SPOE] is essentially a reorganization. It thus stands in tension with the explicit requirements of Title II.").

251. FDIC SPOE Proposal, *supra* note 245, at 76,618 (stating that, to the extent permitted by Dodd-Frank, "the FDIC intends to adapt certain claims forms and practices applicable to a Chapter 11 proceeding"); see also *id.* at 76,619 (stating that the FDIC plans to follow a "'fresh start' model [for] accounting treatment," which is "the accounting framework generally applied to companies emerging from bankruptcy under Chapter 11").

252. JEREMIAH O. NORTON, FDIC, DISCUSSION ON THE CURRENT STATE OF RESOLUTION PLANNING 6 (2013) [hereinafter *NORTON SPEECH*], available at <https://www.fdic.gov/news/news/speeches/archives/2013/spoct2113.pdf>.

and General Motors (GM) in the context of expedited Chapter 11 bankruptcy proceedings.²⁵³ In the Chrysler case—on which the subsequent GM deal was modeled—the federal government (1) created a shell company; (2) provided massive funding to finance the shell company’s purchase of substantially all of Chrysler’s assets; and (3) arranged for the new shell company to assume selected Chrysler liabilities on terms that gave highly preferential treatment to favored classes of creditor claims (including retiree pension claims, employee health care obligations, and debts owed to trade creditors) while giving much worse treatment to disfavored creditors (including secured bondholders and customers with products-liability claims).²⁵⁴ Mark Roe and David Skeel argued that the Chrysler transaction represented a “deviant reorganization” that did not comply with Chapter 11 requirements, and they also pointed out that “[t]he unevenness of compensation to prior creditors raised considerable concerns in the capital markets.”²⁵⁵

Like the Chrysler transaction, the FDIC’s SPOE proposal would disfavor long-term bondholders of the SIFI’s top-tier holding company while offering 100% protection to the holding company’s short-term creditors as well as *all* creditors of the SIFI’s operating subsidiaries, including uninsured depositors, derivatives counterparties, lenders under repurchase agreements, holders of commercial paper, and other wholesale creditors.²⁵⁶ The SPOE proposal thus contemplates “a stealth bailout of subsidiary creditors” by allowing the FDIC to provide funding to ensure 100% protection

253. David A. Skeel, Jr., *Single Point of Entry and the Bankruptcy Alternative*, in *ACROSS THE GREAT DIVIDE: NEW PERSPECTIVES ON THE FINANCIAL CRISIS* 311, 321-23, 329 (Martin Neil Baily & John B. Taylor eds., 2014); Stephen J. Lubben, *OLA After Single Point of Entry: Has Anything Changed?*, in *AN UNFINISHED MISSION: MAKING WALL STREET WORK FOR US* 13, 13 (Mike Konczal & Marcus Stanley eds., 2013), available at http://rooseveltinstitute.org/sites/all/files/Unfinished_Mission_2013.pdf; see also Mark J. Roe & David Skeel, *Assessing the Chrysler Bankruptcy*, 108 MICH. L. REV. 727, 727 (2010) (describing the Chrysler bankruptcy).

254. Skeel, *supra* note 253, at 329; Roe & Skeel, *supra* note 253, at 729-34, 765; Adam Levitin, *Single-Point-of-Entry: No Bank Left Behind*, CREDIT SLIPS (Aug. 31, 2014, 6:42 PM), <http://www.creditslips.org/creditslips/2014/08/single-point-of-entry-no-bank-left-behind.html>.

255. Roe & Skeel, *supra* note 253, at 729-31, 761, 765, 770-71; see also SKEEL, *supra* note 243, at 33-39 (presenting a similar critique of the Chrysler and GM bankruptcies).

256. Skeel, *supra* note 253, at 312-13, 321-23, 329; Levitin, *supra* note 254.

for all of those creditors.²⁵⁷ By protecting derivatives counterparties and other wholesale creditors of operating subsidiaries, the SPOE plan would encourage SIFIs to rely “even more on the derivatives and other complex financial contracts that caused so much trouble” during the financial crisis.²⁵⁸

Given the blanket protection that the SPOE strategy would provide to Wall Street creditors of SIFIs and their operating subsidiaries, it is not surprising that leading Wall Street trade associations have enthusiastically supported the SPOE concept.²⁵⁹ As Adam Levitin has pointed out, SPOE “ensures that Wall Street [creditors] will be rescued if a SIFI goes down. The result is to eliminate all credit risk for Wall Street [creditors] when dealing with SIFIs.”²⁶⁰ As a result, SPOE “ensures that SIFIs will stay too-big-to-fail and . . . there will not be market discipline.”²⁶¹

In sum, the FDIC’s OLA rule and its SPOE strategy provide the FDIC with broad discretion to arrange bailouts for favored creditors of failed SIFIs, especially those with Wall Street connections. Dodd–Frank also provides a funding source for such bailouts. Section 210(n) of Dodd–Frank establishes an Orderly Liquidation Fund (OLF) to finance liquidations of SIFIs.²⁶² As

257. Lubben, *supra* note 253, at 16 (pointing out that “the FDIC will need to meet any and all funding requirements of the [operating] subsidiaries if single point of entry is to work as advertised”).

258. *Skeel Testimony*, *supra* note 250, at 7; *see also* Skeel, *supra* note 253, at 326 (“By committing to fully protect derivatives [SPOE] diminishes the monitoring incentives of derivatives counterparties . . . and it strengthens incentives [of SIFIs] to use derivatives and other short-term financing.”).

259. In February 2014, five trade associations representing major U.S. and foreign financial institutions submitted a comment letter to the FDIC that eagerly endorsed the FDIC’s SPOE strategy. Comment letter from John Court, Managing Dir. & Senior Assoc., Gen. Counsel, The Clearing House, to Robert E. Feldman, Exec. Sec’y, FDIC 1-2 (Feb. 18, 2014), *available at* <https://www.theclearinghouse.org/~media/Files/Association%20Documents/20140218%20Single%20Point%20of%20Entry%20Comment%20Letter.pdf>. Previously, in January 2013, The Clearing House issued a report advocating the SPOE strategy. THE CLEARING HOUSE, ENDING “TOO-BIG-TO-FAIL”: TITLE II OF THE DODD–FRANK ACT AND THE APPROACH OF “SINGLE POINT OF ENTRY” PRIVATE SECTOR RECAPITALIZATION OF A FAILED FINANCIAL COMPANY 37-38 (2013) [hereinafter TCH SPOE REPORT], *available at* http://www.cov.com/files/Publication/714f0b24-8047-4d79-825f-55f5d1e80bdc/Presentation/PublicationAttachment/f7462820-7d03-4ed2-8b75-96b917418d8f/White_Paper_Ending_Too-Big-to-Fail.pdf.

260. Levitin, *supra* note 254.

261. *Id.*

262. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 210(n), 124 Stat. 1376, 1509 (2010).

discussed below, Dodd–Frank does *not* establish a prefunding mechanism for the OLF.²⁶³ However, the FDIC may obtain immediate funding for the OLF by borrowing from the Treasury amounts up to (1) 10% of a failed SIFI’s assets within thirty days after the FDIC’s appointment as receiver, plus (2) 90% of the “fair value” of the SIFI’s assets that are “available for repayment” thereafter.²⁶⁴

The FDIC’s ability to borrow from the Treasury provides “huge amounts of funding” to protect creditors of SIFIs and their operating subsidiaries.²⁶⁵ The “fair value” standard gives the FDIC considerable leeway in calculating how much it can borrow from the Treasury since the “fair value” standard does not require the FDIC to rely on current market prices in determining the values of a failed SIFI’s assets.²⁶⁶ In addition, as David Skeel has observed, Treasury loans for OLA resolutions will likely have “generous” terms because (1) Treasury will charge interest based on “the average interest rate[s] for a basket of corporate bonds” of comparable maturity, and (2) that rate “will almost certainly be less than the penalty rate of interest called for in traditional lender-of-last resort lending.”²⁶⁷

The FDIC must normally repay any OLF borrowings from the Treasury within five years.²⁶⁸ If the proceeds from resolving a failed SIFI are insufficient to repay the full amount that the FDIC borrowed from the Treasury, the FDIC must impose retroactive assessments on large financial companies to make up the difference.²⁶⁹ However, the

263. See *infra* notes 473-478 and accompanying text (discussing the OLF’s lack of a prefunding mechanism and its reliance on *ex post* assessments against large financial companies).

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

265. Skeel, *supra* note 253, at 327-28, 331; see also SKEEL, *supra* note 243, at 144-45 (describing the FDIC’s ability to borrow from the Treasury as a “massive honey pot” that “invites interventions that are essentially bailouts”).

266. Wilmarth, *Dodd–Frank*, *supra* note 15, at 999.

267. Skeel, *supra* note 253, at 327-28 & n.39 (discussing Dodd–Frank § 210(n)(5)(C)); see also Fisher June 2013 Testimony, *supra* note 31, at 81-82 (contending that the FDIC’s authority to borrow from the Treasury will provide “taxpayer funding at far-below-market rates”).

268. Dodd–Frank § 210(n)(9)(B), (o)(1)(B).

269. See *infra* notes 474-478 and accompanying text (discussing the FDIC’s authority to impose retroactive assessments on large financial companies to repay borrowings used to resolve a failed SIFI).

Treasury may extend the FDIC's repayment period in order "to avoid a serious adverse effect on the financial system of the United States."²⁷⁰ During a future systemic crisis, it is likely that the FDIC would request, and the Treasury would approve, a prolonged extension of the FDIC's repayment obligations in order to postpone the FDIC's duty to impose assessments on surviving SIFIs. During a future crisis—as was certainly true in 2008—many SIFIs would not be strong enough to bear the additional burdens of paying large assessments because they would be exposed to many of the same risks that caused the failure of their peers. Accordingly, Treasury loans for OLA resolutions would likely be extended far beyond their presumptive five-year terms and would represent lengthy, taxpayer-funded bridge loans for the benefit of protected SIFI creditors.

FDIC Vice Chairman Thomas Hoenig has expressed deep misgivings about the significant cost of funding advantage that the SPOE strategy and FDIC funding will provide to SIFIs and their operating subsidiaries during future crises:

In times of financial stress, the knowledge that operating units [of failed SIFIs] will be provided funding to meet liquidity demands could serve to encourage corporate treasurers and others to place their funds with SIFIs' operating subsidiaries over other financial firms for whom such assurances are unavailable. Therefore, this assumption and access to funding provides SIFIs a significant competitive advantage²⁷¹

Similarly, FDIC Board Member Jeremiah Norton has warned that the SPOE strategy and FDIC funding could cause "the market equilibrium [to] shift in favor of LCFI subsidiaries" because "creditors of these subsidiaries could perceive that they would not take a loss upon distress at an LCFI and therefore would require a lower return on transactions or investments."²⁷²

Defenders of the SPOE approach contend that the FDIC will not have to borrow large sums from the Treasury if regulators require top-tier holding companies of SIFIs to hold large amounts of "bail-

270. Dodd–Frank § 210(n)(9)(B), (o)(1)(B)–(C).

271. Adler, *supra* note 244 (quoting Thomas Hoenig, Vice Chairman, FDIC, open meeting of FDIC board members (Dec. 10, 2013)) (internal quotation marks omitted).

272. NORTON SPEECH, *supra* note 252, at 9; accord Simon Johnson, *Sadly, Too Big to Fail Is Not Over*, N.Y. TIMES (Aug. 1, 2013, 12:01 AM), http://economix.blogs.nytimes.com/2013/08/01/sadly-too-big-to-fail-is-not-over/?_r=0.

in” debt.²⁷³ SPOE proponents argue that, if a SIFI fails, the holding company’s bail-in debt could be converted into common stock of the BFC in order provide much of the necessary new equity for the BFC.²⁷⁴ However, converting bail-in debt into equity would not provide any *new* funding for the BFC. In addition, a new regulation requiring top-tier holding companies of SIFIs to issue large volumes of bail-in debt would create the immediate problem of identifying appropriate buyers for that debt. It is widely agreed that SIFIs should *not* sell bail-in debt to other large financial institutions because cross-holdings of such debt among SIFIs would greatly increase the risks of contagious failures during a financial crisis.²⁷⁵

SIFIs could potentially sell their bail-in debt to hedge funds and private equity funds. However, those funds would presumably insist on very high interest rates before they bought such risky debt. In addition, many hedge funds and private equity funds borrow significant amounts from SIFIs. Consequently, it could be very dangerous to impose large losses from bail-in debt on those funds

273. TCH SPOE REPORT, *supra* note 259, at 8-9, 34-38; *see also* CHARLES GOODHART & EMILIOS AVGOULEAS, CTR. FOR ECON. POLICY RESEARCH, PAPER NO. 10065, A CRITICAL EVALUATION OF BAIL-INS AS BANK RECAPITALISATION MECHANISMS 1-5 (2014), *available at* http://www.law.ed.ac.uk/includes/remote_people_profile/remote_staff_profile?sq_content_src=%2BdXJsPWh0dHAlM0EIMkYlMkZ3d3cyLmxhdY5lZC5hYy51ayUyRmZpbGVfZG93bmxvYWQIMkZwdWJsaWNhdGlbnMIMkYyXzI3NF9hY3JpdGljYWxldmFsdWF0aW9ub2ZiYWlSaW5hc2FiYW5rcmVjYXBpLnBkZiZhbGw9MQ%3D%3D (describing the “bail-in” debt concept advocated by supporters of the SPOE strategy).

274. *See, e.g.*, MARTIN J. GRUENBERG, FDIC, WALL STREET REFORM: ASSESSING AND ENHANCING THE FINANCIAL REGULATORY SYSTEM 8 (2014), *available at* <https://www.fdic.gov/news/news/speeches/spsep0914.pdf>; TCH SPOE REPORT, *supra* note 259, at 8-9, 31-38; DANIEL K. TARULLO, STATEMENT BEFORE THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS 9-10 (2014), *available at* <http://www.federalreserve.gov/newsevents/testimony/tarullo20140909a.pdf>.

275. Paul Tucker, Deputy Governor Fin. Stability, Speech at INSOL International World Congress: Resolution and Future of Finance 9 (May 20, 2013), *available at* <http://www.bankofengland.co.uk/publications/Documents/speeches/2013/speech658.pdf>; *see also* Ben Moshinsky & Jim Brunsten, *Banks Face Pass-the-Parcel Debt Limit in Writedown Rule*, BLOOMBERG BUS. (Sept. 25, 2014, 7:01 PM), <http://www.bloomberg.com/news/articles/2014-09-25/banks-face-pass-the-parcel-debt-limit-in-writedown-rule> (reporting that the Financial Stability Board adopted a proposed requirement for bail-in debt that would not allow large global banks to satisfy the requirement by selling such debt to other large banks).

during a crisis, thereby impairing their ability to repay their SIFI loans.²⁷⁶

Regulators might therefore be inclined to encourage SIFIs to sell their bail-in debt to mutual funds, pension funds, and other asset managers that oversee investments by ordinary individuals and other “non-systemic” investors. However, “pushing pensioners [and individual investors in mutual funds] under the bus” to save creditors of SIFIs should be no more palatable than taxpayer-financed bailouts.²⁷⁷ Regulators and SIFIs should not be allowed to use bail-in debt to impose the costs of future bailouts on ordinary investors. Individual investors (including those owning shares in mutual funds and pension funds) are in no better position than taxpayers to evaluate the potential risks of SIFIs or to bear the financial burden of bailing out SIFI creditors.²⁷⁸

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

As shown in the previous section, the FDIC has substantial leeway to provide full protection to favored classes of SIFI creditors in OLA resolutions. The FDIC and other federal agencies also have additional tools for protecting SIFI creditors. The “systemic risk exception” (SRE) in the Federal Deposit Insurance Act (FDI Act) provides a significant source of funding to bail out creditors of failed SIFIs.²⁷⁹ Under the SRE, the Treasury Secretary can authorize the FDIC to use deposit insurance funds to provide full protection to uninsured creditors of a bank if such action is deemed necessary to

276. Avinash Persaud, *Bail-Ins Are No Better than Fool’s Gold*, FIN. TIMES (Oct. 21, 2013, 4:01 PM), <http://www.ft.com/cms/s/0/686dfa94-27a7-11e3-8feb-00144feab7de.html#axzz3TtaOvub4>.

277. *Id.*; accord GOODHART & AVGOULEAS, *supra* note 273, at 13.

278. GOODHART & AVGOULEAS, *supra* note 273, at 13; *see also id.* at 5-12, 18-19 (raising additional concerns about the feasibility of the SPOE strategy and bail-in debt, particularly in the context of cross-border resolutions of global SIFIs).

279. *See* FIN. CRISIS INQUIRY COMM’N, PRELIMINARY STAFF REPORT: GOVERNMENTAL RESCUES OF “TOO-BIG-TO-FAIL” FINANCIAL INSTITUTIONS 10-11, 29-32 (2010) [hereinafter FCIC TBTF STAFF REPORT], *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/2010-0831-Governmental-Rescues.pdf (describing the SRE under 12 U.S.C. § 1823(c)(4)(G), as originally enacted in 1991 and as invoked by federal regulators during the financial crisis). I was the principal drafter of the foregoing staff report while I worked as a consultant to the FCIC during the summer of 2010.

avoid or mitigate “serious . . . effects on economic conditions or financial stability.”²⁸⁰ Section 1106 of Dodd–Frank narrowed the scope of the SRE by requiring that a bank must be placed in receivership before the bank’s creditors can receive extraordinary protection under the SRE.²⁸¹ Accordingly, if a failing SIFI owns a bank that is placed in receivership, the SRE would permit the FDIC—with the Fed’s concurrence and the Treasury Secretary’s approval—to provide full protection to that bank’s creditors in order to avoid or mitigate systemic risk. “By protecting a SIFI-owned bank’s creditors[—]which could include the SIFI itself” as well as creditors who have claims against *both* the bank and the SIFI—the FDIC could use the SRE” to support either the SIFI or its creditors.²⁸²

Two other provisions of Dodd–Frank limit, but do not eliminate, the ability of the Fed and the FDIC to provide financial support to failing SIFIs or their subsidiaries outside the OLA or the SRE. Under § 1101 of Dodd–Frank, the Fed may continue to provide emergency loans under § 13(3) of the Federal Reserve Act²⁸³ if the firms receiving such loans are “not insolvent” and are “participant[s] in any program or facility with broad-based eligibility” approved by the Treasury Secretary.²⁸⁴ Under § 1105 of Dodd–Frank, the FDIC may continue to guarantee debt obligations of depository institutions or their holding companies or other affiliates if the FDIC establishes a “widely available program” for “solvent” institutions that is approved by the Treasury Secretary and endorsed by a joint resolution of Congress.²⁸⁵

280. 12 U.S.C. § 1823(c)(4)(G)(i)(I) (2012). In order to invoke the SRE, the Treasury Secretary must receive a favorable recommendation from the FDIC and the Fed and consult with the President. *Id.* § 1823(c)(4)(G)(i).

281. See Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1106(b), 124 Stat. 1376, 2125 (amending 12 U.S.C. § 1823(c)(4)(G)).

282. Wilmarth, *Dodd–Frank*, *supra* note 15, at 1001.

283. 12 U.S.C. § 343; see FCIC TBTF STAFF REPORT, *supra* note 279, at 19, 21-26 (referring to § 13(3) as amended in 1991 and as applied by the Fed to provide emergency credit to particular firms and segments of the financial markets during the financial crisis).

284. Dodd–Frank § 1101(a) (internal quotation marks omitted). Section 1101(a)(6) prohibits the Fed from providing loans under § 13(3) to a company that is the subject of a bankruptcy proceeding, an OLA resolution, “or any other Federal or State insolvency proceeding.” *Id.* § 1101(a)(6); see S. REP. NO. 111-176, at 6, 182-83 (2010) (discussing Dodd–Frank’s restrictions on the Fed’s lending authority under § 13(3)).

285. Dodd–Frank § 1105. Section 1106(a) of Dodd–Frank bars the FDIC from “establish[ing] any widely available debt guarantee program” based on the

Thus, the FDIC cannot guarantee the debt of financial institutions under § 1105 without congressional approval. However, § 1101 allows the Fed—with only the Treasury Secretary’s approval—to create a “broad-based” program similar to the Primary Dealer Credit Facility (PDCF) for the purpose of providing emergency liquidity assistance to a selected *group* of SIFIs that the Fed deems to be “not insolvent.”²⁸⁶ As shown by the events of 2008, “it is [very] difficult for outsiders (including members of Congress) to second-guess a regulator’s determination of solvency [in] the midst of a systemic crisis.”²⁸⁷ “Moreover, regulators are strongly inclined during a crisis to make generous assessments of solvency in order to justify their decision to provide emergency assistance to troubled [SIFIs].”²⁸⁸ Thus, during a future financial crisis the Fed could use its remaining authority under § 13(3) to provide emergency loans to a targeted group of troubled SIFIs that have not yet been placed in OLA resolutions or other bankruptcy or insolvency proceedings.²⁸⁹

“Moreover, Dodd–Frank does not [affect the ability of *individual* SIFIs] to receive liquidity support from the [Fed’s] discount window or from Federal Home Loan Banks (FHLBs).”²⁹⁰ “The [Fed’s] discount window (often referred to as the [Fed’s] ‘lender of last resort’ facility) provides short-term loans to depository

SRE under the FDI Act. *Id.* § 1106(a); see S. REP. NO. 111-176, at 6-7, 183-84 (2010) (discussing Dodd–Frank’s limitations on the FDIC’s authority to guarantee debt obligations of depository institutions and their holding companies).

