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ENHANCED SUPERVISION: A NEW REGIME FOR REGULATING LARGE, COMPLEX FINANCIAL INSTITUTIONS

HEARING

BEFORE THE

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS AND CONSUMER
PROTECTION

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

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FIRST SESSION

ON

EXAMINING ENHANCED SUPERVISION FOR REGULATING LARGE, COMPLEX FINANCIAL INSTITUTIONS

DECEMBER 7, 2011

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C O N T E N T S

WEDNESDAY, DECEMBER 7, 2011

WITNESSES

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

ENHANCED SUPERVISION: A NEW REGIME FOR REGULATING LARGE, COMPLEX FINANCIAL INSTITUTIONS

WEDNESDAY, DECEMBER 7, 2011

U.S. SENATE,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER PROTECTION,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met at 2:04 p.m., in room SD–538, Dirksen Senate Office Building, Hon. Sherrod Brown, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF CHAIRMAN SHERROD BROWN

Chairman BROWN. The Banking Subcommittee on Financial Institutions and Consumer Protection will come to order.

Thank you to the four very distinguished witnesses who have played a very positive role in helping this country work our way through this terrible mess of the last 5 years, and thank you very much for joining us. Senator Corker, I understand, is on his way and was very cooperative in this hearing. Thank you, Professor Swagel. I know he invited you, and I appreciate that.

Three years ago, we experienced what can happen when excessive risk taking and lax oversight are concentrated in our Nation's largest financial institutions. The result, as we painfully know, was the near collapse of our entire economy. In response to the financial crisis of 2008, we passed Dodd-Frank. This legislation provides regulators with significant authority to oversee U.S. megabanks' should they choose to use them, the power to curtail the use of leverage and increase equity funding; at the largest financial companies, the ability to preemptively downsize risky companies. Thanks to the efforts of my colleague Senator Corker, it gave the ability and power to resolve large, complex companies that are on the brink of failure and restrictions on the ability of large banks and financial companies to engage in risky proprietary trading and investment fund activities.

Important questions remain, and that is what we will discuss today. Have we provided the regulators with adequate authority to address the cause of the financial crisis? Will regulators use these authorities that we have provided them to downsize those institutions in order to prevent the next financial crisis, particularly when they had similar powers prior to the 2008 financial crisis? Will the markets force these institutions to increase their equity funding or

exit risky lines of business? Is it even possible to understand or unwind trillion-dollar institutions that have had hundreds of diverse lines of business and operate in sometimes as many as 100 countries? Should we continue to put all our faith in regulators, or is it time to address too big to fail by putting some more fundamental reforms into law?

Last year, Senator Kaufman and I offered an amendment to Dodd-Frank that would have sent the clear message that Congress believes that too big to fail means simply too big. It would have broken up the six biggest U.S. megabanks. In the past 15 years, these banks have grown in total assets from 15 percent of our Nation's GDP 15 years ago to 63 percent of our Nation's GDP today. The amendment failed, but much has changed since then that should make us reconsider this and similar proposals.

We have seen that a small U.S. broker-dealer, MF Global, can go bankrupt without taking the entire financial system with it while a nearly $700 billion Belgian bank, Dexia, with assets that make up over 150 percent of that nation's economy, had to be bailed out by three countries 3 months after they passed their regulator's stress test.

Last week, we found out that the six biggest megabanks borrowed as much as $400 billion in secret, low-cost loans from the Fed, accounting for 63 percent of the average daily debt. These loans accounted for 23 percent of the combined net income for these megabanks 23 percent during the time they were occurring. We know this assistance also helped these institutions to grow even bigger, and that is another thing the financial crisis did.

In today's *Wall Street Journal,* over the last 5 years, they pointed out, the four largest banks in this country have grown from 54 percent to 62 percent of all commercial banking assets. At the time we considered the Brown-Kaufman amendment, many people pointed to European banks as the model for ours in arguing against the amendment. But recent events have shown it would be unwise to replicate their banking system.

While we have chosen to empower our regulators, other nations, including England, are proposing to restrict the activities that their banks can engage in. Maybe it is time we begin to seriously consider that option.

I look forward to hearing from our panelists and look forward to hearing Senator Corker.

Senator CORKER. Thank you, Mr. Chairman, and I think you know I am not much for opening comments. I look forward to hearing from our witnesses and asking questions, but I thank you all for being here.

Chairman BROWN. I like it. You give really good opening comments. Thank you.

[Laughter.]

Chairman BROWN. Senator Hagan, you have an opening statement, I understand.