286. Dodd–Frank § 1101(a)(6) (internal quotation marks omitted).

The [Fed] established the PDCF in March 2008 (at the time of its rescue of Bear) and expanded that facility in September 2008 (at the time of Lehman’s failure). The PDCF allowed the nineteen primary dealers in government securities to make secured borrowings from the [Fed] on [terms] similar to [those governing secured advances to banks from the Fed’s discount window]. The nineteen primary dealers eligible for participation in the PDCF were securities broker-dealers; . . . all but four of those dealers were affiliated with banks.

Wilmarth, *Dodd–Frank*, *supra* note 15, at 1002-03 n.214.

287. Wilmarth, *Dodd–Frank*, *supra* note 15, at 1003.

288. *Id.* at 1003; Johnson, *supra* note 272; SKEEL, *supra* note 243, at 132-40.

289. See *supra* notes 283-284 and accompanying text; see also SKEEL, *supra* note 243, at 11, 139-40 (observing that the Fed can “maneuver around the restrictions [on its § 13(3) lending authority] by creating an across-the-board lending facility that is really a single firm bailout in disguise”).

290. See Wilmarth, *Dodd–Frank*, *supra* note 15, at 1003.

institutions secured by qualifying collateral.”²⁹¹ “Similarly, FHLBs—[sometimes] described . . . as ‘lender[s] of next-to-last resort’—[provide] collateralized ‘advances’ to member institutions, including banks and insurance companies.”²⁹²

During the last financial crisis, banks did not borrow significant amounts from the Fed’s discount window due to the perceived “stigma” of doing so, as well as the availability of alternative sources of credit through FHLBs and emergency liquidity facilities that the Fed established under § 13(3).²⁹³ Following the outbreak of the financial crisis, the FHLBs provided \$235 billion of advances to member institutions during the second half of 2007, including almost \$150 billion of advances to ten major LCFIs. “Six of those LCFIs incurred large losses during the crisis[] and . . . either failed, were acquired in emergency transactions, or received [extraordinary] ‘assistance’ from the federal government.”²⁹⁴ Thus, “FHLB advances provided a significant source of support for troubled LCFIs, [particularly] during the early phase of the financial crisis.”²⁹⁵ During future crises, individual LCFIs would probably use the FRB’s discount window more frequently, along with FHLB advances, because § 1101 of Dodd–Frank makes it more difficult for the Fed to provide emergency credit to individual institutions under § 13(3).²⁹⁶

“Discount window loans and FHLB advances cannot be made to banks [that are already] in receivership, but they do provide a potential source of funding” for banks owned by troubled SIFIs that have not yet been placed in receivership.²⁹⁷ Similarly, as shown

291. See *id.* at 1003 & n.216 (quoting Adam Ashcraft, Morten L. Bech & W. Scott Frame, *The Federal Home Loan Bank System: The Lender of Next-to-Last Resort?*, 42 J. MONEY CREDIT & BANKING 551, 552 (2010)) (discussing the Fed’s authority to make discount window loans to individual banks under 12 U.S.C. § 347b).

292. *Id.* at 1003-04 (footnote omitted) (quoting Ashcraft, Bech & Frame, *supra* note 291, at 554-62, 577-79).

293. Ashcraft, Bech & Frame, *supra* note 291, at 567-79 (internal quotation marks omitted); Stephen G. Cecchetti, *Crisis and Responses: The Federal Reserve in the Early Stages of the Financial Crisis*, 23 J. ECON. PERSP. 51, 64-72 (2009).

294. Wilmarth, *Dodd–Frank*, *supra* note 15, at 1004 (quoting Ashcraft, Bech & Frame, *supra* note 292, at 553, 560, 579-80).

295. *Id.*

296. *Id.*

297. See *id.* (citing 12 U.S.C. § 347b(b) (2012)) (allowing the Fed to make discount window loans to “undercapitalized” banks subject to specified limitations); 12 C.F.R. § 1266.4(b), (d) (2014) (allowing FHLBs to make advances to “capital deficient” banks, but requiring special regulatory approval for advances to insolvent banks).

above, the Fed can provide emergency credit to groups of troubled SIFIs under § 13(3) as long as they have not been declared insolvent.²⁹⁸ To the extent that the Fed or the FHLBs provide any of the foregoing types of loans, “at least some short-term creditors of troubled SIFIs or [their subsidiary] banks are likely to benefit by [receiving] full payment of their claims before any receivership is [established].”²⁹⁹

3. *Dodd–Frank Does Not Prevent Congress from Authorizing Bailouts of SIFIs During Future Crises*

Notwithstanding Dodd–Frank’s explicit promise to end bailouts of SIFIs, the preceding Subsection shows that federal agencies still possess several tools for protecting SIFI creditors during future crises. A more fundamental problem is that Dodd–Frank’s “no bailout” pledge does not prevent a future Congress from allowing regulators to rescue SIFIs. When a future Congress confronts the next systemic financial crisis, that Congress may well decide to abandon the no-bailout promise either explicitly (by amending Dodd–Frank) or implicitly (by looking the other way while regulators expansively construe their authority to protect SIFI creditors).³⁰⁰

In 1989, congressional leaders and President George H.W. Bush made “[n]ever again” pledges when Congress enacted legislation authorizing the use of taxpayer funds to rescue the thrift industry.³⁰¹ Those pledges closely resembled President Obama’s

298. See *supra* notes 286-289 and accompanying text.

299. Wilmarth, *Dodd–Frank*, *supra* note 15, at 1004-05; see also 12 U.S.C. § 347b(b) (allowing the FRB to make discount window loans to “undercapitalized” banks subject to specified limitations).

300. Marc Jarsulic & Simon Johnson, *How a Big-Bank Failure Could Unfold*, N.Y. TIMES (May 23, 2013, 12:01 AM), <http://economix.blogs.nytimes.com/2013/05/23/how-a-big-bank-failure-could-unfold/>; Simon Johnson, *The Case for Megabanks Fails*, N.Y. TIMES (May 2, 2013, 5:00 AM), <http://economix.blogs.nytimes.com/2013/05/02/the-case-for-megabanks-fails/>.

301. Wilmarth, *Dodd–Frank*, *supra* note 15, at 1005 n.225 (quoting “[n]ever again” statements in the House committee report and in President Bush’s signing statement for the 1989 legislation (citing H.R. REP. NO. 101-54, pt. 1, at 310 (1989), reprinted in 1989 U.S.C.C.A.N. 86, 106; Gerhard Peters & John T. Woolley, *George Bush: Remarks on Signing the Financial Institutions Reform, Recovery, and Enforcement Act of 1989*, AM. PRESIDENCY PROJECT (Aug. 9, 1989), <http://www.presidency.ucsb.edu/ws/?pid=17414>)).

“never again” statement when he signed Dodd–Frank into law.³⁰² Similar assurances were made in 1991 when Congress enacted sweeping regulatory reform legislation to deal with the banking crisis of the 1980s and early 1990s.³⁰³ Congressional leaders assured the public in 1991 that the new reforms—including the “prompt corrective action” regime—would significantly reduce the likelihood of TBTF bailouts, even though the legislation included the SRE to deal with “extraordinary cases.”³⁰⁴

Neither the 1989 pledges nor the 1991 assurances stopped Congress, President George W. Bush, and federal agencies from authorizing the use of hundreds of billions of dollars in “public funds to bail out major financial institutions in 2008.”³⁰⁵ In light of that history, Adam Levitin has justifiably concluded that

[l]aw is an insufficient commitment device for avoiding bailouts altogether. It is impossible to produce binding commitment to a preset resolution process, irrespective of the results. The financial Ulysses cannot be bound to the mast. . . . Once the ship is foundering, we do not want Ulysses to be bound to the mast, lest [we] go down with the ship and drown. Instead, we want to be sure his hands are free—too bail.³⁰⁶

Levitin and other scholars predict that future Congresses will relax or remove Dodd–Frank’s constraints on TBTF bailouts, or will permit federal regulators to evade those limitations if such actions are deemed necessary to prevent future collapses of SIFIs that could destabilize our financial system.³⁰⁷

Another major reason for questioning the credibility of Dodd–Frank’s no-bailout promise is the absence of any unified

302. See *supra* note 218 and accompanying text (quoting President Obama’s statement).

303. See S. REP. NO. 102-167, at 17-33 (1991) (describing the need for regulatory reforms to respond to the banking crisis of the 1980s and early 1990s).

304. *Id.* at 3-4, 44-46 (internal quotation marks omitted); see also 137 CONG. REC. H11808 (daily ed. Nov. 26, 1991) (statement of Rep. Slattery) (declaring that the 1991 legislation would “have the effect of putting the brakes on the use of the too big to fail doctrine”); Carnell, *supra* note 62, at 326-30, 363, 367-68 (explaining that the 1991 legislation was designed to “curtail too-big-to-fail policies” by requiring regulators (1) to impose “prompt corrective action” sanctions on undercapitalized banks, and (2) to use a “least-cost” approach in resolving failed banks, subject to a “narrow systemic-risk exception” that would rarely be invoked).

305. Wilmarth, *Dodd–Frank*, *supra* note 15, at 1005; see also FCIC TBTF STAFF REPORT, *supra* note 279, at 10, 21-34.

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

307. *Id.* at 489; accord SKEEL, *supra* note 243, at 12-15, 145; Cheryl D. Block, *Measuring the True Cost of Government Bailout*, 88 WASH. U. L. REV. 149, 224, 227 (2010); Jarsulic & Johnson, *supra* note 300; Johnson, *supra* note 300.

international framework for resolving SIFIs with cross-border operations. An OLA proceeding will not successfully resolve the failure of a global SIFI unless the foreign countries in which the SIFI operates agree to cooperate in carrying out the OLA plan (including the FDIC's proposed SPOE strategy).³⁰⁸ At present, it is highly doubtful whether that kind of foreign cooperation would be forthcoming. In June 2014, the International Monetary Fund (IMF) reported that "as yet, orderly resolution of systemic cross-border banks is not a feasible option."³⁰⁹ Despite efforts by the G20 and the Financial Stability Board (FSB) to create an international resolution blueprint, the IMF concluded that "orderly cross-border resolution is still far from assured. Should a large cross-border bank fail today, it appears unlikely that the pitfalls and misaligned incentives that undermined [international] cooperation in the global financial crisis could be avoided."³¹⁰

Similarly, the FSB reported in September 2014 that "most jurisdictions do not currently have statutory powers to recognise, enforce or give legal effect to foreign resolution measures."³¹¹ The FSB also warned that "judicial recognition procedures" for enforcing foreign orders dealing with business resolutions are "typically designed for corporate insolvency proceedings and are largely untested for actions taken by foreign resolution authorities with respect to financial institutions."³¹² The FSB further cautioned that "very few jurisdictions currently have [cross-border resolution] frameworks in place,"³¹³ and "no jurisdiction has experience" in applying such a framework to accomplish "the resolution of a complex cross-border financial group."³¹⁴

308. See, e.g., GOODHART & AVGOULEAS, *supra* note 273, at 18-19, 22-24; Jarsulic & Johnson, *supra* note 300.

309. INT'L MONETARY FUND, CROSS-BORDER BANK RESOLUTION: RECENT DEVELOPMENTS 4 (2014) [hereinafter IMF BANK RESOLUTION REPORT] (emphasis omitted), available at <http://www.imf.org/external/np/pp/eng/2014/060214.pdf>.

310. *Id.* at 23 (emphasis omitted).

311. FIN. STABILITY BD., CROSS-BORDER RECOGNITION OF RESOLUTION ACTION 3 (2014) [hereinafter FSB CROSS-BORDER RESOLUTION REPORT], available at http://www.financialstabilityboard.org/publications/c_140929.pdf.

312. *Id.*

313. *Id.* at 11.

314. *Id.* at 6. In October 2014, eighteen major banks that are leading global derivatives dealers agreed on changes to their master swaps agreements overseen by the International Swaps and Derivatives Association (ISDA). Gregory Mott, *Banks Back Swap Contracts That Could Help Unwind Too-Big-to-Fail*, BLOOMBERG BUS. (Oct. 11, 2014, 5:00 PM), available at <http://www.bloomberg.com/news/articles/2014-10-11/banks-back-swap-contracts-that-could-help-unwind-too-big-to-fail>. The

To date, relatively few nations have adopted SIFI resolution laws that are similar to Title II of Dodd–Frank.³¹⁵ In addition, past experience suggests that foreign nations are likely to adopt “ring-fencing” policies and engage in “[u]nilateral responses” during future crises, including segregation and seizure of SIFI-owned assets subject to their jurisdiction.³¹⁶ Accordingly, during a future crisis—especially one involving threats to multiple SIFIs—U.S. regulators might well decide that they must arrange bailouts for SIFIs with cross-border operations instead of taking the risk that invoking OLA receiverships would trigger protracted disputes with foreign regulators as well as panicked runs by SIFI creditors.³¹⁷

changes would provide for temporary delays in the termination of derivatives contracts or the seizure of collateral following the insolvency of a derivatives dealer. *Id.* Trade associations representing big international banks proclaimed that the agreed changes to ISDA master contracts would “facilitate cross-border resolution efforts and reduce the risk of a disorderly wind-down.” *Id.* (quoting Scott O’Malia, ISDA Chief Exec. Officer, and a similar statement by TCH president Paul Saltzman) (internal quotation marks omitted). However, the FSB has warned that

contractual solutions to cross-border enforceability . . . have limitations and therefore may not be considered a substitute for statutory regimes in the longer term. . . . [T]he enforceability of such contractual recognition provisions has yet to be tested in the courts and limitations on their enforceability (for example, on public policy grounds) may not always be clear.

FSB CROSS-BORDER RESOLUTION REPORT, *supra* note 311, at 11.

315. See, e.g., Paul L. Lee & Edite Ligere, *Cross-Border Resolution of Banking Groups: International Initiatives and U.S. Perspectives – Part II*, PRATT’S J. BANKR. L., Oct. 2013, at 583, 585-89, 599-609; see also U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-14-261, INTERNATIONAL FINANCIAL REFORMS: U.S. AND OTHER JURISDICTIONS’ EFFORTS TO DEVELOP AND IMPLEMENT REFORMS 29-34 (2014).

316. IMF BANK RESOLUTION REPORT, *supra* note 309, at 5-7 (stating that “[u]nilateral responses [by national authorities] were the norm” in dealing with troubled cross-border SIFIs during the recent financial crisis, “leading in some cases to the breakup of [SIFI] groups into national components”); *id.* at 25-29 (explaining that European authorities had great difficulty in agreeing on resolution strategies for Dexia and Fortis and ultimately decided to separate both cross-border SIFIs into separate, nationalized banks); Paul Taylor, *European Bank Mergers Still Face Hurdles Post-Stress Tests*, REUTERS (Oct. 12, 2014, 3:16 AM), <http://www.reuters.com/article/2014/10/12/us-ecb-banks-tests-insight-idUSKCN01105920141012> (describing the adoption of “ring-fencing” strategies by European banking authorities during the financial crisis, and quoting former Bank of England Governor Mervyn King’s observation that “global banks are global in life but national in death”).

317. See, e.g., Jarsulic & Johnson, *supra* note 300; Johnson, *supra* note 272.

B. The Dodd–Frank Act Does Not Prevent Financial Conglomerates from Using Their Safety-Net Subsidies to Support Risky Capital Markets Activities

In enacting Dodd–Frank, Congress included two provisions—the Volcker Rule and the Lincoln Amendment—that were intended to prevent the federal “safety net” for banks³¹⁸ from being used to subsidize risky activities in the capital markets. As shown below, neither provision has proven to be effective. After aggressive lobbying by Wall Street, the House–Senate conference committee on Dodd–Frank inserted numerous exemptions into the Volcker Rule and the Lincoln Amendment. Following Dodd–Frank’s enactment, the financial industry vigorously lobbied to obstruct the implementation of both provisions, and the industry also promoted legislative efforts to amend or repeal both statutes. In December 2014, Wall Street’s allies in Congress succeeded in repealing the Lincoln Amendment.

The financial industry’s successful campaigns to undermine the Volcker Rule and repeal the Lincoln Amendment reveal fundamental problems with Dodd–Frank’s broader design. The statute does not challenge the business model and operating strategies of megabanks. Instead, Dodd–Frank relies on highly technical regulatory reforms that are not likely to stop megabanks from exploiting federal safety-net subsidies and taking excessive risks. Dodd–Frank’s greatest weakness may be its heavy reliance on the same financial regulatory agencies that repeatedly failed to impose effective discipline on megabanks in the past.

1. *The Volcker Rule Does Not Impose Strong and Enforceable Constraints on Risk-Taking by Megabanks*

Former Fed Chairman Paul Volcker originally proposed the Volcker Rule (§ 619 of Dodd–Frank) in order to stop banks from making speculative trades and investments in the capital markets.³¹⁹

318. “The federal ‘safety net’ for banks” provides significant subsidies in the form of “(1) federal deposit insurance,” (2) the SRE’s potential protection for “uninsured depositors and other uninsured creditors” of TBTF banks and “(3) discount window advances and other liquidity assistance provided by the FRB as lender of last resort.” Wilmarth, *Dodd–Frank*, *supra* note 15, at 1023 n.308.

319. Louis Uchitelle, *Volcker Pushes for Reform, Regretting Past Silence*, N.Y. TIMES, July 10, 2010, at BU1 (describing Mr. Volcker’s determined advocacy for the Volcker Rule).

As approved by the Senate Banking Committee, the Volcker Rule would have barred banks from (1) sponsoring or investing in hedge funds or private equity funds, and (2) engaging in proprietary trading—i.e., buying and selling securities, derivatives, and other financial instruments for the purpose of generating trading profits.³²⁰ As the Senate committee report explained, the Volcker Rule was designed to prevent banks “protected by the federal safety net, which have a lower cost of funds, from directing those funds to high-risk uses” involving speculative trading and investments.³²¹

Wall Street vehemently opposed the Volcker Rule.³²² As a result of extensive lobbying by the financial industry, the House–Senate conference committee on the Dodd–Frank Act agreed on a last-minute compromise that substantially weakened the Volcker Rule.³²³ The final compromise on the Volcker Rule included exemptions that permit banks to (1) invest up to 3% of their Tier 1 capital in hedge funds or private equity funds (as long as such investments do not exceed 3% of the total ownership interests in any single fund); (2) purchase and sell government securities; (3) engage in “[r]isk-mitigating hedging activities”; (4) purchase and sell securities, derivatives, and other financial instruments “in connection with underwriting or market-making-related activities”; (5) make investments through insurance company affiliates; and (6) make investments through small business investment companies.³²⁴ The

320. S. REP. NO. 111-176, at 8-9, 90-92 (2010).

321. *Id.* at 8-9, 90 (explaining that the Volcker Rule was intended to “eliminate any economic subsidy to high-risk activities that is provided by access to lower-cost capital because of participation in the regulatory safety net”).

322. John Cassidy, *The Volcker Rule: Obama’s Economic Adviser and His Battles over the Financial-Reform Bill*, NEW YORKER (July 26, 2010), <http://www.newyorker.com/magazine/2010/07/26/the-volcker-rule>; see also Eamon Javers & Victoria McGrane, *Chris Dodd Proposal Hits Wall Street Hard*, POLITICO (Mar. 16, 2010, 5:10 AM), <http://www.politico.com/news/stories/0310/34463.html> (reporting that the Volcker Rule was “hated on Wall Street”).

323. Cassidy, *supra* note 322 (reporting that the compromise disappointed Mr. Volcker); Bradley Keoun & Christine Harper, *The Financial Reform Law: A ‘Fig Leaf,’* BLOOMBERG BUS. (July 1, 2010), http://www.bloomberg.com/bw/magazine/content/10_28/b4186042369207.htm (reporting on the final compromise that weakened the Volcker Rule).

324. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, 124 Stat. 1376, 1620-27 (2010) (internal quotation marks omitted) (enacting § 13(d) of the BHC Act).

final compromise also granted long phase-in periods for the Volcker Rule's provisions.³²⁵

A particularly troublesome aspect of the Volcker Rule is the statute's attempt to distinguish between prohibited "proprietary trading" and permissible "market-making."³²⁶ Both proprietary trading and market-making involve purchasing and selling securities as principal, and it is therefore "notoriously difficult" to draw a clear dividing line between the two activities.³²⁷ Similarly, it is very hard to articulate a workable distinction between prohibited proprietary trading and permitted "[r]isk-mitigating hedging activities."³²⁸ As Fed Governor Daniel Tarullo observed, a "fundamental challenge" in separating the three closely related activities is "the fact that a specific trade may be either permissible or impermissible depending on the context and circumstances within which that trade is made."³²⁹

Congress left it to the three federal banking agencies, along with the CFTC and the SEC, to implement the Volcker Rule by adopting joint regulations.³³⁰ As a result of extensive lobbying by the financial industry and disagreements among the five regulators, final implementing regulations for the Volcker Rule were not issued until

325. Wilmarth, *Dodd-Frank*, *supra* note 15, at 1028 (explaining that § 13(c) of the BHC Act, as enacted by the Volcker Rule, gave banks (1) until July 2017 "to bring most of their equity-investing and proprietary-trading activities into compliance with the Volcker Rule," and (2) until July 2022 "to bring their 'illiquid' investments that were . . . in existence on May 1, 2010, into compliance with the Rule").

326. Dodd-Frank § 619 (internal quotation marks omitted) (enacting § 13(d)(1)(B) and (h)(4) of the BHC Act).

327. Wilmarth, *Dodd-Frank*, *supra* note 15, at 1029; *see also* CARNELL, MACEY & MILLER, *supra* note 138, at 619-21 (explaining that "market makers" must act "as principals, taking securities into their own inventories as owners" to ensure their ability to satisfy customer purchase or sell orders; as a result, "implementing [the market-making] exception has proven extremely difficult" for regulators in carrying out the Volcker Rule).

328. Dodd-Frank § 619 (internal quotation marks omitted) (enacting § 13(d)(1)(C) and (h)(4) of the BHC Act); *see also* CARNELL, MACEY & MILLER, *supra* note 138, at 622 ("Another major obstacle in implementing the Volcker Rule in a coherent way is that it appears virtually impossible to reconcile the rule's ban on proprietary trading with the need of banks to reduce risk by hedging.").

329. Daniel K. Tarullo, Fed. Reserve Governor, Opening Statement (Dec. 10, 2013) [hereinafter Tarullo Volcker Rule Statement], *available at* <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210a-tarullo-statement.htm> (publishing the statement issued by Governor Tarullo in connection with the Fed's approval of final regulations implementing the Volcker Rule).

330. Dodd-Frank § 619 (enacting § 13(b)(2) of the BHC Act).

December 2013.³³¹ Wall Street responded to the final regulations with considerable relief because the regulations “leave market-making operations intact” and also provide leeway for “aggregate hedges” as well as the retention of some funds managed by banks.³³²

Former Wells Fargo chairman Richard Kovacevich described the final outcome as “reasonable and one that the industry can live with.”³³³ Hence, Wall Street’s lobbying campaign appears to have been successful in softening the Volcker Rule’s impact.³³⁴

The final regulations (including guidance) are lengthy and complex, covering 140 pages in the *Federal Register*.³³⁵ Fed Governor Tarullo acknowledged that while “[m]any of us—myself included—had hoped for a final rule substantially more streamlined than the 2011 proposal,” the final regulations are “only modestly simplified.”³³⁶ Given the ambiguity of key definitions, the complexity

331. Chris Bruce & K. Claire Compton, *Bumpy Phase-In Seen for Volcker Rule Despite Extended Compliance Deadlines*, 101 BNA’S BANKING REP. 965, 965-66 (2013); see also Wilmarth, *Blind Eye*, *supra* note 63, at 1302-04 (describing the financial industry’s aggressive lobbying efforts that delayed adoption of the implementing regulations).

332. Michael J. Moore, Dakin Campbell & Laura Marcinek, *Wall Street Exhales as Volcker Rule Seen Sparing Market-Making*, BLOOMBERG BUS. (Dec. 11, 2013, 12:00 AM), <http://www.bloomberg.com/news/articles/2013-12-11/wall-street-exhales-as-volcker-rule-seen-sparing-market-making>; see also Silla Brush, Cheyenne Hopkins & Jesse Hamilton, *Volcker Rule Ushers in Era of Increased Oversight of Trades*, BLOOMBERG BUS. (Dec. 10, 2013, 3:17 PM), <http://www.bloomberg.com/news/articles/2013-12-10/volcker-rule-eases-market-making-while-hedges-face-new-scrutiny> (reporting that “Wall Street’s lobbying efforts paid off in easing some provisions of the rule” as “[r]egulators granted a broader exemption for banks’ market-making desks”); Sheelah Kolhatkar, *Is the Volcker Rule Too Soft on Wall Street?*, BLOOMBERG BUS. (Dec. 11, 2013), <http://www.bloomberg.com/bw/articles/2013-12-11/is-the-volcker-rule-too-soft-on-wall-street> (“[T]he consensus is that the final rule is far less dire than bankers feared.”); Sarah N. Lynch & Ross Kerber, *U.S. Fund Industry Sees Modest Wins in Final Volcker Rule*, REUTERS (Dec. 11, 2013, 2:57 AM), <http://www.reuters.com/article/2013/12/11/us-financial-regulation-volcker-fund-idUSBRE9BA00K20131211> (reporting that “[r]egulators decided to exempt certain funds after Wall Street complained,” and the exempted funds include “many commodity pools, foreign registered mutual funds, securitized loans and corporate structures such as joint ventures”).

333. Moore, Campbell & Marcinek, *supra* note 332 (quoting Richard Kovacevich).

334. Brush, Hopkins & Hamilton, *supra* note 332; Kolhatkar, *supra* note 332.

335. Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5536-6075 (proposed Jan. 31, 2014).

336. Tarullo Volcker Rule Statement, *supra* note 329.

of the final regulations, and the agencies' decision to rely heavily on internal compliance efforts by banks, the ability of regulators to enforce the Volcker Rule in any rigorous manner remains very doubtful.³³⁷

As soon as the final regulations were issued, the financial industry sought further concessions. In January 2014, regulators approved an additional exemption for CDOs that held trust-preferred securities issued by community banks.³³⁸ The financial industry immediately pushed for another exemption covering collateralized loan obligations (CLOs).³³⁹ After members of Congress applied considerable pressure, the Fed granted a two-year extension for banks to bring their CLOs into compliance with the Volcker Rule.³⁴⁰

Banks also lobbied for an extended delay of their obligation to bring their private equity and venture capital investments into compliance with the Volcker Rule.³⁴¹ In addition, the financial industry provided massive support to Republican candidates in the

337. Peter J. Henning, *Don't Expect Eye-Popping Fines for Volcker Rule Violations*, N.Y. TIMES (Dec. 16, 2013, 12:29 AM), http://dealbook.nytimes.com/2013/12/16/dont-expect-eye-popping-fines-for-volcker-rule-violations/?_r=0; Matt Miller, *Matt Miller: Firms Lawyer up as Volker Rule Is Rolled Out*, WASH. POST (Dec. 11, 2013), http://www.washingtonpost.com/opinions/matt-miller-firms-lawyer-up-as-volker-rule-is-rolled-out/2013/12/11/e6d6b8b8-6266-11e3-aa81-e1dab1360323_story.html; see also Mayra Rodriguez Valladares, *Why Volcker Rule Compliance Is a Fool's Errand*, AM. BANKER (Oct. 1, 2014, 2:00 PM), <http://www.americanbanker.com/bankthink/why-volcker-rule-compliance-is-a-fools-errand-1070294-1.html?zkPrintable=true> (describing the Volcker Rule as "one of the most complex regulatory rules ever written" and warning of "the insurmountable difficulties of complying with and enforcing this rule").

338. Jesse Hamilton & Cheyenne Hopkins, *Volcker Rule Curbs on Banks Owning CDOs Eased in U.S.*, BLOOMBERG BUS. (Jan. 15, 2014, 12:01 AM), <http://www.bloomberg.com/news/articles/2014-01-14/u-s-regulators-said-ready-to-ease-volcker-cdo-limits-for-banks>.

339. Jesse Hamilton & Cheyenne Hopkins, *Bank Industry Pushes for More Revisions to Volcker Rule*, BLOOMBERG BUS. (Jan. 16, 2014, 12:01 AM), <http://www.bloomberg.com/news/articles/2014-01-15/banks-push-for-further-changes-to-volcker-rule-following-cdo-fix>.

340. Cheyenne Hopkins, *Banks Given Two More Years to Meet Volcker CLO Standards*, BLOOMBERG BUS. (Apr. 7, 2014, 6:07 PM), <http://www.bloomberg.com/news/articles/2014-04-07/federal-reserve-delays-volcker-clo-conformance-by-two-years>; see also Rob Tricchinelli, *Facing Pressure, Federal Regulators Grant Two-Year Extension on CLOs*, 46 SEC. REG. & L. REP. 695, 695 (2014).

341. Andrew Ackerman & Ryan Tracy, *Banks Push to Delay Rule on Investments*, WALL ST. J., Aug. 13, 2014, at C3; see also Yalman Onaran, *SIFMA Says Fed Should Delay Parts of Volcker for Some Funds*, 46 SEC. REG. & L. REP. 2045, 2045 (2014).

2014 midterm elections, and that support helped Republicans to capture the Senate and retain control of the House.³⁴² The incoming Republican leaders in the Senate and the House promptly announced that they would target several provisions of Dodd-Frank for repeal or modification, including the Volcker Rule.³⁴³

Thus, there is a strong possibility that Congress will soon pass legislation to weaken the Volcker Rule.³⁴⁴ Meanwhile, effective implementation of the existing Rule will depend on coordination among five federal agencies that have found it very difficult to reach consensus in the past.³⁴⁵ Given those challenges and Wall Street's abundant opportunities to "circumvent" the Rule's complex provisions,³⁴⁶ it is highly doubtful whether the Rule will stop

342. See Silla Brush, Cheyenne Hopkins & Jesse Hamilton, *Emboldened by Swap Victory, Banks Eye Further Changes in 2015*, BLOOMBERG BUS. (Dec. 12, 2014, 4:26 PM), <http://www.bloomberg.com/news/articles/2014-12-12/emboldened-by-swap-victory-banks-eye-further-changes-in-2015> ("Wall Street firms . . . will be counting on Republican control of both houses of Congress to speed reversal of what they call the overreach of the [Dodd-Frank Act]."). The finance, insurance, and real estate (FIRE) sector was by far the largest source of political contributions among all industry sectors during the 2014 midterm elections. The FIRE sector contributed \$464 million to political action groups, parties, and candidates, and the sector gave 62% of its political contributions to Republican candidates. Ctr. for Responsive Politics, *Interest Groups*, OPENSECRETS, <http://www.opensecrets.org/industries/> (last visited Mar. 18, 2015).

343. Rob Tricchinelli, *As Republicans Control Both Chambers, Dodd-Frank Is Squarely in the Crosshairs*, 47 SEC. REG. & L. REP. 172, 172 (2015) ("Several aspects of the [Dodd-Frank Act] . . . are in Republicans' crosshairs, including . . . the Volcker Rule."); Simon Johnson, *The Republican Strategy to Repeal Dodd-Frank*, BASELINE SCENARIO (Jan. 7, 2015), <http://baselinescenario.com/2015/01/07/the-republican-strategy-to-repeal-dodd-frank/> (stating that Republican leaders in the new Congress plan to "chip away" at various Dodd-Frank provisions, and their "initial target is the Volcker Rule").

344. Tricchinelli, *supra* note 343, at 172; Johnson, *supra* note 343.

345. Chris Bruce, *Banking Lawyers See Rocky Road for Implementation of Volcker Rule*, 103 BNA'S BANKING REP. 542, 542 (2014); see also Nela Richardson, *Volcker Rule's Bite Depends on Enforcement: BGOV Insight*, 101 BNA'S BANKING REP. 1001, 1001 (2013) (observing that "[t]he final rule is vague and leaves much discretion to the five regulators charged with enforcing it"); Peter Eavis & Ben Protes, *Pressure Builds to Finish Volcker Rule on Wall St. Oversight*, N.Y. TIMES (Nov. 17, 2013, 7:38 PM), http://dealbook.nytimes.com/2013/11/17/pressure-builds-to-finish-volcker-rule-on-wall-st-oversight/?_r=0 (reporting on "tension" and "internal wrangling" among the five agencies that "stymied them for years" in their efforts to adopt joint regulations to implement the Volcker Rule).

346. Bruce, *supra* note 345, at 543 (paraphrasing the view of Professor M. Todd Henderson that the Volcker Rule "will be a futile effort in many respects [because] Wall Streeters will be able to circumvent its restrictions"). As one journalist observed:

megabanks from continuing to engage in speculative capital markets activities.³⁴⁷

2. *Wall Street Persuaded Congress to Repeal the Lincoln Amendment*

Senator Blanche Lincoln (D-AR) originally sponsored the Lincoln Amendment (§ 716 of Dodd–Frank).³⁴⁸ As approved by the Senate Agriculture Committee (which Senator Lincoln chaired), § 716 would have barred dealers in swaps and other over-the-counter derivatives from receiving any assistance from the FDIC’s deposit insurance fund or from the Fed’s discount window or other emergency lending facilities.³⁴⁹

The Lincoln Amendment was intended to force banks to “spin off their derivatives operations” in order to shield taxpayers from being compelled to “bail out” a bank after its “derivatives deals failed.”³⁵⁰ Senator Lincoln also wanted to prevent banks from using “cheaper funding provided by deposits insured by the FDIC[,] to subsidize their trading activities.”³⁵¹ “Thus, the purposes of the Lincoln Amendment—[insulating] banks from the risks of speculative activities and [preventing] the spread of safety net subsidies—were similar to the objectives of the Volcker Rule, but

Wall Street’s phalanxes of lawyers will surely be able to breathe more ambiguity into the deep vagueness the text [of the final regulations] already seems to contain. . . . What’s more, if these rules will be enforced by regulators who may want to get hired into lucrative jobs by the banks they’re supervising, can we be confident the tough calls will be resolved in the public interest?

Miller, *supra* note 337.

347. Wilmarth, *Dodd–Frank*, *supra* note 15, at 1029-30; Jonathan Weil, *Keep Your Expectations for the Volcker Rule Low*, BLOOMBERGVIEW (Dec. 10, 2013, 10:04 AM); *see also* Rodriguez Valladares, *supra* note 337 (concluding that “despite Volcker’s laudable goal, banks will not end up doing much to sufficiently reduce their risks and protect U.S. taxpayers”).

348. Wilmarth, *Dodd–Frank*, *supra* note 15, at 1030.

349. *Id.* (discussing § 716 as approved by the Senate Agriculture Committee).

350. Richard Hill, *Derivatives: Conferees Reach Compromise: Banks Could Continue to Trade Some Derivatives*, 42 SEC. REG. & L. REP. 1234, 1234 (2010).

351. Robert Schmidt & Phil Mattingly, *Banks Would Be Forced to Push Out Derivative Trading Under Plan*, BLOOMBERG (Apr. 14, 2010), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aDgYbbi7GobY>.

the Lincoln Amendment focused on dealing and trading in derivatives instead of all types of proprietary trading.”³⁵²

Senator Lincoln’s amendment provoked “tremendous pushback . . . from Republicans, fellow Democrats, the White House, banking regulators, and Wall Street interests.”³⁵³ As was true with the Volcker Rule, the House–Senate conference committee agreed on a final compromise that significantly weakened the Lincoln Amendment.³⁵⁴ As enacted, § 716 allowed FDIC-insured banks to deal in (1) swaps used for “[h]edging and other similar risk mitigating activities directly related to the [bank’s] activities”; (2) swaps based on interest rates, currency rates, and other “reference assets that are permissible for investment by a national bank,” including gold and silver; and (3) credit default swaps that are cleared pursuant to Title VII of Dodd–Frank.³⁵⁵

The final compromise on the Lincoln Amendment probably would have required major banks to transfer less than one-fifth of their pre-Dodd–Frank derivatives activities into separate affiliates.³⁵⁶ Even so, the Lincoln Amendment would have forced the largest banks to spin off a significant amount of their existing swaps-trading operations. For example, JPMorgan Chase and Citigroup conduct virtually all of their derivatives activities within their banks, and they

352. Wilmarth, *Dodd–Frank*, *supra* note 15, at 1031.

353. Hill, *supra* note 350; *see also* Stacy Kaper & Cheyenne Hopkins, *Key Issues Unresolved as Reform Finishes Up; Fate of Derivatives, Volcker Rule Still in Limbo in Final Hours*, AM. BANKER, June 25, 2010, at 1 (“[B]anks have vigorously opposed [the Lincoln Amendment], arguing it would cost them millions of dollars to spin off their derivatives units. Regulators, too, have argued against the provision, saying it would drive derivatives trades overseas or underground, where they would not be regulated.”).

354. Barrett Devlin & Damian Paletta, *The Financial-Regulation Overhaul: A Fight to the Wire as Pro-Business Democrats Dig in on Derivatives*, WALL ST. J., June 26, 2010, at A5; Edward Wyatt & David M. Herszenhorn, *Accord Reached for an Overhaul of Finance Rules: Historic Deal Expands Federal Authority to Curb Risky Wall St. Practices*, N.Y. TIMES, June 26, 2010, at A1, A12.

355. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 716(d), 124 Stat. 1376, 1648 (2010); *see also* Hill, *supra* note 350; Wyatt & Herszenhorn, *supra* note 354, at A12.

356. Keoun & Harper, *supra* note 323; Randall Smith & Aaron Lucchetti, *The Financial-Regulation Overhaul: Biggest Banks Manage to Dodge Some Bullets*, WALL ST. J., June 26, 2010, at A5; *see also* Hill, *supra* note 350 (quoting the Consumer Federation of America’s view that the final compromise “‘significantly weakened’” the Lincoln Amendment).

would have been required to make significant changes in their derivatives operations.³⁵⁷

To prevent the Lincoln Amendment from taking effect, the financial industry launched a vigorous lobbying campaign to repeal the statute. In 2013, the House overwhelmingly passed a bill to repeal the Lincoln Amendment—a bill that Wall Street crafted and eagerly supported.³⁵⁸ In response to Wall Street’s entreaties, the Fed and the Office of the Comptroller of the Currency (OCC) agreed in 2013 to postpone the compliance date for the Lincoln Amendment until July 2015.³⁵⁹

Before that extended compliance period expired, the financial industry and its congressional allies engineered a repeal of the Lincoln Amendment in December 2014.³⁶⁰ With support from most Republicans and some Democrats, Republican leaders successfully attached a repeal measure to “must-pass spending legislation,”³⁶¹ and the Obama Administration accepted the repeal in order “to get the budget deal done.”³⁶² Wall Street’s massive lobbying efforts for the

357. See *infra* note 446 and accompanying text (stating that Chase and Citigroup each hold 99% of the notional value of their derivatives within their banks); see also Johnson, *supra* note 343 (explaining that the repeal of the Lincoln Amendment in December 2014 “primarily benefited Citigroup and JP Morgan Chase”).

358. Victoria Finkle, *House Votes to Roll Back Dodd–Frank Swaps Provision*, AM. BANKER, Oct. 31, 2013 (reporting that the House passed a bill to repeal the Lincoln Amendment “by a bipartisan vote of 292-122, including 70 Democrats”); Eric Lipton, *House Votes to Repeal Dodd–Frank Provision*, N.Y. TIMES, Oct. 31, 2013, at B3 (reporting that Citigroup drafted most of the repeal bill, and Wall Street banks engaged in “intense lobbying” to push the bill through the House).

359. In 2013, the Fed and OCC issued rules giving domestic and foreign banks until July 2015 to bring their swaps activities into compliance with the Lincoln Amendment. Jeff Kearns & Jesse Hamilton, *Fed Releases Final Swaps Push-Out Rule for Foreign Banks*, BLOOMBERG BUS. (Dec. 24, 2013, 2:57 PM), <http://www.bloomberg.com/news/articles/2013-12-24/fed-finalizes-dodd-frank-swaps-push-out-rule-effective-jan-31>; see also Jesse Hamilton, *Deutsche Bank Among Lenders Given Two-Year U.S. Swaps Phase-Out*, BLOOMBERG BUS. (July 16, 2013, 9:40 AM), <http://www.bloomberg.com/news/articles/2013-07-15/fed-gives-four-banks-two-year-phase-out-for-certain-swaps-trades>.

360. Dave Clarke, Kate Davidson & Jon Prior, *How Wall St. Got Its Way*, POLITICO (Dec. 11, 2014, 10:40 PM), <http://www.politico.com/story/2014/12/wall-street-spending-bill-congress-113525.html>.

361. Cheyenne Hopkins & Silla Brush, *Wall Street’s Win on Swaps Rule Shows Washington Resurgence*, BLOOMBERG BUS. (Dec. 12, 2014, 5:00 AM), <http://www.bloomberg.com/news/articles/2014-12-12/wall-street-s-win-on-swaps-rule-shows-resurgence-in-washington>.