STATEMENT OF SENATOR KAY HAGAN

Senator HAGAN. I do. Thank you, Mr. Chairman. I appreciate that. But before I turn to the issue of enhanced supervision, I did want to talk briefly about the upcoming vote on the nomination of Richard Cordray. I know, Senator Brown, that you have definitely been a tireless advocate for Mr. Cordray. I was proud to support his nomination to become the first Director of the Consumer Financial Protection Bureau when it was considered by the Banking Committee. I will be proud to do so again later on this week when his nomination is brought before the full Senate.

For too long, Americans have fallen victim to schemes at the hands of predatory lenders. As a State Senator, I remember witnessing payday lenders in North Carolina, who would trap many, many families in endless long-term debt before we put a stop to predatory lending practices in North Carolina.

There was a woman, Sandra Harris, who was a Head Start employee from Wilmington. When her husband lost his job, she got a $200 payday loan to help pay for car insurance. When she went to repay the loan, she was told that she could renew it. She really found herself at her wits' end when she ended up having six different payday loans and paid some $8,000 in fees.

Well, there are many more of these individuals across the country that I think would greatly benefit from the Consumer Financial Protection Bureau. We cannot afford to continue to leave these families at risk. We need a strong Director to help improve the oversight over these predatory lenders who continue to prey on American families across our country. This is not about financial interest versus consumer protection. North Carolina is home to some of the largest financial institutions in our country and a vibrant network of community banks. We are a banking State, and I am very proud of that.

We also understand that responsible financial regulation also protects consumers and businesses. That is why I supported the creation of the CFPB and why I believe it is well past time that we put a strong director in place. I believe Mr. Cordray is that strong Director.

Mr. Chairman, I know that today we are here to talk about another immensely important topic—the supervision of large, complex financial institutions. Dodd-Frank represents a major step forward on this issue by granting important new authorities to our prudential regulators. Living wills, orderly liquidation authority, and enhanced prudential standards give financial regulators the tools to make our financial system safer.

Chairman Bair, it is good to have you back with us today. I think everybody knows that you were instrumental in crafting the rules that we are talking about. In April, under your leadership the FDIC released a study that examined how the FDIC could have successfully used Dodd-Frank's orderly liquidation authority to execute a cross-border resolution of Lehman Brothers, a systemically important financial institution. It found that with the new authorities, the FDIC could have "promoted systemic stability while recovering substantially more for creditors than the bankruptcy proceedings."

In addition to the FDIC study, the Economist recently gathered Larry Summers, Rudgin Cohen, Donald Kohn, and others to demonstrate how the orderly liquidation of a large, systemically important financial institution would be successful under Dodd-Frank's new authorities.

Chairman Bair, I know that you have also advocated for a robust cross-border resolution framework. It appears that those efforts are bearing fruit in crucial jurisdictions such as Japan, the United Kingdom, and the EU—where comment is currently being sought on a regime akin to Title II. I will be interested in how you respond to Simon Johnson's comments about the cross-border resolution.

Finally, I wanted to comment briefly on the work of the Basel Committee as it relates to enhanced prudential regulation. Yesterday, Governor Tarullo testified that capital requirements are of paramount importance in the future of our financial system. I could not agree with him more. Domestic implementation of Basel III deserves a thorough review so that it does not become a Euro-centric rule book. I was glad to hear that the Federal Reserve is looking closely at the example of liquidity cover ratios. These rules will need to adequately account for the unique components of our domestic banking system such as the Federal Home Loan Bank System, agency debt, and the lack of a legislative framework for covered bonds.

Again, Senator Brown, I appreciate you holding this hearing, and I look forward to our witnesses' testimony.

Chairman BROWN. Thank you, Senator Hagan, and just to follow up briefly on your comments, I probably know Richard Cordray better than any Member of the Senate. I knew him when he was a State representative and county treasurer and State treasurer and Attorney General and have continued to work with him, and there is no question of his qualification. Sometime ago I asked the Senate historian if this has ever happened that a political party has blocked the nomination of someone because they did not like the construction of the agency, and he said no, it has never happened. And I am hopeful that this will be different.

Let me introduce the four witnesses, and we will hear from them, and Senator Corker and Senator Hagan and I will have questions.

Sheila Bair is certainly—a cliche among cliches—no stranger to this Committee, she really is not, and has served, has given great public service from her work with Senator Dole to her work with the FDIC from 2006 to 2011. She is now a senior advisor at Pew Charitable Trusts, working on a book, and she has assumed a prominent role in the Government's response to the recent financial crisis, including bolstering public confidence and system stability that resulted in no runs on bank deposits. Thank you, Ms. Bair.