362. Clarke, Davidson & Prior, *supra* note 360.

repeal included personal telephone calls from JPMorgan Chase CEO Jamie Dimon to key members of Congress.³⁶³ As I observed at the time of the repeal, “Wall Street’s determined lobbying [to repeal] Section 716 provides compelling evidence that Wall Street’s business model depends on the ability of large financial conglomerates to keep exploiting the cheap funding provided by their ‘too big to fail’ subsidies.”³⁶⁴ The repeal of the Lincoln Amendment raises grave doubts about Dodd–Frank’s ability to impose any lasting restraints on speculative risk-taking and the exploitation of safety-net subsidies by megabanks.³⁶⁵

3. *Dodd–Frank Does Not Change the High-Risk Business Model of Universal Banks, and the Statute Instead Relies on Regulators Who Are Vulnerable to Industry Capture*

As shown above, Dodd–Frank does not solve the TBTF problem, and it will not stop megabanks from continuing to engage in speculative risk-taking. During the financial crisis, the federal government made the TBTF problem even worse by adopting extraordinary measures to ensure the survival of big financial institutions. The government’s “fail safe” program for megabanks enabled those institutions to become even larger and more powerful than they had been before the crisis.³⁶⁶

Dodd–Frank has not changed that outcome. Four years after Dodd–Frank’s enactment, FDIC Vice Chairman Thomas Hoenig observed that “[c]ompared to 2008, the largest financial firms today are in most instances larger, more complicated, and more interconnected.”³⁶⁷ He also pointed out that Dodd–Frank has not

363. *Id.*; Hopkins & Brush, *supra* note 361.

364. Rob Blackwell, *Why Citi May Soon Regret Its Big Victory on Capitol Hill*, AM. BANKER, Dec. 15, 2014 (quoting my remarks).

365. Johnson, *supra* note 343 (stating that “the repeal of Section 716” shows the determination of Republican leaders “to strip away all meaningful restrictions imposed on Citigroup, JP Morgan Chase, and other megabanks—and to roll-back Dodd–Frank as far as possible, until it becomes meaningless or they are finally able to repeal it completely”).

366. *See supra* Part I; *see also* JOHNSON & KWAK, *supra* note 90, at 180, 191 (pointing out that the federal government’s response to the financial crisis produced “much larger market shares for the fewer but bigger megabanks,” thereby contributing to “the enormous growth of top-tier financial institutions and the corresponding increase in their economic and political power”).

367. Thomas M. Hoenig, Vice Chairman, FDIC, Address at the Boston Economic Club: Can We End Financial Bailouts?, (May 7, 2014) [hereinafter Hoenig May 7, 2014 Address]; *see also supra* note 30 and accompanying text

forced megabanks to change their high-risk business strategies. Megabanks continue to exploit “the safety net subsidy to support their expansion across the globe,” and they also continue to (1) combine “commercial, investment banking, and broker-dealer activities,” and (2) rely on “wholesale funding markets” that “are major sources of volatility in times of financial stress.”³⁶⁸ Notwithstanding efforts by banking agencies to strengthen capital requirements, the largest U.S. banks still “remain excessively leveraged with ratios, on average, of nearly 22 to 1,” while the “remainder of the industry averages below 12 to 1.”³⁶⁹

Thus, as I have previously argued, it is very unlikely that Dodd–Frank will compel “large financial conglomerates to change their business model or to reduce their appetite for risk-taking.”³⁷⁰ I have also contended that “the universal banking model is deeply flawed by its excessive organizational complexity, its vulnerability to culture clashes and conflicts of interest, and its tendency to permit excessive risk-taking within far-flung, semi-autonomous units that lack adequate oversight from either senior management or regulatory

(stating that the four largest U.S. banks increased their share of total U.S. banking assets from 32% in 2005 to 47.7% in 2013).

368. Hoenig May 7, 2014 Address, *supra* note 367.

369. *Id.*; see also *id.* at n.6 (citing FDIC, GLOBAL CAPITAL INDEX: CAPITALIZATION RATIOS FOR GLOBAL SYSTEMATICALLY IMPORTANT BANKS (2013), available at <https://www.fdic.gov/about/learn/board/hoenig/capitalizationratios4q13.pdf>) (providing a weblink to a “Global Capital Index,” showing that the average leverage capital ratio was 4.62% during the fourth quarter of 2013 for the eight major U.S. banks designated as “Global Systemically Important Banks” by the FSB); *Quarterly Banking Profile: Fourth Quarter 2013*, 8 FDIC Q., no. 1, 2014, at 2, 5 tbl.I-A (showing that the average leverage capital ratio for all FDIC-insured institutions was 9.41% during the fourth quarter of 2013). For a comprehensive analysis demonstrating that regulators should require banks (especially the largest banks) to hold significantly higher levels of equity capital and to operate with much less leverage, see generally ANAT ADMATI & MARTIN HELMWIG, THE BANKERS’ NEW CLOTHES: WHAT’S WRONG WITH BANKING AND WHAT TO DO ABOUT IT (2013).

370. Wilmarth, *Blind Eye*, *supra* note 63, at 1437; see also Martin Wolf, *Financial Reform: Call to Arms*, FIN. TIMES (Sept. 3, 2014, 8:41 PM), <http://www.ft.com/intl/cms/s/0/152ccd58-3294-11e4-93c6-00144feabdc0.html#axzz3SP7gA3aA> (stating that “cynics” might reasonably conclude that the “manic rulemaking [in the United States and elsewhere] is designed to disguise the fact that the thrust of it all has been to preserve the system that existed before the crisis: . . . it will continue to rely on the interaction of vast financial institutions with freewheeling financial markets; it will continue to be highly leveraged; and it will continue to rely for profitability on successfully managing huge maturity and risk mismatches,” and also contending that the “financial system remains fragile” and vulnerable to the risk of “further crises”).

agencies.”³⁷¹ The pervasive managerial and regulatory failures that contributed to Citigroup’s near-collapse in 2007 and 2008 indicate that today’s megabanks are “not only [TBTF], but also too big and too complex to manage or regulate effectively.”³⁷² The “London Whale” debacle at JPMorgan Chase—which resulted in more than \$6 billion of losses from speculative trading in derivatives—revealed similar failures in risk management and oversight by Chase’s senior executives, the New York Fed, and the OCC.³⁷³

Failures by the New York Fed and the OCC to stop disastrous risk-taking by Citigroup and Chase are unfortunately consistent with a much longer series of supervisory lapses with respect to large financial institutions. During the 1970s and 1980s, regulators did not prevent major banks from pursuing hazardous (and in many cases fatal) strategies, including rapid growth with heavy concentrations in high-risk assets and excessive reliance on volatile, short-term liabilities.³⁷⁴ Regulators were unwilling or unable to stop risky behavior during that period as long as banks continued to report profits.³⁷⁵

Similarly, federal banking and securities regulators failed to restrain excessive risk-taking by large banks and securities firms

371. Wilmarth, *Citigroup*, *supra* note 14, at 136.

372. *Id.* at 72, 90-132 (describing the managerial and regulatory failures that contributed to Citigroup’s near-collapse and bailouts).

373. Wilmarth, *Blind Eye*, *supra* note 63, at 1430-37 (internal quotation marks omitted) (describing failures by Chase’s executives and by the OCC that contributed to the “London Whale” trading losses); Tom Braithwaite & Gina Chon, *Fed Did Not Act on JPMorgan “Whale” Fears*, *FIN. TIMES*, (Oct. 21, 2014, 5:11 PM), <http://www.ft.com/intl/cms/s/0/7177f1e4-592e-11e4-9546-00144feab7de.html#axzz3SP7gA3aA> (discussing a report by the Fed’s Office of Inspector General, which cited failures by the New York Fed to share information with the OCC or to conduct further examinations after becoming aware of Chase’s risky derivatives trades); Craig Torres, *Fed Watchdog Criticizes Scrutiny of JPMorgan London Whale*, *BLOOMBERG BUS.* (Oct. 21, 2014, 9:14 AM), <http://www.bloomberg.com/news/articles/2014-10-21/fed-watchdog-criticizes-scrutiny-of-jpmorgan-london-whale> (same); *see also* OFFICE OF INSPECTOR GEN., DEP’T OF THE TREASURY, *OIG-14-035, AUDIT REPORT: OCC NEEDS TO STRENGTHEN SUPERVISION OF TRADING ACTIVITIES IN LIGHT OF THE JPMORGAN CHASE LOSSES 1 (2014)* (“OCC had many opportunities to address weaknesses in [Chase’s] risk management of trading activities, but did not act strongly or timely enough to address those weaknesses. In some cases, OCC failed to act at all.”).

374. FCIC TBTF STAFF REPORT, *supra* note 279, at 5-10; Wilmarth, *Transformation*, *supra* note 13, at 313-16.

375. George Hanc et al., *An Examination of the Banking Crises of the 1980s and Early 1990s*, in 1 *FDIC, HISTORY OF THE EIGHTIES: LESSONS FOR THE FUTURE* 39-46, 245-47, 373-78 (1997).

during the two decades that preceded the financial crisis of 2007–2009.³⁷⁶ Scholars have uncovered strong evidence of “regulatory capture” by large financial institutions during that period, resulting from factors such as (1) large-scale political contributions and lobbying expenditures by the financial industry; (2) an intellectual and policy environment that strongly favored deregulation and a “light touch” approach to supervision; and (3) a “revolving door” that facilitated a continuous interchange of senior personnel between the top echelons of Wall Street and the financial regulatory agencies.³⁷⁷ Leading financial institutions also engaged in global regulatory arbitrage by threatening to move significant parts of their operations from the United States to London or other foreign financial centers if U.S. regulators did not make regulatory concessions.³⁷⁸

As reflected in the highly ambiguous terms of the Volcker Rule,³⁷⁹ Dodd–Frank does not prescribe, except in very general terms, the standards that federal regulators must incorporate into their implementing rules. The creation of a robust regulatory regime therefore depends upon the agencies’ ability and willingness to establish and enforce rigorous standards.³⁸⁰ Unfortunately, as Simon Johnson and James Kwak have pointed out, “solutions that depend on smarter, better regulatory supervision and corrective action ignore the political constraints on regulation and the political power of the

376. See, e.g., JAMES R. BARTH, GERARD CAPRIO JR. & ROSS LEVINE, *GUARDIANS OF FINANCE: MAKING REGULATORS WORK FOR US* 4-7, 85-115 (2012); KATHLEEN C. ENGEL & PATRICIA A. MCCOY, *THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE, AND NEXT STEPS* 157-223 (2011); JOHNSON & KWAK, *supra* note 90, at 6-10, 120-50; Wilmarth, *Blind Eye*, *supra* note 63, at 1328-45; see also John C. Coffee, Jr., *Bail-Ins Versus Bail-Outs: Using Contingent Capital to Mitigate Systemic Risk* 24 (Columbia Law Sch. Ctr. for Law & Econ. Studies, Working Paper No. 380, 2010), available at <http://ssrn.com/abstract=1675015> (stating that “[a]greement is virtually universal that lax regulation by all the financial regulators played a significant role in the 2008 financial crisis”).

377. JOHNSON & KWAK, *supra* note 90, at 82-109, 118-21, 133-50; Wilmarth, *Blind Eye*, *supra* note 63, at 1328-45, 1359-69, 1390-428; Deniz Igan, Prachi Mishra & Thierry Tresselt, *A Fistful of Dollars: Lobbying and the Financial Crisis* 4-5 (Int’l Monetary Fund, Working Paper No. 09/287, 2009), available at <http://ssrn.com/abstract=1531520>.

378. Coffee, *supra* note 376, at 18-21, 25-26; Jeffrey N. Gordon & Christopher Muller, *Confronting Financial Crisis: Dodd–Frank’s Dangers and the Case for a Systemic Emergency Insurance Fund*, 28 *YALE J. ON REG.* 151, 178-79 (2011); Wilmarth, *Blind Eye*, *supra* note 63, at 1393-97.

379. See *supra* Subsection IV.B.1.

380. SKEEL, *supra* note 243, at 80-92; Wilmarth, *Dodd–Frank*, *supra* note 15, at 1012.

large banks.”³⁸¹ As a result of Wall Street’s aggressive lobbying and litigation efforts, federal regulators completed only about half of Dodd–Frank’s required regulations by the statute’s fourth anniversary in July 2014, and regulators did not even issue proposals for half of the unfinished rules.³⁸²

The battles over the Volcker Rule and the Lincoln Amendment provide vivid examples of the financial industry’s ability to block or delay reforms and extract concessions from regulators.³⁸³ For additional evidence of the financial industry’s clout, consider first the successful campaign by mutual fund companies to defeat efforts by former SEC Chairman Mary Schapiro and FSOC to require retail money market mutual funds (MMMFs) to operate with floating net asset values (NAVs) instead of a misleading “fixed” NAV of \$1 per share.³⁸⁴ Then consider the ability of banks to persuade regulators to accept no-down-payment mortgages as “qualified residential mortgages” (QRMs) that are exempt from Dodd–Frank’s risk retention requirement for mortgages securitized by banks.³⁸⁵ Wall

381. JOHNSON & KWAK, *supra* note 90, at 207.

382. Ben Weyl, *Dodd–Frank Birthday Means Rhetoric, Not New Laws*, CQ NEWS, July 18, 2014, available at 2014 WLNR 20146118 (reporting that agencies completed only 52% of the 398 required regulations by July 2014, and agencies failed to issue even proposed rules for 24% of the mandated regulations); see also Wilmarth, *Blind Eye*, *supra* note 63, at 1296-322 (describing the financial industry’s campaign to obstruct the implementation of Dodd–Frank).

383. See *supra* Subsections IV.B.1-2.

384. Christopher Rowland, *Fidelity Fought Washington over Money Market Funds—and Won*, BOSTON GLOBE (Oct. 19, 2014), <http://www.bostonglobe.com/news/politics/2014/10/18/with-aggressive-strategy-fidelity-fought-washington-over-money-market-funds-and-won/3ZbsOGsb9rfMuPpx2wx58H/story.html> (describing how Fidelity and other large mutual fund companies defeated efforts by Chairman Schapiro and FSOC to require retail MMMFs to operate with floating NAVs “representing the actual value of a fund’s investments,” so that “taxpayers would not be asked again to bail out investors in money funds” as occurred in 2008).

385. Peter Eavis, *U.S. Regulators Approve Eased Mortgage Lending Rules*, N.Y. TIMES, Oct. 22, 2014, at B3 (reporting that “after a firestorm of criticism from bankers and consumer advocates,” federal regulators issued rules providing that QRMs would not need any down payments in order to be exempt from the requirement that banks securitizing mortgages must retain 5% of the risks); Stephen Hall, *Weakening Reforms in the Securitization Market to Protect Mortgage Financing from an Uncertain Threat Is a Bad Trade*, BETTER MARKETS BLOG (Oct. 23, 2014, 10:19 AM), https://www.bettermarkets.com/blogs/weakening-reforms-securitization-market-protect-mortgage-financing-uncertain-threat-bad-trade#.VEmp_nF-WU (stating that the QRM rules “will not require the lender/packager [of no-down-payment mortgages] to retain meaningful risk,” with the result that securitizing banks “will have no skin in the game just as before the [financial] crisis, effectively defeating a core purpose of the rule”).

Street's continued success in undermining Dodd–Frank's reforms "raises profound questions about the concentrated economic and political power wielded by a small group of megabanks."³⁸⁶

Any hope that today's megabanks can be effectively managed or regulated is further undermined by the continuing series of major scandals that have implicated most of the top global banks.³⁸⁷ For example, leading global banks have paid very large penalties for (1) fraudulent sales of hundreds of billions of dollars of subprime mortgages and MBS;³⁸⁸ (2) fraudulent sales of CDOs and other securities law violations;³⁸⁹ (3) far-reaching violations of anti-money laundering laws involving transfers of funds to drug gangs and rogue "nations linked with terrorists (including Iran, Burma, Cuba, North Korea and Sudan)"³⁹⁰; (4) aiding and abetting widespread tax evasion by U.S. citizens;³⁹¹ and (5) systematic collusion in manipulating Libor and other international interest and currency rates.³⁹²

386. Wilmarth, *Blind Eye*, *supra* note 63, at 1444.

387. See Neha Dimri & Avik Das, *FACTBOX – Bank Settlements Top \$50 Bln This Year as US Cracks Down*, REUTERS NEWS (Aug. 6, 2014), available at <http://uk.reuters.com/article/2014/07/16/banks-settlement-idUKL4N0PP48Z20140716> (listing penalties for serious misconduct that officials have imposed on fifteen leading global banks since 2008).

388. See *id.* (listing more than \$50 billion in penalties and costs imposed by government authorities on BofA, Citigroup, Chase, Morgan Stanley, Deutsche Bank, Barclays Bank, and Wells Fargo for fraudulent sales of subprime mortgages and MBS); see *supra* note 104 (describing the mortgage fraud committed by BofA and Citigroup).

389. Wilmarth, *Blind Eye*, *supra* note 63, at 1344-45, 1380-82 (describing SEC orders requiring BofA, Chase, Citigroup, and Goldman Sachs to pay more than \$1.2 billion to resolve alleged securities law violations, but noting criticisms of the SEC's actions as being too lenient).

390. *Id.* at 1324-25, 1374-75 (describing the money laundering violations committed by HSBC and Standard Chartered); Dimri & Das, *supra* note 387 (listing over \$11 billion of penalties assessed by government authorities against BNP Paribas, HSBC, and Standard Chartered for money laundering).

391. Dimri & Das, *supra* note 387 (listing nearly \$3.3 billion of penalties imposed on Credit Suisse and UBS for promoting tax evasion by U.S. citizens); Wilmarth, *Blind Eye*, *supra* note 63, at 1376-77 n.445 (describing the tax evasion violations committed by UBS).

392. See Wilmarth, *Blind Eye*, *supra* note 63, at 1323-25, 1375-77 (describing nearly \$2 billion in penalties assessed by U.S. and international officials against Barclays and UBS for manipulating Libor); Jenny Anderson, *Banking Fines*, N.Y. TIMES, Oct. 22, 2014, at B7 (reporting on over \$100 million in fines imposed by EU officials on Chase, RBS, UBS, and Credit Suisse for "cartel behavior" in rigging Swiss franc benchmark interest rates); Minouche Shafik, Deputy Governor, Bank of Eng., Making Markets Fair and Effective (Oct. 27, 2014) [hereinafter Shafik Oct. 27, 2014 Speech], available at <http://www.bankofengland.co.uk/>

In a closed-door meeting with Wall Street executives in October 2014, New York Fed President William Dudley cited the “long list of . . . fines and penalties” imposed on large financial institutions for “serious professional misbehavior, ethical lapses and compliance failures.”³⁹³ He noted that “[t]he pattern of bad behavior did not end with the financial crisis, but continued despite the considerable public sector intervention that was necessary to stabilize the financial system.”³⁹⁴ He declared that the financial industry had a serious “culture problem” and had “largely lost the public trust.”³⁹⁵

In Mr. Dudley’s view, the pervasive “cultural failures” of megabanks raised the “important question [of] whether the sheer size, complexity and global scope of large financial firms today have left them ‘too big to manage.’”³⁹⁶ He also highlighted “the shift in the prevailing business model” of megabanks toward “trading” and “transaction-oriented activities,” in which “[c]lients became counterparties—the other side of a trade—rather than partners in a

publications/Documents/speeches/2014/speech771.pdf (citing “a series of appalling cases of misconduct in Fixed Income, Currency, Commodity and other markets”).

393. William C. Dudley, President & CEO, Fed. Reserve Bank of N.Y., *Enhancing Financial Stability by Improving Culture in the Financial Services Industry* (Oct. 20, 2014) [hereinafter Dudley Oct. 20, 2014 Speech], available at <http://www.newyorkfed.org/newsevents/speeches/2014/dud141020a.html>; see also Matthew Boesler, *Dudley Warns Banks Must Improve Culture or Be Broken Up*, BLOOMBERG BUS. (Oct. 20, 2014, 4:30 PM), <http://www.bloomberg.com/news/articles/2014-10-20/dudley-warns-banks-must-improve-culture-or-be-broken-up> (reporting that Mr. Dudley presented his remarks “at a closed-doors workshop attended by senior bankers at the New York Fed on reforming Wall Street culture and behavior”).

394. Dudley Oct. 20, 2014 Speech, *supra* note 393. Fed Governor Daniel Tarullo, who also spoke at the same closed-door meeting, stated that “headlines describing misconduct in financial firms have appeared with disturbing regularity” with respect to post-crisis as well as pre-crisis behavior. Daniel K. Tarullo, Member, Bd. of Governors of the Fed. Reserve Sys., *Good Compliance, Not Mere Compliance* (Oct. 20, 2014) [hereinafter Tarullo Oct. 20, 2014 Speech], available at <http://www.federalreserve.gov/newsevents/speech/tarullo20141020a.pdf>. Mr. Tarullo warned that “if banks do not take more effective steps to control the behavior of those who work for them, there will be both increased pressure and propensity on the part of regulators and law enforcers to impose more requirements, constraints, and punishments.” *Id.*

395. Dudley Oct. 20, 2014 Speech, *supra* note 393. Similarly, Bank of England Deputy Governor Minouche Shafik referred in a recent speech to “a series of appalling cases of misconduct” by large financial institutions that “proved [to be] surprisingly prevalent and persistent” and “further eroded the trust of the general public in financial markets.” Shafik Oct. 27, 2014 Speech, *supra* note 392.

396. Dudley Oct. 20, 2014 Speech, *supra* note 393.

long-term business relationship.³⁹⁷ He warned that if “bad behavior” by large financial institutions continued, “the inevitable conclusion will be reached that your firms are too big and complex to manage effectively,” and “financial stability concerns would dictate that your firms need to be dramatically downsized and simplified.”³⁹⁸ One news report indicated that senior bankers were “unnerved” by Mr. Dudley’s suggestion that large banks might be broken up if their behavior did not improve.³⁹⁹

It is unfortunate that Mr. Dudley chose to deliver his sharp warning to Wall Street’s leaders in a private meeting that was closed to the media.⁴⁰⁰ As one commentator noted, a public meeting would have provided an opportunity for “probably the most important public policy discussion since the financial crisis.”⁴⁰¹ The closed-door setting of Mr. Dudley’s speech was not well chosen if his goal was to promote greater public confidence either in Wall Street or in a regulatory agency that is widely viewed as having a “cozy relationship” with Wall Street.⁴⁰²

However, Mr. Dudley’s speech did appear to recognize that the status quo on Wall Street is neither healthy nor sustainable. Unless much stronger measures are taken to prevent megabanks from exploiting safety-net subsidies and pursuing speculative risks in the capital markets, they will have abundant opportunities and incentives to do so. In addition, unless community banks are given substantial relief from Dodd–Frank’s compliance burdens, their position in our

397. *Id.*

398. *Id.*

399. Peter Eavis, *Regulator Tells Banks to Clean Up Bad Behavior or Face Downsizing*, N.Y. TIMES (Oct. 20, 2014, 8:03 PM), available at <http://dealbook.nytimes.com/2014/10/20/regulator-tells-banks-to-clean-up-bad-behavior-or-face-downsizing/>.

400. David Weidner, *Opinion: Why You Weren’t Invited to the Fed’s “Ethics” Talk with Wall Street*, MARKETWATCH (Oct. 21, 2014, 6:00 AM), available at <http://www.marketwatch.com/story/why-you-werent-invited-to-the-feds-ethics-talk-with-wall-street-2014-10-21>. In contrast, a week after Mr. Dudley’s speech, Bank of England Deputy Governor Minouche Shafik chose to present a similarly hard-edged critique of scandals involving large U.K. banks in a public address that was covered by the media. Shafik Oct. 27, 2014 Speech, *supra* note 392; Sam Fleming & Chris Giles, *City Facing More than “A Few Bad Apples,”* FIN. TIMES (Oct. 27, 2014, 3:52 PM) (describing Deputy Governor Shafik’s “blistering speech” presented to “an audience at the London School of Economics”).

401. Weidner, *supra* note 400.

402. *Id.*; see also Wilmarth, *Blind Eye*, *supra* note 63, at 1401-03, 1418-19 (describing strong concerns about Wall Street’s ability to exercise undue influence over the New York Fed); Wilmarth, *Citigroup*, *supra* note 14, at 124-30 (same).

financial system will continue to decline, and the quality of financial services offered to consumers and small businesses will further erode. Part V of this Article proposes a new regulatory regime that could successfully address these important concerns.

V. A TWO-TIERED SYSTEM OF REGULATION IS NEEDED TO
MAINTAIN A HEALTHY COMMUNITY BANKING SECTOR AND
ELIMINATE THE TBTF SUBSIDY FOR MEGABANKS

A. Congress and Federal Regulators Should Reduce Compliance
Burdens for Community Banks and Should Encourage the
Formation of De Novo Community Banks

As shown above, Dodd–Frank imposes a number of costly new compliance burdens on community banks. The CFPB’s new mortgage lending rules and the federal banking agencies’ new capital regulation create difficult challenges that impair the ability of community banks to provide customized home mortgage loans to entrepreneurs and farmers.⁴⁰³ Unless those compliance burdens are significantly reduced, many community banks are likely to abandon the residential mortgage business.⁴⁰⁴

Accordingly, the CFPB should expand the small creditor exception in its QM regulation as well as the small servicer exception in its mortgage servicing regulation so that both exceptions apply to all banks with assets under \$10 billion. Expanding those exceptions would not threaten the interests of customers who obtain mortgages from community banks. Both exceptions require qualifying smaller banks to satisfy a series of safeguards to ensure that mortgage borrowers will be treated fairly by smaller mortgage originators and servicers.⁴⁰⁵

The federal banking agencies should also revise their new capital regulation to provide less punitive treatment for MSAs retained by banks with assets under \$10 billion.⁴⁰⁶ Community banks have established a record of sound home mortgage lending that is far superior to the performance of big banks.⁴⁰⁷ There is no good reason to require community banks to deal with the same regulatory burdens that Congress imposed on megabanks after determining that those

403. See discussion *supra* Section II.B.

404. See *supra* notes 141-142 and accompanying text.

405. See *supra* notes 128-130, 134-135 and accompanying text.

406. See *supra* notes 137-140 and accompanying text.

407. See *supra* notes 92-97 and accompanying text.

banks were primarily responsible for the reckless lending and securitization practices that created the subprime lending bubble.⁴⁰⁸

While Dodd–Frank does not go nearly far enough, it does reflect a growing recognition by policymakers that compliance burdens should be reduced across the board for community banks.⁴⁰⁹ In recent congressional testimony, Fed Governor Daniel Tarullo supported a number of steps to reduce examination, reporting, and other regulatory costs for community banks. He also recommended that Congress exclude community banks “from the scope of the Volcker rule and from the incentive compensation requirements of section 956 of the Dodd–Frank Act” because those provisions are directed at concerns that primarily relate to the largest financial institutions.⁴¹⁰

Congress and federal regulators should promptly undertake a comprehensive review of federal banking statutes and regulations for the purpose of identifying compliance requirements that can be eliminated, simplified, or made more flexible for community banks. Of course, regulatory relief for community banks should be granted in a way that does not endanger the safety and soundness of our banking system or create substantial concerns about consumer protection. In addition, Congress should index to inflation the \$10 billion statutory ceiling for community bank status. An inflation-adjusted maximum will help to ensure that the statutory ceiling continues to provide a reliable standard for identifying community banks that qualify for a simplified and more flexible compliance regime.

Another pressing need is for the FDIC to liberalize its current policy governing approvals of applications by de novo community banks for deposit insurance. The FDIC has approved deposit insurance for only one de novo community bank since the end of 2010.⁴¹¹ In contrast, the FDIC approved an average of 159 de novo

408. See S. REP. NO. 111-176, at 4-6, 11-17 (2010).

409. See *supra* notes 108-114 and accompanying text.

410. *Wall Street Reform: Assessing and Enhancing the Financial Regulatory System: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs*, 113th Cong. 16 (2014) (statement of Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System).

411. Jeff Bater, *Community Banks: Bank Groups Ask Regulator to Review Procedures on De Novo Bank Applications*, 101 BNA'S BANKING REP. 929, 929 (2013); Ryan Tracy, *Tally of U.S. Banks Sinks to Record Low*, WALL ST. J. (Dec. 3, 2013, 7:33 AM), <http://www.wsj.com/articles/SB10001424052702304579404579232343313671258> (reporting that Bank of Bird-in-Hand in Lancaster County, Pennsylvania, received FDIC approval for deposit insurance and thereby became

bank applications each year between 1984 and 2008.⁴¹² The FDIC's current policy for approving deposit insurance for newly chartered banks frequently compels de novo banks to raise \$20 million or more in capital investments in order to open for business. That amount of capital is extremely difficult to raise in rural areas or small towns.⁴¹³

The FDIC should liberalize its application procedures to provide a more reasonable opportunity for de novo community banks to be established, particularly in rural areas and small towns where very few other banks are located.⁴¹⁴ The FDIC should reduce the required amount of initial capital for de novo banks to a level that is appropriate for the risks inherent in each bank's business plan. To provide appropriate protection for the deposit insurance fund, the FDIC could require more frequent examinations of de novo banks during their early years of operation and could also impose tighter restrictions on their ability to rely on brokered deposits.⁴¹⁵ In view of the vital role played by community banks in providing credit and customized services to small business and consumers, as well as their crucial support for the civic life of local communities, the FDIC should encourage the formation of new community banks on sound and reasonable terms.

B. A Two-Tiered Regulatory System Would Encourage the Relationship-Based Business Model of Community Banks and Reduce the Speculative Risks Created by Megabanks

In order to preserve the viability of community banks and reduce the risks of megabanks, we must establish a two-tiered regulatory system. The first tier should encourage and support the deposit-taking and lending activities of community banks and other

"the first new bank startup in the U.S. since December 2010"); *see also* Andy Peters, *Blast from the Past: De Novo Drought May End in Amish Country*, AM. BANKER, Jan. 22, 2013, at 1 (reporting on Bank of Bird-in-Hand's application and stating that a Connecticut bank that "opened in December 2010, was the nation's last de novo").

412. Letter from David Baris, Exec. Dir., Am. Ass'n of Bank Dirs. & Camden R. Fine, President & CEO, Indep. Cmty. Bankers of Am. to Martin Gruenberg, Chairman, FDIC 1 n.1 (Dec. 2, 2013) [hereinafter ICBA De Novo Bank Letter], available at <http://icba.files.cms-plus.com/ICBASites/PDFs/Gruenberg%20letter%20on%20de%20novo%20banks%2012%2002%2013%20-%20FINAL.pdf>.

413. *See id.* at 2; Tracy, *supra* note 411 (noting that the Bank of Bird-in-Hand raised \$17 million of capital in order to secure the FDIC's approval).

414. *See supra* note 1 and accompanying text (explaining that community banks operate the only banking facilities in many rural counties and small towns).

415. ICBA De Novo Bank Letter, *supra* note 412, at 2-3.

banking organizations that adopt a relationship-based business model. The second tier should squarely address the TBTF problem that Dodd–Frank has failed to solve. To remove the TBTF subsidy exploited by universal banks, we must change their structure so that (1) they cannot transfer their federal safety-net subsidies to their nonbank affiliates engaged in risky capital markets activities, and (2) it would be much easier for regulators to separate banks from their nonbank affiliates when any segments of their holding companies are threatened with failure. We must also require SIFIs to internalize the systemic risks they create by paying risk-based premiums to prefund the Orderly Liquidation Fund.

My proposal for a two-tiered system of financial regulation builds on similar recommendations that I have presented previously.⁴¹⁶ As explained below, the first tier of relationship-based banking organizations would be permitted to offer a relatively broad range of banking-related services. However, those organizations and their affiliates would not be allowed to engage as principal in capital markets activities, including securities underwriting and dealing, insurance underwriting, and derivatives dealing.

In contrast, the second tier of “narrow banks” could affiliate with “nontraditional” financial conglomerates engaged in capital markets operations (except for commodities trading, merchant banking, and private equity investments). Narrow banks would be prohibited from making any extensions of credit or other transfers of funds to their nonbank affiliates, except for lawful dividends paid to their parent holding companies. The narrow bank concept provides the most politically feasible approach for ensuring that megabanks cannot transfer their safety-net subsidies to affiliated companies engaged in speculative transactions in the capital markets.⁴¹⁷ To further reduce the systemic risk of large financial conglomerates, those institutions should be required to (1) pay risk-based premiums to prefund the Orderly Liquidation Fund in order to reduce the likelihood of taxpayer-funded rescues of SIFIs, and (2) structure their compensation plans for executives and other key employees so

416. For a previous description of my two-tiered proposal, which serves as a basis for this Part V, see Wilmarth, *Dodd–Frank*, *supra* note 15, at 1034-52.

417. For discussions of similar “narrow bank” proposals, see ROBERT E. LITAN, *WHAT SHOULD BANKS DO?* 164-89 (1987); Ronnie J. Phillips & Alessandro Roselli, *How to Avoid the Next Taxpayer Bailout of the Financial System: The Narrow Banking Proposal* (Aug. 2009) (unpublished manuscript), *available at* http://ssrn.com/abstract_id=1459065.

that at least half of their compensation is paid in the form of long-term contingent convertible bonds.

1. *The First Tier of Banking Organizations Would Engage in Relationship-Based Intermediation*

Under my proposal, the first tier of regulated banking firms would be relationship-based banking organizations that limit their activities (including the activities of their holding company affiliates) to lines of business that are “closely related to banking” under § 4(c)(8) of the Bank Holding Company Act (BHC Act).⁴¹⁸ To provide a reasonable degree of flexibility to first-tier banking organizations, Congress should amend § 4(c)(8) to allow the Fed to expand the list of “closely related” activities that are currently permissible for holding company affiliates of traditional banks.⁴¹⁹

The first tier of relationship banks could take deposits, make loans, offer fiduciary services, and act as agents in selling securities, mutual funds, and insurance products that are underwritten by non-affiliated firms. Additionally, relationship banks could underwrite and deal in “bank-eligible” securities that national banks are permitted to underwrite and deal in directly.⁴²⁰ First-tier banking organizations could also purchase, as end-users, derivatives transactions that (1) hedge against their own firm-specific risks, and (2) qualify for hedging treatment under Financial Accounting Standard (FAS) Statement No. 133.⁴²¹ However, first-tier banks would not be allowed to engage, either directly or through affiliates,

418. See 12 U.S.C. § 1843(c)(8) (2012); CARNELL, MACEY & MILLER, *supra* note 138, at 416-18 (describing activities that are “closely related to banking” and are permissible for nonbank subsidiaries of BHCs under § 4(c)(8)).

419. The Gramm–Leach–Bliley Act (GLBA) prohibits the Fed from approving any “closely related” activities for bank holding companies under § 4(c)(8) of the BHC Act in addition to those that were permitted on November 11, 1999. CARNELL, MACEY & MILLER, *supra* note 138, at 417-18. Congress should amend § 4(c)(8) to authorize the Fed to approve a limited range of new activities that are “closely related” to the traditional banking functions of accepting deposits, extending credit, discounting negotiable instruments, and providing fiduciary services. Wilmarth, *Dodd–Frank*, *supra* note 15, at 1036-37 n.375.

420. See Wilmarth, *Transformation*, *supra* note 13, at 225-26 n.30 (internal quotation marks omitted) (discussing “bank-eligible” securities that national banks are authorized to underwrite or purchase or sell for their own account); CARNELL, MACEY & MILLER, *supra* note 138, at 132-34 (same).

421. Wilmarth, *Dodd–Frank*, *supra* note 15, at 1036 (explaining the importance of limiting derivatives for first-tier “traditional” banking organizations to those that qualify for hedging treatment under FAS 133).

in underwriting or dealing in “bank-ineligible” securities,⁴²² insurance underwriting, derivatives dealing, commodities trading, merchant banking, or private equity investing.

First-tier banking firms would include community banks as well as midsized regional banks that choose to follow a relationship-based business model. In the past, those types of banks have not engaged to any substantial extent in capital markets activities, and it therefore should not be difficult for first-tier banks to comply with the prohibition against any affiliation with capital markets businesses. My proposal would encourage first-tier banks to maintain and strengthen their current focus on attracting core deposits; providing customized, relationship-based loans to consumers and small businesses; and offering wealth management and other fiduciary services to local customers.⁴²³ First-tier banks and their holding companies would continue to operate under their current supervisory arrangements, and their deposits (up to the current statutory maximum of \$250,000 per qualifying account) would be covered by deposit insurance.

2. *The Second Tier of Nontraditional Banking Organizations Would Be Barred from Exploiting Federal Safety-Net Subsidies*

Unlike first-tier banking firms, the second tier of “nontraditional” banking organizations—which would probably include all of today’s megabanks—would be authorized to engage in a broader range of “financial in nature” activities through nonbank affiliates.⁴²⁴ The permissible activities for nonbank affiliates of second-tier banks would include underwriting and dealing in bank-ineligible securities, underwriting all types of insurance, and dealing and trading in derivatives.⁴²⁵ Second-tier banking organizations

422. See Wilmarth, *Transformation*, *supra* note 13, at 219-20, 225-26 n.30, 318-20 (internal quotation marks omitted) (discussing the distinction between (1) “bank-eligible” securities, which banks may underwrite and deal in directly, and (2) “bank-ineligible” securities, which affiliates of banks may underwrite and deal in under GLBA, but banks may not).

423. See *supra* Sections II.B, III.A (discussing the relationship-based business model followed by community banks); see also Wilmarth, *Transformation*, *supra* note 13, at 262-70 (same).

424. See CARNELL, MACEY & MILLER, *supra* note 138, at 420-23 (discussing “financial in nature” activities that are permitted for financial holding companies under GLBA).

425. Wilmarth, *Dodd-Frank*, *supra* note 15, at 1037.

would include (1) financial holding companies (FHCs) registered under §§ 4(k) and 4(l) of the BHC Act;⁴²⁶ (2) holding companies owning grandfathered “nonbank banks”; and (3) grandfathered “unitary thrift” holding companies.⁴²⁷ In addition, firms controlling industrial banks should be required either to register as FHCs or to divest their ownership of such banks if they do not wish to comply with the BHC Act’s prohibition against commercial activities.⁴²⁸ Second-tier holding companies would thus encompass banking organizations that engage in capital markets activities as well as other financial conglomerates that control FDIC-insured depository institutions.

Under my proposal, FDIC-insured banks that are subsidiaries of second-tier holding companies would be required to operate as “narrow banks.” The purpose of the narrow bank structure would be to prevent “nontraditional,” second-tier holding companies from causing their subsidiary banks to transfer their federal safety-net subsidies to nonbank affiliates. Narrow banks could offer FDIC-insured deposit accounts, including checking and savings accounts

426. 12 U.S.C. § 1843(k)-(l) (2012); see CARNELL, MACEY & MILLER, *supra* note 138, at 420-21, 467-70 (describing the requirements for FHC status under the BHC Act, as amended by GLBA).

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

428. Industrial banks are exempted from treatment as “banks” under the BHC Act. See 12 U.S.C. § 1841(c)(2)(H) (2012). “As a result, the BHC Act allows commercial (i.e., nonfinancial) firms” to own industrial banks. Wilmarth, *Dodd-Frank*, *supra* note 15, at 1037 n.379. Section 603 of Dodd-Frank imposed a “three-year moratorium on the authority of federal regulators to approve any new acquisitions of industrial banks by commercial firms.” *Id.* However, that moratorium expired in July 2013. Philip van Doorn, *WalMart May Still Get Its Bank: Street Whispers*, THE STREET (Nov. 19, 2012), <http://www.thestreet.com/story/11770633/1/walmart-may-still-get-its-bank-street-whispers.html> (reporting that Dodd-Frank’s “moratorium on new industrial loan companies ends on July 21, 2013”). I have previously argued that Congress should prohibit commercial firms from owning industrial banks because such ownership (1) undermines the long-established U.S. policy of separating banking and commerce; (2) threatens to spread federal safety-net subsidies to the commercial sector of the U.S. economy; (3) threatens the solvency of the deposit insurance fund; (4) creates competitive inequities between commercial firms that own industrial banks and other commercial firms; and (5) increases the likelihood of federal bailouts of commercial companies. Wilmarth, *Wal-Mart*, *supra* note 427, at 1543-44, 1554-620.

and certificates of deposit. Narrow banks would be required to hold all of their assets in the form of cash and marketable, short-term debt obligations, including qualifying government securities, high-quality commercial paper, and other liquid, short-term debt instruments that are eligible for investment by MMMFs under the SEC's rules.⁴²⁹

Narrow banks could not make any other types of loans or investments, nor could they accept any uninsured deposits. Narrow banks would present a very small risk to the FDIC's Deposit Insurance Fund (DIF) because (1) each narrow bank's non-cash assets would consist solely of marketable, short-term debt securities that could be "marked to market" on a daily basis, and the FDIC could therefore readily determine whether a narrow bank was threatened with insolvency, and "(2) the FDIC could promptly convert a narrow bank's assets into cash if the FDIC decided to liquidate the bank and pay off the claims of its insured depositors."⁴³⁰ Thus, my proposed limitations on narrow bank investments would protect the DIF from any significant loss if a narrow bank failed.