Simon Johnson is the Ronald Kurtz Professor of Entrepreneurship at MIT Sloan School of Management, senior fellow at the Peterson Institute for International Economics. He is the former chief economist at the IMF and coauthor with James Kwak of the book "13 Bankers"—and it is a terrific book—and the financial blog "The Baseline Scenario."

The Honorable Phillip Swagel is professor of international economic policy at the Maryland School of Public Policy. Professor Swagel was Assistant Secretary for Economic Policy at Treasury

from 2006 to 2009, a rather crucial time in that period, and in that position he advised Secretary Paulson on economic policy and also on the Troubled Asset Relief Program.

Arthur Wilmarth is professor of law and executive director of the Center for Law, Economics and Finance at George Washington University here. He is the author of publications in the fields of banking law and American constitutional history and the coauthor of a book on corporate law. In 2005, the American College of Consumer Financial Services Lawyers awarded him its prize for the best Law Review article published in the field of consumer financial services law during the year 2004.

Ms. Bair, if you would begin.

STATEMENT OF SHEILA C. BAIR, SENIOR ADVISOR, PEW CHARITABLE TRUSTS

Ms. BAIR. Chairman Brown, Ranking Member Corker, and Senator Hagan, it is my pleasure to address you today at this hearing entitled "A New Regime for Regulating Large, Complex Financial Institutions."

There is no single issue more important to the stability of our financial system than the regulatory regime applicable to large, complex financial institutions. I hope that by now there is general recognition of the role certain large, mismanaged institutions played in the lead-up to the financial crisis and the subsequent need for massive, governmental assistance to contain the damage caused by their behavior. The disproportionate failure rate of large, so-called systemic entities stands in stark contrast to the relative stability of smaller, community banks of which less than 5 percent have failed. As our economy continues to reel from the financial crisis, with high unemployment and millions losing their homes, we cannot afford a repeat of the regulatory and market failures which allowed this debacle to occur.

There is nothing inherently wrong with size in and of itself. However, size should be driven by market forces, not implied Government subsidies. With the implied Government support provided to Fannie Mae, Freddie Mac, and so-called too-big-to-fail financial institutions, the smart money fed the beasts and the smart money proved to be right. As failures mounted, the Government blinked and opened up its checkbook. Creditors and trading partners were made whole. Many executives and board members survived. In most cases, the Government did not even wipe out shareholders.

Regulators for the most part did not try to constrain these trends, but left the market largely to regulate itself. In some cases, such as derivatives, Congress explicitly told the regulators "hands off." As free markets became free-for-all markets, compensation rose, skyrocketing past wages paid to equally skilled employees in other fields. This enticed many of our best and brightest to forgo careers in areas like engineering and technology to heed the siren song of quick, easy money from an overheated, overleveraged financial industry.

In recognition of the harmful effects of too-big-to-fail policies, a central feature of Dodd-Frank is the creation of a resolution framework which will impose losses and accountability on shareholders, creditors, boards, and executives when mismanaged institutions

fail. We cannot end too big to fail unless we can convince the market that shareholders and creditors will take losses if the institution in which they have invested goes down.

An essential component of resolution authority is the requirement that large bank holding companies and nonbank systemic entities submit resolution plans demonstrating how they could be resolved during a crisis without systemic disruptions. The Dodd-Frank standard of resolvability in bankruptcy is very tough, and my sense is that all the major banks will need to make significant structural changes to achieve it. They will need to do much more to rationalize their business lines with their legal entities to make it much easier for the FDIC—or a bankruptcy court—to hive off and sell healthy operations, while maintaining troubled operations in a "bad bank." Rationalizing and simplifying legal structures will improve the ability of boards and management to understand and monitor activities in these large banks' far-flung operations. I hope regulators will consider requiring strong intermediate boards and managers to oversee major subsidiaries. Many of these centralized boards and management do not have a comprehensive understanding of what is going on inside their organizations. This was painfully apparent during the crisis.

One element of Dodd-Frank's living will provision that has not yet been implemented is the requirement for credit exposure reports. Credit exposure reports are essential to make sure regulators understand crucial interrelationships between distress at one institution and its potential to cause major losses at other institutions. This type of information was lacking during the crisis. For those concerned about the potential domino effect of a large bank failure, it is essential not only to identify, understand, and monitor these exposures but also to limit them in advance. I would urge the FDIC and the Federal Reserve Board to complete this final piece of the living will rule as soon as possible.