Restricting the permissible investments of second-tier narrow banks should not have a significant impact on bank lending to small businesses. As shown above, megabanks—unlike community banks—generally do not make relationship loans to small firms. Instead, big banks provide credit to small businesses primarily through standardized, "cookie cutter" loan programs, including business credit cards and equipment leases, which (1) rely on impersonal credit-scoring techniques and other automated technologies and (2) enable many of the resulting loans to be securitized.⁴³¹ Similarly, major banks typically provide loans to large businesses through a syndication process that is closely tied to the capital markets and is very similar to an underwriting of debt securities. Indeed, lead banks in loan syndications typically sell most of the resulting loans to institutional investors.⁴³²

429. Wilmarth, *Dodd-Frank*, *supra* note 15, at 1038.

430. *Id.* (internal quotation marks omitted); Kenneth E. Scott, *Deposit Insurance and Bank Regulation: The Policy Choices*, 44 *BUS. LAW.* 907, 921-22, 928-29 (1989).

431. See *supra* notes 155-164 and accompanying text (describing how big banks provide credit to SMEs primarily through impersonal, highly automated loans); see also Wilmarth, *Transformation*, *supra* note 13, at 262-67 (same).

432. Wilmarth, *Dark Side*, *supra* note 13, at 980-84, 1039-42 (describing the loan syndication process employed by big banks and the selling of the resulting loans to institutional investors, including insurance companies, pension funds, mutual funds, and collateralized loan obligations); Wilmarth, *Transformation*, *supra* note 13, at 378-80 (same); see also Lisa Abramowicz, *Dirty Secret of \$1 Trillion*

Under my proposal, second-tier holding companies would be allowed to conduct their current business lending programs through nonbank subsidiaries that are funded by the capital markets through securitization and loan sales. The main difference from current practice—and an important one—is that second-tier holding companies would not be permitted to use low-cost, FDIC-insured deposits to fund their lending activities. Because megabanks use a lending strategy tied to the capital markets, those banks should not be allowed to rely on subsidized deposits (rather than capital markets funding) to conduct their lending activities.⁴³³

Three additional rules are essential to prevent second-tier holding companies from exploiting the federal safety-net subsidies provided to their FDIC-insured narrow banks. First, narrow banks should be absolutely prohibited—without any possibility of a regulatory waiver—from making extensions of credit or other transfers of funds to their affiliates, except for the payment of lawful dividends out of profits to their parent holding companies. Currently, transactions between FDIC-insured banks and their affiliates are restricted by §§ 23A and 23B of the Federal Reserve Act. However, the Fed repeatedly waived those restrictions during recent financial crises. The Fed's waivers allowed bank subsidiaries of FHCs to provide extensive financial support to affiliated securities broker-dealers and MMMFs.⁴³⁴ By granting those waivers, the Fed enabled FHC-owned banks to transfer the safety-net subsidies embedded within their low-cost, FDIC-insured deposits to their nonbank affiliates.⁴³⁵

Loans Is When You Get Your Money Back, BLOOMBERG (Sept. 18, 2014, 11:29 AM), <http://www.bloomberg.com/news/articles/2014-09-17/dirty-secret-of-1-trillion-loans-is-when-do-you-get-money-back> (describing sales by big banks of syndicated leveraged corporate loans to institutional investors).

433. Wilmarth, *Dodd-Frank*, *supra* note 15, at 1049 (noting that Congress, if it wished, could allow narrow banks that are subsidiaries of second-tier holding companies to make a limited amount of relationship loans to bank-dependent firms, up to a specified maximum percentage (e.g., 10%) of their assets, as long as such loans were retained on the banks' balance sheets and were not securitized).

434. *Id.* at 1041; see Scott, *supra* note 430, at 929; see also 12 U.S.C. §§ 371c, 371c-1 (2012).

435. Wilmarth, *Dodd-Frank*, *supra* note 15, at 1041-42. For a comprehensive analysis of the Fed's repeated waivers of § 23A during the most recent financial crisis, 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, 1729-63 (2011).

Dodd–Frank limits, but does not remove, the Fed’s authority to grant future waivers or exemptions under §§ 23A and 23B. Dodd–Frank requires the Fed to obtain the concurrence of either the OCC (with respect to waivers granted by orders for national banks) or the FDIC (with respect to waivers granted by orders for state banks or general exemptions granted by regulation).⁴³⁶ However, it is very unlikely that the OCC or the FDIC would refuse to concur if the Fed sought a future waiver to deal with a perceived threat to one or more megabanks. Accordingly, Dodd–Frank does not guarantee that the Fed will adhere to § 23A’s and § 23B’s restrictions on affiliate transactions in the future.⁴³⁷

“For example, the [Fed] . . . permitted BofA [in 2011] to evade the restrictions of § 23A by transferring an undisclosed amount of derivatives contracts from its Merrill broker-dealer subsidiary to its subsidiary bank.”⁴³⁸ That transaction increased the potential risk that the DIF and taxpayers might ultimately be compelled to cover losses incurred by BofA on the transferred derivatives. The derivatives transfer reportedly allowed BofA—which was then struggling with a host of problems—to avoid contractual requirements to post \$3.3 billion of additional collateral with its derivatives counterparties. BofA’s ability to avoid posting additional collateral was due to the fact that BofA’s subsidiary bank was explicitly protected by the federal safety net and therefore held a significantly higher credit rating than Merrill.⁴³⁹ One commentator noted that “the Fed’s

436. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 608(a)(4), 124 Stat. 1376, 1609-10 (2010) (amending 12 U.S.C. § 371c(f)); *id.* § 608(b)(6) (amending 12 U.S.C. § 371c-1(e)(2)).

437. Wilmarth, *Dodd–Frank*, *supra* note 15, at 1042.

438. *Enhanced Supervision: A New Regime for Regulating Large, Complex Financial Institutions: Hearing Before the Subcomm. on Fin. Inst. & Consumer Prot. of the S. Comm. on Banking, Hous., & Urban Affairs*, 112th Cong. 57 (2011) (statement of Arthur E. Wilmarth, Jr. Professor of Law, George Washington University Law School).

439. For discussions of the Fed’s approval of BofA’s transfer of derivatives, see Kate Davidson, *Democrats Raise Red Flag on B of A Derivatives Transfer*, NAT’L MORTGAGE NEWS (Oct. 28, 2011, 9:42 AM), http://www.nationalmortgagenews.com/dailybriefing/2010_464/red-flag-boa-derivatives-transfer-1027181-1.html; Simon Johnson, *Bank of America Is Too Much of a Behemoth to Fail: Simon Johnson*, BLOOMBERGVIEW (Oct. 23, 2011, 7:05 PM), <http://www.bloomberg.com/news/articles/2011-10-23/bank-of-america-too-much-of-behemoth-to-fail-commentary-by-simon-johnson>; Jonathan Weil, *Bank of America Bosses Find Friend in the Fed: Jonathan Weil*, BLOOMBERGVIEW (Oct. 19, 2011, 8:00 PM), <http://www.bloomberg.com/news/articles/2011-10-20/bank-of-america-bosses-find-friend-in-the-fed-jonathan-weil>.

priorities seem to lie with protecting [BofA] from losses at Merrill, even if that means greater risks for the FDIC's insurance fund."⁴⁴⁰

My proposal for second-tier narrow banks would replace §§ 23A and 23B with an ironclad rule. That rule would absolutely prohibit all extensions of credit or other transfers of funds by second-tier narrow banks to their nonbank affiliates, except for lawful dividends paid to parent holding companies. My proposal would bar federal regulators from approving any transfers of safety-net subsidies from narrow banks to their affiliates. An absolute bar on affiliate transactions is necessary to prevent narrow banks (and the DIF) from being used as sources of bailout funding for nonbank affiliates of second-tier financial conglomerates.

Second, narrow banks should be barred both from acting as dealers in derivatives and from purchasing derivatives as end-users, except in transactions that qualify for position-specific hedging treatment under FAS 133. My proposal would require second-tier financial conglomerates to conduct all of their derivatives dealing and trading activities through separate nonbank subsidiaries. My approach would be consistent with GLBA's requirement that FHCs must conduct all of their underwriting and dealing activities for bank-ineligible securities and insurance products through nonbank subsidiaries.⁴⁴¹ Many derivatives function as "synthetic" substitutes for securities or insurance.⁴⁴² Accordingly, those derivatives should be foreclosed to banks for the same reasons that banks cannot engage directly in underwriting or dealing in bank-ineligible securities or insurance.⁴⁴³ Prohibiting second-tier narrow banks from dealing or trading in derivatives is urgently needed to stop financial conglomerates from using federal safety-net subsidies to support

440. Weil, *supra* note 439.

441. See CARNELL, MACEY & MILLER, *supra* note 138, at 25-26, 130-33, 154-55, 420-23, 429-30 (explaining that under GLBA, all underwriting and dealing by FHCs in bank-ineligible securities and insurance products must be conducted through nonbank holding company subsidiaries or (in the case of securities) through nonbank financial subsidiaries of banks); Wilmarth, *Transformation*, *supra* note 13, at 219-20, 225-26 n.30, 318-20.

442. Wilmarth, *Dodd-Frank*, *supra* note 15, at 1044 & n.405; Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n, Testimony Concerning Regulation of Over-the-Counter Derivatives (Jun. 22, 2009), available at <http://www.sec.gov/news/testimony/2009/ts062209mls.htm>.

443. Wilmarth, *Dodd-Frank*, *supra* note 15, at 1044 & n.405.

speculative trading activities within their FDIC-insured bank subsidiaries.⁴⁴⁴

The OCC has pointed out that FHCs generate higher profits when they conduct derivatives activities within their subsidiary banks, in part because the “favorable [funding] rate enjoyed by the banks” is lower than the “borrowing rate of their holding companies.”⁴⁴⁵ Not surprisingly, the three largest U.S. banking organizations—JPMorgan Chase, BofA, and Citigroup—conduct “the vast majority” of their derivatives transactions within their FDIC-insured subsidiary banks.⁴⁴⁶ Indeed, Chase’s “London Whale” trading debacle occurred within the “Chief Investment Office” established by Chase’s subsidiary bank, which used “excess deposits” to invest in high-risk synthetic credit derivatives.⁴⁴⁷

Allowing FHC-owned subsidiary banks to trade in derivatives may be favorable to FHCs, but it is certainly *not* beneficial for the DIF and taxpayers. The DIF and taxpayers are exposed to a significantly higher risk of losses when derivatives dealing and

444. See *supra* Subsection IV.B.2 (explaining that the financial industry persuaded Congress to repeal the Lincoln Amendment because that provision threatened to force megabanks to transfer significant portions of their risky derivatives activities into nonbank affiliates that would not be protected by the FDIC).

445. Letter from John D. Hawke, Jr., Comptroller of the Currency, to James A. Leach, Chairman, Comm. on Banking & Fin. Servs. 3 (Sept. 13, 2000), available at <http://www.occ.gov/static/interpretations-and-precedents/sep00/int892.pdf>; see also Simon Nixon, *Barclays Capped by Regulatory Risk*, WALL ST. J., July 13, 2010, at C10 (stating that Barclays Capital (Barcap), a large securities firm, “gets cheaper funding than it could access as a stand-alone” because Barclays Bank PLC uses its “retail deposits to provide cheap funding to Barcap”).

446. Jesse Hamilton & Silla Brush, *Regulators Weigh Delay for Separating Banks’ Swaps Units*, BLOOMBERG (Sept. 19, 2014, 12:01 AM), <http://origin-www.bloomberg.com/apps/news?pid=conewsstory&tkr=MS:US&sid=aKZvvWQ6BflQ>; see also Silla Brush, *JPMorgan to BofA Get Delay on Rule Isolating Derivatives*, BLOOMBERG BUS. (Jan. 4, 2013, 4:36 PM), <http://www.bloomberg.com/news/articles/2013-01-03/jpmorgan-and-bofa-get-two-year-delay-in-dodd-frank-swaps-pushout> (reporting that “JPMorgan [Chase] had 99 percent of its \$72 trillion in notional swaps trades in its commercial bank in the third quarter of 2012 . . . [while] Bank of America had 68 percent of its \$64 trillion [of derivatives] in its commercial bank”); Campbell, *supra* note 33 (reporting that “[m]ore than 99 percent of the notional value of Citigroup’s derivatives were at its bank subsidiary” in March 2014); Nixon, *supra* note 445 (stating that “[m]ost of Barcap’s positions, including derivatives exposures, lie on Barclays Bank PLC’s balance sheet,” and noting that Barcap’s reliance on “cheap funding” from Barclays Bank “exposes depositors to investment-banking risk”).

447. Wilmarth, *Blind Eye*, *supra* note 63, at 1430-31 (internal quotation marks omitted).

trading activities are conducted directly within banks. Chase's "London Whale" scandal inflicted losses of \$6.2 billion on Chase's subsidiary bank,⁴⁴⁸ and those losses would have been a matter of great concern to the FDIC and taxpayers if the bank had failed. My proposal would stop megabanks from exploiting safety-net subsidies in their derivatives activities and would force second-tier banking organizations to conduct such activities within nonbank affiliates.⁴⁴⁹

Third, Congress should repeal the "systemic risk exception" (SRE), which is still incorporated in the FDI Act.⁴⁵⁰ By repealing the SRE, Congress would require the FDIC to follow the least costly resolution procedure for every failed bank, and the FDIC could no longer rely on the TBTF policy as a justification for protecting uninsured creditors of a failed megabank or its nonbank affiliates. Repealing the SRE would make clear to the financial markets that the DIF protects *only* bank depositors. "Uninsured creditors of [megabanks] and their nonbank [affiliates] would therefore have stronger incentives to monitor the financial operations and condition of such entities."⁴⁵¹

A repeal of the SRE would also help to protect smaller banks from being forced to share the potential cost of protecting uninsured creditors of megabanks. Under current law, all FDIC-insured banks must pay a special assessment (allocated in proportion to their total assets) to reimburse the FDIC for the cost of invoking the SRE to protect uninsured creditors of a TBTF bank.⁴⁵² A 2000 FDIC report noted the unfairness of expecting smaller banks to help pay for "systemic risk" bailouts when "it is virtually inconceivable that they would receive similar treatment if distressed."⁴⁵³ The FDIC report suggested that the way to correct this inequity is "to remove the [SRE],"⁴⁵⁴ as my proposal would do.

448. *Id.* (internal quotation marks omitted).

449. Wilmarth, *Dodd-Frank*, *supra* note 15, at 1044-45.

450. *See supra* notes 279-282 and accompanying text (discussing the SRE).

451. Wilmarth, *Dodd-Frank*, *supra* note 15, at 1042-43.

452. 12 U.S.C. § 1823(c)(4)(G)(ii) (2012).

453. FDIC, OPTIONS PAPER 33 (2000), *available at* http://www.fdic.gov/deposit/insurance/initiative/Options_080700m.pdf.

454. *Id.*

3. *Two Supplemental Rules Would Prevent Second-Tier Banking Organizations from Engaging in Speculative Activities in the Commercial Sector*

Congress should enact two supplemental rules to prevent second-tier banking companies from extending their speculative operations into the commercial sector. First, Congress should prohibit second-tier banks and their holding company affiliates from engaging in “merchant banking,” which is generally understood to include the business of making private equity investments.⁴⁵⁵ To accomplish this reform, Congress should repeal §§ 4(k)(4)(H) and (I) of the BHC Act,⁴⁵⁶ which currently allow FHCs to acquire and hold long-term, controlling stakes in commercial firms if they comply with regulations governing merchant banking and insurance company portfolio investments.⁴⁵⁷ In addition, Congress should repeal the exemption in the Volcker Rule that allows banking organizations and nonbank SIFIs to make limited investments in private equity funds.⁴⁵⁸

Private equity investments involve a high degree of risk and have inflicted significant losses on FHCs in the past.⁴⁵⁹ In addition, such investments threaten to “weaken the separation [of] banking and commerce” by allowing FHCs “to maintain long-term control over entities that conduct commercial (i.e., nonfinancial) businesses.”⁴⁶⁰ Large-scale combinations between banks and commercial firms are likely to create serious financial risks and economic distortions, including (1) potential threats to the safety and

455. CARNELL, MACEY & MILLER, *supra* note 138, at 425-26.

456. 12 U.S.C. § 1843(k)(4)(H)-(I).

457. See CARNELL, MACEY & MILLER, *supra* note 138, at 425-26 (explaining that GLBA’s grant of merchant banking authority allows FHCs to “own and control nonfinancial firms” with “remarkably little constraint,” while the implementing regulations adopted by the Fed and the Treasury provide “some constraint” but still permit “significant nonfinancial affiliations”).

458. See *supra* note 324 and accompanying text (discussing limited private equity investments permitted by the Volcker Rule).

459. Wilmarth, *Transformation*, *supra* note 13, at 330-32, 375-78 (discussing losses incurred by financial conglomerates on risky equity investments during the late 1990s and early 2000s); see also Donal Griffin, *Pandit Pay Climbs as Citigroup Revenue Slumps*, BLOOMBERG BUS. (Mar. 12, 2012, 12:00 AM), <http://www.bloomberg.com/news/articles/2012-03-12/pandit-compensation-climbs-toward-53-million-as-citigroup-revenue-slumps> (reporting that Citigroup recorded an investment loss of \$200 million after it acquired a large hedge fund, Old Lane Partners, in 2007 and later decided to shut down the fund).

460. Wilmarth, *Wal-Mart*, *supra* note 427, at 1581.

soundness of banks that affiliate with commercial firms; (2) conflicts of interest resulting in biased lending decisions by such banks; (3) unfair competitive advantages for commercial firms that affiliate with banks and thereby secure access to safety-net subsidies; (4) a greater probability of TBTF bailouts that will spread from the financial industry to the commercial sector; and (5) unhealthy concentrations of financial, economic, and political power.⁴⁶¹

Second, Congress should bar second-tier narrow banks and their holding company affiliates from owning or trading in physical commodities (including energy). Under § 4(k) of the BHC Act, the Fed has allowed a dozen FHCs to engage in certain physical commodities businesses after determining that those businesses were “complement[ary]” to permissible “financial activities.”⁴⁶² Some FHCs also bought physical commodities firms purportedly as merchant banking investments under § 4(k)(4)(H) of the BHC Act.⁴⁶³ In addition, JPMorgan Chase and BofA acquired significant commodities-related businesses as a result of their emergency

461. *Id.* at 1588. For further discussion of this argument, see *id.* at 1588-613, 1619-21. In 2009, the federal government arranged a very costly rescue of GMAC, an FDIC-insured industrial bank with \$172 billion of assets that was controlled by General Motors (GM). See CONG. OVERSIGHT PANEL, MARCH OVERSIGHT REPORT: THE UNIQUE TREATMENT OF GMAC UNDER THE TARP 1, 4 (2010), available at <http://cybercemetery.unt.edu/archive/cop/20110402042135/http://cop.senate.gov/documents/cop-031110-report.pdf>. The federal government’s rescue of GMAC and its simultaneous bailout of GM provide a vivid illustration of why banking-commercial conglomerates are likely to become potential candidates for TBTF bailouts. See *id.* at 1-32, 54-56, 115-21 (describing how the federal government provided \$17.2 billion of TARP capital infusions and other financial assistance to prevent the failure of GMAC, and also discussing the subsidy-related issues created by the close connection between the GMAC rescue and the federal government’s bailout of GM); *id.* at 122-28 (providing additional views of J. Mark McWatters and Paul S. Atkins, discussing same matters).

462. *Regulating Financial Holding Companies and Physical Commodities: Hearing Before the Subcomm. on Fin. Insts. & Consumer Prot. of the S. Comm. on Banking, Hous., & Urban Affairs*, 113th Cong. 2 (2014) [hereinafter *Gibson Testimony*] (statement of Michael S. Gibson, Director, Board of Governors of the Federal Reserve System’s Division of Banking Supervision and Regulation). For a comprehensive analysis of the Fed’s approval of certain commodities-related businesses as permissible complementary activities, see Saule T. Omarova, *The Merchants of Wall Street: Banking, Commerce, and Commodities*, 98 MINN. L. REV. 265, 285-89, 299-310 (2013).

463. *Gibson Testimony*, *supra* note 462, at 4 (stating that § 4(k)(4)(H) allows FHCs “to make merchant banking investments” in commodities-related businesses “without prior [Fed] approval”); see also Omarova, *supra* note 462, at 281-85, 336-37 (discussing the apparent ability of FHCs to make merchant banking investments in commodities-related businesses with a substantial amount of flexibility).

takeovers of Bear and Merrill during the financial crisis.⁴⁶⁴ Finally, Goldman and Morgan Stanley established very large physical commodities operations by claiming broad “grandfathered” authority to engage in such activities under § 4(o) of the BHC Act.⁴⁶⁵

The involvement of leading banks in physical commodities operations has triggered allegations of unlawful manipulation of prices for electricity and metals as well as other anticompetitive conduct.⁴⁶⁶ Members of Congress have repeatedly called on the Fed to stop banking organizations from owning or trading in physical commodities, but the largest banks have vigorously resisted attempts

464. *Gibson Testimony*, *supra* note 462, at 5 (stating that “the range of permissible physical commodities activities [of Chase after acquiring Bear Stearns and of BofA after acquiring Merrill Lynch] is limited because they are not grandfathered under section 4(o)”; *see also* Omarova, *supra* note 462, at 324-33 (describing the commodities businesses established by Chase after acquiring Bear and RBS Semptra during the financial crisis, as well as Chase’s reliance on a Fed-approved “grace period” to continue those activities).