Another benefit of resolution authority emanates from the harshness of the process, and it is a harsh process, particularly for certain board members and senior management who not only lose their jobs but are subject to a 2-year clawback of all their compensation. This will give them strong incentives to avoid resolution by raising capital or selling their operations, even if the terms seem unfavorable. With this new resolution, the management of large financial firms now know what their fate will be, and it is not a pretty one. Bailouts are prohibited and there will be no exceptions. If they cannot right their own ship, they will sink with it.

As important as it is, resolution authority obviously cannot substitute for high-quality prudential supervision. Excessive leverage was a key driver of the 2008 crisis as it has been for virtually all financial crises. This was forgotten in the early 2000s when regulators stood by and effectively lowered capital minimums among U.S. investment banks through implementation of Basel II.

We need to correct those mistakes through timely implementation of Basel III and the SIFI surcharges which strengthen the definition of high-quality capital and substantial raise risk-based capital ratios for large institutions. Regulators also need to focus on constraining absolute leverage through an international leverage

ratio that is significantly higher than the Basel Committee's proposed 3-percent standard.

Many industry advocates continue to argue that higher capital requirements will inhibit lending. It is fallacy to think that thinly capitalized institutions will do a better job of lending. A large financial institution nearing insolvency will quickly pull credit lines and cease lending to maintain capital. On the other hand, a well-capitalized bank will keep functioning even when the inevitable business cycle turns downward.

Liquidity also needs more attention from regulators, both in the U.S. and abroad. We need to dramatically toughen the types of collateral than can be used to secure repos and other short-term loans. We should also think about caps on the amount of short-term debt that financial institutions can use, as well as the establishment of minimum requirements for the issuance of long-term debt. And money market mutual funds should be required to use a floating NAV which should substantially reduce this highly volatile source of short-term funding.

Finally, I hope that regulators will give high priority to finalizing simple, enforceable rules to implement the Volcker provision of the Dodd-Frank statute, rules that focus on the underlying economics of a transaction as opposed to its label or accounting treatment. If the transaction will make money by the customer paying for a service through fees, interest, and commissions, it should pass the test. But if profitability or loss is driven by market movements, then it should fail. And gray areas associated with market making and investment banking should be done outside of the insured bank and supported by high levels of capital.

Much work remains to be done to rein in the types of activities that caused our 2008 financial crisis. It is my hope that the Fed will soon issue its long-anticipated rules on heightened prudential standards for large financial institutions. Robust implementation of a credible resolution mechanism, strong capital and liquidity requirements, and curbs on proprietary trading can once again make our financial system the envy of the world and an engine of growth for the real economy.

Thank you very much.

Chairman BROWN. Thank you, Ms. Bair.

Mr. Johnson, welcome.

STATEMENT OF SIMON JOHNSON, RONALD A. KURTZ PROFESSOR OF ENTREPRENEURSHIP, MIT SLOAN SCHOOL OF MANAGEMENT

Mr. JOHNSON. Thank you very much, Senator.

I think the Brown-Kaufman amendment, which would have imposed a hard cap on the size of banks relative to the economy, was exactly right when it was proposed. I think that is exactly what we need today, and I would like to point out to the Committee that this is absolutely not a partisan issue. Presidential candidate Jon Huntsman in his financial reform program has endorsed exactly this approach, perhaps even wants to go a little bit further than you, Senator Brown, in terms of making this actually happen immediately. And his point and I think the point that resonates across the political spectrum is the arrangements we have right

now are not a market. We are looking at—with the continued existed of too-big-to-fail banks, we have an unfair, nontransparent, and extremely dangerous Government subsidy scheme. I think sensible people on the right and on the left recoil in horror when they see the details of this scheme, and we should work to end it. And I think the Brown-Kaufman amendment is the best workable bipartisan idea that we have before us.

Now, to answer your four questions directly, Senator Brown: Did you grant enough authority under Dodd-Frank? No, I am afraid you did not, and the problem, Senator Hagan, is exactly the global nature of these businesses. Let me use two quotes that are in my written testimony. One was a senior—I have heard the same things from many people in private. These are on-the-record remarks. A senior Federal Reserve Board regulator said in, apparently 2011, post-Dodd-Frank, "Citibank is a $1.8 trillion company, in 171 countries with 550 clearance and settlement systems . . . .We think we're going to effectively resolve that using Dodd-Frank? Good luck!"