465. *Gibson Testimony*, *supra* note 462, at 4-5 (stating that Goldman and Morgan Stanley “claim the right to conduct commodities activities under the grandfather provision found in section 4(o)” of the BHC Act, which permits companies that were not previously bank holding companies and became FHCs after November 12, 1999, to continue engaging in commodities operations that those companies conducted in the United States prior to October 1, 1997); *see also* Omarova, *supra* note 462, at 289-93, 310-24, 333-36 (describing the extensive commodities activities conducted by Goldman and Morgan Stanley in alleged reliance on § 4(o) of the BHC Act).

466. *See, e.g.*, Omarova, *supra* note 462, at 266-67, 321-24, 331-32, 347-49 (discussing commodities-related controversies involving Chase and Goldman); *see also* Lynn Garner, *FERC Approves Settlement with J.P. Morgan for \$410 Million in Penalties, Disgorgement*, 101 BNA’S BANKING REP. 227, 227 (2013) (reporting that Chase agreed to “pay \$410 million in civil penalties and disgorgement of profits to settle a market manipulation investigation [by the Federal Energy Regulatory Commission (FERC)] involving the California and Midwest electricity markets”); Carolyn Whetzel, *FERC Fines Barclays, Four Traders \$488M, Cites Manipulation of Western Energy Market*, 101 BNA’S BANKING REP. 153, 153 (2013) (“Barclays Bank PLC and four of its former traders must pay \$487.9 million for allegedly manipulating wholesale electricity markets in California and other western markets, under a final [FERC] order . . .”); David Kocieniewski, *A Shuffle of Aluminum, but to Banks, Pure Gold*, N.Y. TIMES, July 21, 2013, at A1 (describing allegations that Goldman manipulated aluminum supplies and prices); Gretchen Morgenson, *Off Limits, but Blessed by the Fed*, N.Y. TIMES, Dec. 22, 2013, at BU1 (“Maneuvering in markets for electricity, metals, oil and more added billions to the bottom line at banks like JPMorgan, Goldman Sachs and Morgan Stanley in recent years. . . . Industrial users of aluminum and other metals contend that questionable activities by major banks have increased their costs.”).

to limit their authority to engage in those activities.⁴⁶⁷ The Fed has requested public comment and conducted a protracted review of physical commodities activities by FHCs, but it has not taken any public measures to restrict physical commodities operations by FHCs.⁴⁶⁸

Congress must prohibit second-tier banking organizations from owning or trading in physical commodities for the same reasons that it must prohibit those organizations from making private equity investments. The involvement of leading banks in physical commodities operations, as with other inherently commercial activities, creates a broad range of unacceptable risks. As indicated above, those risks include threats to the safety and soundness of systemically important banks; conflicts of interest resulting in biased lending decisions; bank transfers of safety-net subsidies to bank-affiliated commodities firms; and unhealthy concentrations of

467. Jeff Bater, *Industry, Democrats Square Off as Fed Looks at Banks in Commodity Businesses*, 102 BNA'S BANKING REP. 707, 707 (2014); Ryan Tracy, *Senators Push Fed on Commodities*, WALL ST. J., Jan. 16, 2014, at C3; Cheyenne Hopkins & Jesse Hamilton, *Banks Tell Fed Commodity Business Benefits Outweigh Risks*, BLOOMBERG BUS. (Apr. 17, 2014, 3:38 PM), <http://www.bloomberg.com/news/articles/2014-04-17/banks-tell-fed-commodity-business-benefits-outweigh-risks>; Douwe Miedema & David Sheppard, *At Senate, Wall St. and Fed Feel Heat over Commodity Trade*, REUTERS (July 23, 2013), <http://www.reuters.com/article/2013/07/23/us-commodities-banks-senate-idUSBRE96M03O20130723>; Michael J. Moore & Jesse Hamilton, *Fed Criticized on Oversight of Bank-Owned Commodity Units*, BLOOMBERG BUS. (July 23, 2013, 7:20 PM), <http://www.bloomberg.com/news/articles/2013-07-23/congress-must-rein-in-bank-commodities-units-rosner-says>; Joseph Richter & Lynn Doan, *Warren Says Banks Using Enron Commodity Model Face Risk*, BLOOMBERG BUS. (July 23, 2013, 1:43 PM), <http://www.bloomberg.com/news/articles/2013-07-23/warren-says-banks-using-enron-commodity-model-face-risk>.

468. Anna Louie Sussman, *PROFILE-Oregon Lawmaker Will Not Let Fed Forget to Tackle Commodities*, REUTERS (Aug. 17, 2014), <http://www.reuters.com/article/2014/08/17/commodities-usa-senate-idUSL2N0QC28K20140817> (reporting that Senator Jeff Merkley (D-OR) criticized the Fed for not acting to restrict commodities activities by banks after the Fed solicited public comments and reviewed the matter); see also Cheyenne Hopkins, *Fed Weighs Further Restrictions on Banks' Commodity Units*, BLOOMBERG BUS. (Jan. 14, 2014, 4:25 PM), <http://www.bloomberg.com/news/articles/2014-01-14/fed-weighs-further-restrictions-on-banks-commodities-units> (reporting on the Fed's request for "public input on whether to put restrictions on banks' trading and warehousing of physical commodities," and explaining that the Fed had previously said in July 2013 that it was "reconsidering" a 2003 decision that allowed banks to expand into physical commodities activities).

financial, economic, and political power.⁴⁶⁹ Moreover, as shown by the recent financial crisis, the lamentable performance of managers and regulators of many FHCs raises fundamental doubts about the ability of executives and regulators to manage or regulate even more complex conglomerates that encompass both financial and commercial operations.⁴⁷⁰

In combination, the supplemental rules described above would prevent second-tier banking organizations from using their federal safety-net subsidies to finance risky activities in the commercial sector and thereby undermine the traditional separation between banking and commerce. Restricting the scope of the TBTF subsidy and other safety-net subsidies is of utmost importance in restoring a more level playing field between small and large banks and also between banking and commercial firms.⁴⁷¹ The unchecked expansion of safety-net subsidies has increasingly distorted our regulatory and economic policies over the past three decades.⁴⁷² My proposal would

469. See *supra* note 461 and accompanying text; see also Omarova, *supra* note 462, at 342-51; John Kemp, *COLUMN-Reasons to Be Wary About Banks' Commodity Trading: Kemp*, REUTERS (Oct. 21, 2013), <http://www.reuters.com/article/2013/10/21/banks-commodity-trading-idUSL5N0IB20E20131021>.

470. Omarova, *supra* note 462, at 351-54; Kemp, *supra* note 469.

471. See INT'L MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: MOVING FROM LIQUIDITY- TO GROWTH-DRIVEN MARKETS 101-32 (2014). A detailed analysis of the magnitude of the TBTF subsidy for large banks is beyond the scope of this Article. However, most studies have concluded that big financial institutions benefited from a very large TBTF subsidy during the period leading up to the financial crisis of 2007–2009, and especially during the crisis itself. *Id.* Some studies have found that the TBTF subsidy declined after 2009 in the United States but remained significant in the EU due to the EU's continuing sovereign debt problems. For recent surveys of past studies and results of new studies, see *id.*; U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-14-621, LARGE BANK HOLDING COMPANIES: EXPECTATIONS OF GOVERNMENT SUPPORT 46-54 (2014) [hereinafter GAO TBTF SUBSIDY STUDY], available at <http://www.gao.gov/assets/670/665162.pdf>; THOMAS HOENIG, TBTF SUBSIDY FOR LARGE BANKS—LITERATURE REVIEW (2014), available at <https://www.fdic.gov/news/news/speeches/literature-review.pdf>. Thus, most studies have concluded that the TBTF subsidy for major banks becomes very large during financial crises, when the federal government essentially provides catastrophe insurance for those institutions. For example, the GAO determined that major U.S. banks would have benefited from a TBTF subsidy in 2013—in the form of significantly lower bond funding costs, compared with smaller banks—if the highly stressed credit conditions in 2008 had still been present in 2013. GAO TBTF SUBSIDY STUDY, *supra*, at 54.

472. See JOHNSON & KWAK, *supra* note 90, at 204-05 (“TBTF banks are bad for competition and therefore bad for the economy. Bond investors realize that megabanks have an implicit government guarantee, and therefore they are willing to lend them money at lower rates than their smaller competitors. . . . This subsidy

stop megabanks from using safety-net subsidies to expand their operations into commercial fields.

4. *Second-Tier Banking Organizations and Other SIFIs Should Pay Risk-Based Premiums to Prefund the OLF*

As discussed above, Dodd–Frank establishes an Orderly Liquidation Fund (OLF) to provide financing for the FDIC’s liquidation of failed SIFIs. However, Dodd–Frank does not require SIFIs to pay any assessments to prefund the OLF. During the legislative debates over Dodd–Frank, the financial industry and its Republican allies were successful (with behind-the-scenes support from the Obama Administration) in defeating several attempts by House and Senate Democrats to establish a prefunded OLF.⁴⁷³ As a result of the financial industry’s victories, taxpayers face a clear risk that they will be expected to finance future resolutions of failed SIFIs.

In the absence of a prefunded OLF, the FDIC will be obliged to borrow the necessary funds from the Treasury in order to finance an OLA proceeding after a SIFI is placed in receivership.⁴⁷⁴ Dodd–Frank generally requires the FDIC to repay its borrowings from the Treasury within five years by making retroactive assessments on (1) creditors who received preferential payments (to the extent of such payments); (2) nonbank SIFIs supervised by the Fed under Dodd–Frank; (3) BHCs with assets of \$50 billion or more; and (4) other financial companies with assets of \$50 billion or more.⁴⁷⁵ As noted above, however, Dodd–Frank allows the FDIC and the Treasury to avoid assessments on favored creditors and to extend the five-year

makes it harder for smaller banks to compete.”); Wolf, *supra* note 370 (“The business model of contemporary banking has been this: employ as much implicitly or explicitly guaranteed debt as possible; employ as little equity as one can This was a wonderful model for banks. For everybody else, it was a disaster.”).

473. See Wilmarth, *Dodd–Frank*, *supra* note 15, at 1015-19 (describing how the financial industry and its political allies defeated (1) a House Democratic proposal that would have prefunded the OLF by collecting \$150 billion in risk-based assessments from nonbank SIFIs and large banks; (2) a Senate Democratic proposal that would have prefunded the OLF with \$50 billion of such assessments; and (3) a proposal by Democratic members of the House–Senate conference committee to impose a \$19 billion tax on large banks and large hedge funds).

474. See *supra* notes 263-267 and accompanying text (describing the FDIC’s borrowing authority).

475. 12 U.S.C. § 5390(o)(1) (2012).

repayment period if such actions are deemed necessary to avoid a serious threat to financial stability.⁴⁷⁶

Thus, Dodd–Frank relies on an *ex post* funding system for financing liquidations of SIFIs, and it also allows the Treasury to make long-term OLF bridge loans that ultimately will be funded by taxpayers.⁴⁷⁷ It is contrary to customary insurance principles to rely on an empty OLF that can be funded only *after* a SIFI fails and must be liquidated.⁴⁷⁸ When commentators have considered analogous insurance issues related to the DIF, they have recognized that the FDIC should reduce moral hazard problems by requiring banks to pay risk-based premiums that compel “[e]ach bank [to] bear the cost of its own risk-taking.”⁴⁷⁹ No one advocates a post-funded DIF today; indeed, analysts have generally argued that the DIF needs a *higher* level of prefunding in order to respond adequately to systemic banking crises.⁴⁸⁰

Because the OLF is not prefunded, SIFIs receive an implicit, unpriced subsidy in the form of lower funding costs, which they enjoy by reason of the protection their creditors expect to receive from the Treasury-backed OLF. SIFIs will pay nothing for that subsidy until the first SIFI fails.⁴⁸¹ When the Dodd–Frank conference committee rejected proposals for a prefunded OLF, large financial institutions viewed that outcome as a significant “victory” because it relieved them of the burden of paying an “upfront fee” to cover the potential costs of their implicit subsidy.⁴⁸²

476. See *supra* notes 263-270 and accompanying text (discussing the leeway afforded to the FDIC and Treasury under Dodd–Frank’s provisions governing the OLA and OLF).

477. Wilmarth, *Dodd–Frank*, *supra* note 15, at 999-1000, 1015-22.

478. *Id.* at 1017 & n.280 (observing that insurers typically collect premiums in advance from their policyholders, pool and invest those claims, and rely on the resulting pool of funds to pay claims made by policyholders).

479. CARNELL, MACEY & MILLER, *supra* note 138, at 282-83.

480. See, e.g., Viral V. Acharya, João A. C. Santos & Tanju Yorulmazer, *Systemic Risk and Deposit Insurance Premiums*, FRBNY ECON. POL’Y REV., Aug. 2010, at 89, 89 (2010).

481. Wilmarth, *Dodd–Frank*, *supra* note 15, at 1017.

482. Mike Ferullo, *Regulatory Reform: Democrats Set to Begin Final Push to Enact Dodd–Frank Financial Overhaul*, 94 BNA’S BANKING REP. 1277, 1277 (2010) (reporting that the conference committee’s decision to forgo a prefunded OLF was “seen as a victory for large financial institutions,” and quoting analyst Jaret Seiberg’s comment that “[t]he key for [the financial services] industry was to avoid the upfront fee”).

A prefunded OLF is essential to shrink the TBTF subsidy for LCFIs.⁴⁸³ The FDIC should be authorized to assess risk-based premiums over a period of several years to establish a prefunded OLF with sufficient financial resources to provide reasonable protection to taxpayers against the potential cost of resolving failures of SIFIs during a future systemic financial crisis. As noted above, federal regulators provided \$290 billion of capital assistance to the nineteen largest BHCs—each with assets of more than \$100 billion—and to AIG during the financial crisis. Accordingly, \$300 billion (appropriately adjusted for inflation) should be the minimum acceptable size for a prefunded OLF. The FDIC should impose risk-based OLF premiums on all BHCs with assets of more than \$100 billion (also adjusted for inflation) and on all designated nonbank SIFIs. The FDIC should also impose additional assessments on SIFIs to replenish the OLF after the OLF incurs any loss due to the failure of a SIFI.⁴⁸⁴

There are five additional reasons why Congress must amend Dodd–Frank to establish a prefunded OLF. First, it is unlikely that most SIFIs would have adequate financial resources to pay large OLF assessments after one or more of their peers fail during a future financial crisis. SIFIs are frequently exposed to highly correlated risk exposures during a serious financial disruption because they typically follow similar high-risk business strategies (herding) during credit booms that lead to financial crises. Many SIFIs are therefore

483. See *supra* note 471 (citing studies confirming the existence of a large TBTF subsidy for megabanks during the financial crisis).

484. See *supra* note 24 and accompanying text (discussing support provided by the federal government to the nineteen largest banks and AIG during the financial crisis); see also Wilmarth, *Dodd–Frank*, *supra* note 15, at 1019-20 (discussing the need to impose risk-based assessments on SIFIs to prefund the OLF or replenish the OLF after a SIFI fails). Jeffrey Gordon and Christopher Muller have proposed a similar “Systemic Emergency Insurance Fund” with a prefunded base of \$250 billion, which would be financed by risk-adjusted assessments paid by large financial firms. See Gordon & Muller, *supra* note 378, at 204-06. They would also provide their proposed fund with a supplemental borrowing authority of up to \$750 billion from the Treasury. *Id.*; see also Xin Huang, Hao Zhou & Haibin Zhu, *A Framework for Assessing the Systemic Risk of Major Financial Institutions*, 33 J. BANKING & FIN. 2036, 2036 (2009) (proposing a methodology for calculating an insurance premium sufficient to create a hypothetical fund that could cover losses of more than 15% of the total liabilities of twelve major U.S. banks during the period 2001–2008, and concluding that the hypothetical aggregate insurance premium for that fund would have had an “upper bound” of \$250 billion in July 2008).

likely to face a substantial risk of failure during a major disturbance in the financial markets.⁴⁸⁵

Accordingly, during a future financial crisis, the FDIC probably will not be able in the short term to collect enough premiums from surviving SIFIs to cover the costs of resolving one or more failed SIFIs. As a result, the FDIC will have to borrow large sums from the Treasury to cover short-term resolution costs. Even if the FDIC ultimately repays the borrowed funds by imposing retroactive assessments on surviving SIFIs, the public and the financial markets will rightly conclude that the federal government (and ultimately the taxpayers) provided bridge loans to pay the creditors of failed SIFIs.⁴⁸⁶

“Second, under Dodd–Frank’s post-funded OLF, the most reckless SIFIs will effectively shift the potential costs of their risk-taking” to more conservatively managed SIFIs, as “the latter will be more likely to survive and bear the [retroactive] costs of resolving their failed peers.”⁴⁸⁷ Thus, our post-funded OLF creates “a terrible free-rider problem” by encouraging aggressive SIFIs to pursue high-risk strategies without paying for the likely costs of their hazardous ventures.⁴⁸⁸

Third, a prefunded OLF would encourage each SIFI to monitor other SIFIs and to alert regulators to excessive risk-taking by those institutions. Every SIFI would know that the failure of another SIFI would deplete the OLF and would also trigger future assessments that it and other surviving SIFIs must pay. “Thus, each SIFI would have good reason[s] to complain to regulators if it became aware of unsound practices or conditions at another SIFI.”⁴⁸⁹

Fourth, requiring SIFIs to pay risk-based premiums to prefund the OLF would shrink the TBTF subsidy “by forcing [SIFIs] to

485. For evidence of “herding” by large financial institutions prior to the financial crisis of 2007–2009 and earlier crises, see Wilmarth, *Dodd–Frank*, *supra* note 15, at 1020 & n.293 (citing several studies).

486. See *supra* notes 263–270, 473–482 and accompanying text.

487. Wilmarth, *Dodd–Frank*, *supra* note 15, at 1021.

488. See Viral V. Acharya et al., *Taxing Systemic Risk*, in *REGULATING WALL STREET: THE DODD–FRANK ACT AND THE NEW ARCHITECTURE OF GLOBAL FINANCE* 121, 134 (Viral V. Acharya et al. eds., 2011).

489. Wilmarth, *Dodd–Frank*, *supra* note 15, at 1021; see also Gordon & Muller, *supra* note 378, at 210 (contending that a prefunded OLF that has authority to impose additional assessments to offset the costs of resolving failed SIFIs would create a desirable “mutualization of risk [among SIFIs] that should encourage more cautious firms to press regulators to rein in firms and practices that pose systemic risks”).

internalize more of the ‘negative externality’ (i.e., the potential public bailout cost) of their activities.”⁴⁹⁰ Risk-based premiums to prefund the OLF would be analogous to a “systemic risk tax,” which a number of commentators have advocated for the purpose of compelling SIFIs to “internalize the systemic risk costs imposed on the rest of the financial sector and external real economy.”⁴⁹¹ In addition to requiring SIFIs to pay for the potential external costs of their operations, a prefunded OLF would provide a much-needed reserve fund that would shield governments and taxpayers from having to incur the expense of underwriting future resolutions of failed SIFIs.⁴⁹²

Fifth, as Jeffrey Gordon and Christopher Muller have noted, a prefunded OLF would also reduce the TBTF subsidy by making Dodd–Frank’s “liquidation threat more credible.”⁴⁹³ They correctly point out that a prefunded OLF would encourage regulators to invoke the OLA receivership process for a failing SIFI because a prefunded OLF would give regulators the necessary financial resources to cover shortfalls in the SIFI’s assets.⁴⁹⁴ In contrast, Dodd–Frank’s post-funded OLF creates strong incentives for regulators to grant forbearance in order to postpone (and hopefully avoid) an OLA receivership that would force regulators to take the politically unpopular step of borrowing from the Treasury to finance the resolution of a failing SIFI.⁴⁹⁵

To further shrink the TBTF subsidy for SIFIs, the OLF should be strictly separated from the DIF, which insures bank deposits. As discussed above, the SRE in the FDI Act provides a potential source of bailout funds for SIFI-owned banks and their uninsured creditors.⁴⁹⁶ Congress should repeal the SRE and should designate the

490. Wilmarth, *Dodd–Frank*, *supra* note 15, at 1021-22.

491. Acharya et al., *supra* note 488, at 124, 138 (citing “other papers that also call for Pigouvian-type taxes” on systemic risks created by SIFIs); *see also id.* at 124-31 (setting forth a proposed formula and procedure for calculating and implementing a systemic risk tax).

492. Wilmarth, *Dodd–Frank*, *supra* note 15, at 1021-22.

493. Gordon & Muller, *supra* note 378, at 208.

494. *Id.*

495. *Id.* at 193.

496. *See supra* notes 279-282 and accompanying text (discussing the SRE as a potential bailout source for SIFIs). For example, the FDIC relied on the SRE when it agreed with the Treasury and the Fed to provide more than \$400 billion of asset guarantees to Citigroup and BofA during the financial crisis. Wilmarth, *Dodd–Frank*, *supra* note 15, at 1022-23 & n.304 (pointing out that the Treasury Secretary

OLF as the exclusive source of future funding for all resolutions of failed SIFIs. By repealing the SRE, Congress would make clear that (1) the FDIC must apply the FDI Act's least-cost test in resolving all future bank failures; (2) the DIF must be used solely to pay the claims of bank depositors; and (3) non-deposit creditors of SIFIs could no longer view the DIF as a potential source of financial support. By making all of the foregoing changes, Congress would significantly reduce the implicit TBTF subsidy currently exploited by SIFIs.⁴⁹⁷

5. *Top Executives and Key Employees of Second-Tier Banking Organizations Should Receive at Least Half of Their Total Compensation in the Form of Contingent Convertible Debt*

There is wide agreement that compensation packages for senior managers and other key employees of major banks encouraged the pursuit of reckless and destructive business strategies during the period leading up to the financial crisis.⁴⁹⁸ Leading banks adopted bonus and stock option plans that provided very large rewards to managers and key employees (including traders) if they met short-term revenue and profit targets. Bonuses and equity-based incentives caused executives and key employees to focus primarily on boosting short-term returns for shareholders while paying little or no attention to the interests of long-term creditors (including the deposit insurance fund and taxpayers).⁴⁹⁹ The resulting emphasis on short-

ultimately did not invoke the SRE for BofA because the terms of BofA's asset guarantee were agreed to in principle but not finalized).

497. See Wilmarth, *Dodd-Frank*, *supra* note 15, at 1023.

498. See, e.g., BARTH, CAPRIO, JR. & LEVINE, *supra* note 376, at 57-76; JOHNSON & KWAK, *supra* note 90, at 58-61, 115-16; Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 249-74 (2010); John McCormack, Morgan Stanley & Judy Weiker, *Rethinking "Strength of Incentives" for Executives of Financial Institutions*, 22 J. APPLIED CORP. FIN. 65, 66-69 (2010); Frederick Tung, *Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation*, 105 NW. U. L. REV. 1205, 1216-23 (2011); FCIC REPORT, *supra* note 18, at xix, 61-64; Bair FCIC Testimony, *supra* note 103; Dudley Oct. 20, 2014 Speech, *supra* note 393; Tarullo Oct. 20, 2014 Speech, *supra* note 394, at 8-10.

499. See authorities cited *infra* note 501; see also Sanjai Bhagat & Brian Bolton, *Misaligned Bank Executive Incentive Compensation 1-6, 13-14, 17-33* (June 2013) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2277917 (analyzing executive compensation plans at fourteen of the largest U.S. financial institutions between 2000 and 2008 and concluding that (1) those fourteen institutions provided much larger amounts of equity-based pay to their chief executive officers, compared with thirty-seven

term shareholder returns was particularly dangerous in the financial industry due to the highly leveraged condition of many large financial institutions and the explicit and implicit subsidies provided to those institutions by the federal safety net.⁵⁰⁰

Recent studies have shown that financial institutions were more likely to default or perform poorly during the financial crisis if their compensation packages for senior executives were more heavily weighted toward equity-based pay.⁵⁰¹ In addition, after Congress authorized banks to expand on a nationwide basis in 1994 and to affiliate with securities firms and insurance companies in 1999, the largest banks responded by increasing their equity-based incentives.⁵⁰² Big bank executives responded to those enhanced incentives by adopting a variety of high-risk measures, including aggressive acquisitions, rapid expansion of nontraditional, fee-based businesses (including investment banking), and large investments in subprime MBS.⁵⁰³

In contrast, banks whose top executives had larger amounts of “inside debt” performed significantly better during the financial crisis and had a substantially lower risk of default.⁵⁰⁴ “Inside debt”

smaller banks that did not receive TARP assistance; and (2) the same fourteen institutions incurred much greater risks and performed much worse during the financial crisis, compared with the same group of smaller banks); Wilmarth, *Citigroup*, *supra* note 14, at 99, 104-05, 115-17 (describing how bonuses based on short-term revenue and profit targets encouraged reckless behavior by Citigroup’s senior executives, traders, and other key employees).

500. Rosalind L. Bennett, Levent Güntay & Haluk Unal, *Inside Debt, Bank Default Risk and Performance During the Crisis* 2-3 (FDIC Ctr. for Fin. Research, Working Paper No. 2012-03, 2014), available at <http://ssrn.com/abstract=2122619>; McCormack, Stanley & Weiker, *supra* note 498, at 66; Tung, *supra* note 498, at 1210-16; Sjoerd Van Bekkum, *Inside Debt and Bank Risk* 3-4 (Mar. 14, 2014) (unpublished manuscript), available at <http://ssrn.com/abstract=1682139>.

501. Robert DeYoung, Emma Y. Peng & Meng Yan, *Executive Compensation and Business Policy Choices at U.S. Commercial Banks*, 48 J. FIN. & QUANTITATIVE ANALYSIS 165, 166-68, 193-95 (2013); Rüdiger Fahlenbrach & René M. Stulz, *Bank CEO Incentives and the Credit Crisis*, 99 J. FIN. ECON. 11, 12-13, 24-25 (2011); see Bennett, Güntay & Unal, *supra* note 500, at 1-6, 19-24, 36-37.

502. See DeYoung, Peng & Yan, *supra* note 501, at 165-66, 180-82; Tung, *supra* note 498, at 1216-23.

503. See DeYoung, Peng & Yan, *supra* note 501, at 166-68, 175, 177, 180-83, 189, 192-95; Jens Hagendorff & Francesco Valscas, *CEO Pay Incentives and Risk-Taking: Evidence from Bank Acquisitions*, 17 J. CORP. FIN. 1078, 1079-80, 1084-86, 1091-94 (2011).

504. See Bennett, Güntay & Unal, *supra* note 500, at 3-6, 19-24, 34-37; Bekkum, *supra* note 500 (manuscript at 4-7, 17-26, 30-31); Frederick Tung & Xue Wang, *Bank CEOs, Inside Debt Compensation, and the Global Financial Crisis* 3-5,

includes executive rights to pensions and deferred compensation, which are “typically unfunded and unsecured” and therefore “face default risk just as outside creditors do.”⁵⁰⁵ Studies have found that executives holding a higher proportion of inside debt in relation to their equity interests had incentives that were more aligned with creditors and therefore followed lower-risk business strategies.⁵⁰⁶

In view of the risk-reducing influence of inside debt, analysts and regulators have proposed that senior managers and key employees of large banks should receive a substantial portion of their total compensation in the form of long-term debt rather than equity. Giving long-term debt a greater role in compensation would encourage managers and traders to choose operating plans that promote the long-term survival of the bank, an outcome that would serve the interests of the deposit insurance fund and taxpayers.⁵⁰⁷

In a previous article, I argued that SIFIs should be required to pay a significant percentage of the compensation received by senior managers and other key employees in the form of contingent convertible bonds (CoCos).⁵⁰⁸ CoCos held by executives and key employees should be converted automatically into common stock upon the occurrence of a designated event of financial stress, including (1) a decline in capital below a specified level that would “trigger” automatic conversion or (2) the initiation of an OLA proceeding or a receivership, conservatorship, or insolvency proceeding for a SIFI or one of its principal subsidiaries. The primary regulator of a SIFI should have the power to mandate the activation of the pre-insolvency “trigger” for financial distress.

22-29 (Boston Univ. Sch. of Law, Working Paper No. 11-49, 2012), available at <http://ssrn.com/abstract=1570161>.

505. See Tung & Wang, *supra* note 504, at 1, 6-7 (noting that “pensions and deferred compensation . . . give managers fixed claims against the firm that like conventional debt, depend on the firm’s solvency for full payment”).

506. See *supra* note 504.

507. See McCormack, Stanley & Weiker, *supra* note 498, at 70-71; Tung, *supra* note 498, at 1226-41, 1245-51; Dudley Oct. 20, 2014 Speech, *supra* note 393; see also Caroline Salas Gage & Craig Torres, *Fed Citing Wall Street Lapses Leads Drive on Bonds as Pay*, BLOOMBERG BUS. (Apr. 30, 2014, 12:01 AM), <http://www.bloomberg.com/news/articles/2014-04-30/fed-citing-wall-street-lapses-leads-drive-on-bonds-as-pay> (quoting comments supporting debt-based executive compensation from Comptroller of the Currency Thomas Curry, New York Fed President William Dudley, and former FDIC Chairman Sheila Bair).

508. See Wilmarth, *Dodd–Frank*, *supra* note 15, at 1008-09. For a helpful survey of the terms and characteristics of CoCos, see Stefan Avdjiev, Anastasia Kartasheva & Bilyana Bogdanova, *CoCos: A Primer*, BIS Q. REV., Sept. 2013, at 43, available at http://www.bis.org/publ/qtrpdf/r_qt1309f.pdf.

As noted above, domestic and foreign regulators are actively considering resolution plans that would require SIFIs to sell large amounts of “bail-in” debt (including CoCos) to outside investors.⁵⁰⁹ A significant potential risk of the bail-in debt strategy is that pulling the mandatory conversion “trigger” at one SIFI could precipitate a generalized “creditor flight” from debt issued by all other financial institutions with similar risk exposures.⁵¹⁰ That risk would not arise with the issuance of CoCos to senior managers and key employees because they are “captive investors” who could be required, as a condition of their employment, to accept and retain CoCos during their term of service and also during a lengthy post-employment period.⁵¹¹

Senior managers and key employees should not be allowed to make voluntary conversions of their CoCos into common stock until the expiration of a lengthy period (e.g., three to five years) after the end of their employment. In addition, managers and key employees should be required to spread any sales of common stock received upon voluntary conversion of their CoCos over an additional period of similar length. Managers and key employees should also be prohibited from purchasing any derivatives or other financial instruments (e.g., credit default swaps or put options on stock) for the purpose of hedging their exposure to CoCos or the common stock issuable upon conversion of CoCos (either mandatory or voluntary). A lengthy post-employment holding period for CoCos and a further holding period for stock issued upon conversion “would discourage managers and key employees from taking excessive risks to boost the value of [their voluntary] conversion” option during their term of employment.⁵¹² At the same time, as explained above, CoCos “should be subject to mandatory conversion into common stock upon the occurrence of a designated ‘triggering’ event of financial distress.”⁵¹³ It is likely that any common stock received upon mandatory conversion would soon become worthless.⁵¹⁴

509. See *supra* text accompanying notes 273-278; see also GOODHART & AVGOULEAS, *supra* note 273, at 1-4, 7-10.

510. See GOODHART & AVGOULEAS, *supra* note 273, at 11-12, 17-18, 20-21.

511. See Wilmarth, *Dodd-Frank*, *supra* note 15, at 1008-09 (internal quotation marks omitted).

512. *Id.* at 1009.

513. *Id.*

514. For similar proposals that advocate the use of CoCos to change the incentives of senior managers and key employees of SIFIs, see Wulf A. Kaal, *Contingent Capital in Executive Compensation*, 69 WASH. & LEE L. REV. 1821, 1854-72 (2012); Jeffrey N. Gordon, *Executive Compensation and Corporate*

Requiring senior executives and key employees to receive at least half of their total compensation in the form of CoCos and to hold those CoCos (and any resulting common stock) for several years after their employment would give those insiders a powerful incentive to follow prudent business policies that serve the interests of longer-term shareholders and creditors (including the deposit insurance fund and taxpayers). Insiders would face the risk of automatically losing the value of their CoCos if their company became distressed, without the need for any affirmative clawback by senior management or regulators. Thus, my proposal “would cause managers and key employees to realize that (1) they will not be able to ‘cash out’ a significant percentage of their accrued compensation unless their organization achieves long-term success and viability, and (2) they will lose a significant portion of their accrued compensation if their institution” encounters severe financial distress.⁵¹⁵

Section 956(b) of Dodd–Frank requires federal financial regulators to adopt joint rules prohibiting incentive-based compensation arrangements that encourage financial institutions to assume “inappropriate risks.”⁵¹⁶ Regulators have not adopted final rules to implement § 956(b), even though Dodd–Frank established a deadline of April 2011 for that action.⁵¹⁷ Regulators should promptly

Governance in Financial Firms: The Case for Convertible Equity-Based Pay 8-14 (Columbia Law Sch. & European Corporate Governance Inst., Working Paper No. 373, 2010), available at <http://ssrn.com/abstract=1633906>.

515. Wilmarth, *Dodd–Frank*, *supra* note 15, at 1009.

516. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 956(b), 124 Stat. 1376, 1905 (2010).

517. *See id.* (requiring federal financial regulators to adopt regulations implementing § 956(b) “[n]ot later than 9 months after” Dodd–Frank’s enactment in July 2010). Federal regulators issued proposed regulations in April 2011, but those regulations have not been finalized. *See* Incentive-Based Compensation Arrangements, 76 Fed. Reg. 21,170 (proposed Apr. 14, 2011) (to be codified at 12 C.F.R. pt. 1232) (publishing proposed rules to implement § 956). According to one published report, the proposed regulations became “bogged down in regulatory infighting” among the six federal agencies responsible for issuing final rules. Gina Chon, *US Bank Bonus Curb Hit by Regulatory Squabble*, FINANCIAL TIMES (Aug. 14, 2014), <http://www.ft.com/intl/cms/s/0/e4c322e4-23ba-11e4-8e29-00144feabdc0.html#axzz3ZILDNyc9>. In January 2015, Fed Governor Jerome Powell stated that federal financial regulators were “preparing for . . . comment a proposed *new* rule on incentive compensation.” Governor Jerome H. Powell, Comments on the Fair and Effective Markets Review (Jan. 20, 2015), available at <http://www.federalreserve.gov/newsevents/speech/powell20150120a.htm> (emphasis added). Thus, it appears that federal regulators are far from achieving Dodd–Frank’s mandate for imposing effective limits on incentive-based compensation.

adopt rules that would carry out the intent of § 956(b) by including the CoCo compensation plan described above.

CONCLUSION

The regulatory framework established by Dodd–Frank is deeply flawed and threatens to inflict additional harm on our financial markets and our economy. The statute imposes onerous and unjustified compliance burdens on community banks. The statute also fails to solve the TBTF problem and leaves the door open for future bailouts of SIFIs and their creditors. Without significant changes, Dodd–Frank will further weaken the community bank sector, accelerate the ongoing consolidation of our banking industry, and enable megabanks to exercise even greater influence over our political and regulatory systems.

In light of Dodd–Frank’s manifest shortcomings, we must adopt a two-tiered regulatory system that will promote the health of community banks and control the risks of megabanks. The first tier of regulation must encourage and preserve the proven business model of relationship-based intermediation that has long provided superior service to small businesses, local communities, and consumers. The second regulatory tier must compel large financial conglomerates to conduct their deposit-taking activities within narrow banks, which are strictly separated from capital markets activities and are also prohibited from transferring their safety-net subsidies to nonbank affiliates. We must adopt further regulatory reforms (including a prefunded Orderly Liquidation Fund) to shrink the TBTF subsidy. We must also require SIFIs to pay a large share of compensation for executives and key employees in the form of CoCos, so that the incentives of insiders will be better aligned with the interests of long-term creditors, the FDIC, and taxpayers.

My proposal’s ultimate purpose is to force large financial conglomerates to prove that they can produce superior risk-related returns for investors *without* relying on explicit and implicit government subsidies. Most studies have failed to confirm the existence of favorable economies of scale or scope within giant financial conglomerates. Indeed, those conglomerates have failed to produce consistently positive returns, even under the current regulatory system that allows them to exploit extensive federal

subsidies.⁵¹⁸ In December 2009, a prominent bank analyst suggested that if Congress prevented nonbank subsidiaries of FHCs from accessing the low-cost deposit funding provided by their affiliated banks, large FHCs would not be economically viable and would be forced to break up voluntarily.⁵¹⁹

Many of the largest commercial and industrial conglomerates in the United States and Europe were broken up during the past three decades by hostile takeovers and voluntary divestitures after they proved to be “less efficient and less profitable than companies

518. ADMATI & HELLWIG, *supra* note 369, at 89, 144, 270 n.31, 290 n.29; JOHNSON & KWAK, *supra* note 90, at 212-13; Wilmarth, *Blind Eye*, *supra* note 63, at 1427; Wilmarth, *Reforming Financial Regulation*, *supra* note 23, at 748-49; *see also* Christine Harper, *Breaking up Big Banks Hard to Do as Market Forces Fail*, BLOOMBERG BUS. (June 27, 2012, 12:55 PM), <http://www.bloomberg.com/news/articles/2012-06-27/breaking-up-big-banks-hard-to-do-as-market-forces-fail> (reporting that the stock prices of JPMorgan Chase, BofA, Citigroup, Goldman, and Morgan Stanley were “languishing at or below tangible book value” despite the massive assistance they received from the federal government during the financial crisis, and describing the views of fund managers Michael Price and Phillip Purcell, who contended that big banks should be broken up to increase shareholder returns); Michael J. Moore, *JPMorgan Worth One-Third More in Break-Up, Mayo Says*, BLOOMBERG BUS. (Feb. 27, 2012, 11:47 AM), <http://www.bloomberg.com/news/2012-02-27/jpmorgan-would-be-worth-more-if-split-up-mayo.html> (quoting a report issued by analyst Michael Mayo, who pointed out that JPMorgan’s stock was 2% below its value at the end of 2004 and also stated, “[e]ight years is a long time to wait for a higher share price when the top five executives at JPM from 2004-2010 received over \$600 million in compensation”); Hugh Son, *Goldman Says JPMorgan Should Break Itself into Pieces*, BLOOMBERG BUS. (Jan. 5, 2015, 11:38 AM), <http://www.bloomberg.com/news/articles/2015-01-05/goldman-says-jpmorgan-should-break-itself-into-pieces> (describing a report issued by a team of Goldman analysts, who argued that Chase could provide greater returns to its shareholders by splitting itself into two or four parts).

519. Karen Shaw Petrou, the managing partner of Federal Financial Analytics, explained that “[i]nteraffiliate restrictions would limit the use of bank deposits on nonbanking activities,” and “[y]ou don’t own a bank because you like branches, you own a bank because you want cheap core funding.” Stacy Kaper, *Big Banks Face Most Pain Under House Bill*, AM. BANKER (Dec. 2, 2009), *available at* http://license.icopyright.net/user/viewContent.act?clipid=411892257&mode=cnc&tag=3.7343%3Ficx_id%3D1004692 (quoting Ms. Petrou). Ms. Petrou therefore concluded that an imposition of stringent limits on affiliate transactions “really strikes . . . at the heart of a diversified banking organization” and “I think you would see most of the very large banking organizations pull themselves apart” if Congress passed such legislation. *Id.* (quoting Ms. Petrou); *see also* Nixon, *supra* note 445 (reporting that Barclays Capital, a large securities firm, received “cheap funding for a major trading operation” from the “retail deposits” held by Barclays Bank, but the stock of Barclays Bank still traded “at just 0.8 times tangible book value” even with the “implicit subsidy between the two businesses”).

pursuing more focused business strategies.”⁵²⁰ It is long past time for financial conglomerates to be stripped of their safety-net subsidies and their presumptive access to TBTF bailouts so that they will become subject to the same type of scrutiny and discipline that the capital markets have applied to commercial and industrial conglomerates. My proposal provides a workable plan to impose such scrutiny and discipline on financial behemoths, which currently enjoy far too much power and influence within our financial and political systems. In addition, my proposal would align U.S. regulatory policy with financial restructuring plans for SIFIs that have already been adopted in the U.K. and are under active consideration in the EU.⁵²¹ The time for action is now—we dare not wait any longer.

520. Wilmarth, *Dodd–Frank*, *supra* note 15, at 1047.

521. See Arthur E. Wilmarth, Jr., *Narrow Banking as a Structural Remedy for the Problem of Systemic Risk: A Comment on Professor Schwarcz’s Ring-Fencing*, 88 S. CAL. L. REV. POSTSCRIPT 1, 7-8 (2015) (describing (1) the U.K. Parliament’s adoption of legislation that will require large banks to separate their “retail” activities (including deposit-taking and lending to consumers and small firms) from their capital markets activities, and (2) the EU Parliament’s preliminary consideration of legislation that would require large banks to transfer certain trading and capital markets activities into ring-fenced affiliates); see also FIN. STABILITY BD., STRUCTURAL BANKING REFORMS: CROSS-BORDER CONSISTENCIES AND GLOBAL FINANCIAL STABILITY IMPLICATIONS 6-9 (2014), available at http://www.financialstabilityboard.org/wp-content/uploads/r_141027.pdf?page_moved=1.