I think the problem relative to the Economist simulation, Senator Hagan, which I have also paid attention to, is they were doing a very simple business there. They said it was a trillion-dollar bank. They had a U.S. and U.K. operation. There was a *deus ex machina,* a sleight of hand. They assumed a stay on the U.K. business, derivative business, that actually would be illegal. Anyone operating a U.K. business on that basis would go to jail. But they used that in their simulation, in one country. There is no cross-border authority you can grant. The U.S. Congress cannot do that. You need an intergovernmental agreement. There is no such agreement. There is nobody at the level of the G20 with whom I am familiar who is pushing for such agreement. It is not going to happen. Despite all the very hard and great work done by Ms. Bair and her colleagues, you cannot do cross-border resolution, and that is the issue for the big six megabanks.

Your second question was: Will the regulators use the authority which you granted them? I do not think so, and I would turn specifically, not to single them out but it is a graphic case, to Bank of America, the exemption they apparently received from Section 23A that allowed them to transfer the derivative business to the deposit side of the bank, insured by the FDIC. We are just encouraging the same sort of risk taking, but an egregious, dangerous level. This is the taxpayer subsidy at work in our faces. And what do the regulators say about this? I understand the matter is still being discussed, but as far as I hear, they are just going to let it go. So you gave them the authority to stop exactly this kind of activity, and they will not stop it.

Your third question, Senator, was: Will the market increase the equity funding? Will there be more capital in these banks due to market pressure? And I think the answer to that is obviously no. The externalities, the spillover effects are what this game is all about. That is how you get the subsidies. These executives are paid on a return-on-equity basis unadjusted for risk. They like leverage. This is the mechanism. And the regulators, again, will not move sufficiently—Anat Admati, for example, a professor at Stanford, has been pressing very hard on the basis of deep knowledge of cor-

porate finance—and absolutely unanswerable arguments. She has been pressing for the suspension of dividends by these banks until they have reached a much higher level of capital. And she has not just been rebuffed by the regulators. Typically, they will not even speak to her.

What kind of process is this? If you want to see where this is going, Senators, I suggest you look carefully at Europe. The European banking system is in a slow, dramatic meltdown because of insufficient capital. Their banks, of course, are likely beyond too big to fail. They are in the too-big-to-save, which is the Irish experience. That is where we are heading, too.

Your last question, Senator, was: Will the market force these banks to exit their lines of business? Will we have any version of the Volcker Rule as proposed by Senators Merkley and Levin? Will that really come into force? I do not think so. I think that that amendment—the legislation as drafted is exactly on target, but what we are seeing now come out of the regulatory process is not convincing, and I have the details in my written testimony.

Thank you, Senator.

Chairman BROWN. Thank you, Mr. Johnson.

Mr. Swagel, welcome.

STATEMENT OF THE HONORABLE PHILLIP L. SWAGEL, PROFESSOR OF INTERNATIONAL ECONOMIC POLICY, UNIVERSITY OF MARYLAND SCHOOL OF PUBLIC POLICY

Mr. SWAGEL. Thank you, Chairman Brown, Ranking Member Corker, and Members of the Committee. Thank you for the opportunity to testify today.

The diversity of firm sizes in the U.S. financial system is an important strength of the U.S. economy. I would say that both small banks and large financial institutions play an important role in fostering a strong U.S. economy.

As discussed in my written testimony, I believe it would be a mistake to break up large, complex financial institutions. This would sacrifice considerable benefits to the U.S. economy and to broader society without a commensurate gain in terms of a safer financial system.

The Dodd-Frank Act takes a better approach, which is to strengthen regulation and oversight of large, complex financial institutions, including with features that will help regulators detect, avoid, and respond to future crises. The Financial Stability Oversight Council, the FSOC, in particular will help avoid a repetition of the problems in which no regulator had clear responsibility for AIG.

Increased capital and liquidity requirements on large financial institutions will better allow firms to absorb losses and weather market strains. But there will be an impact on financial intermediation, and thus on the economy. Real-world banks react to binding capital requirements by making fewer loans, and increased capital requirements could again drive activity into the less regulated shadow banking system. Higher capital standards are useful, but they do not escape the tradeoff between stability and economic vitality.

The new regulatory regime in Dodd-Frank does not break up large financial institutions or reinstate the Glass-Steagall separation of commercial and investment banking. I think this is appropriate. The repeal of Glass-Steagall is not well correlated with failures in the recent crisis. Bear Stearns and Lehman Brothers, for example, both remained investment banks and failed, while JPMorgan Chase crossed the Glass-Steagall line, combining investment banking and commercial banking, but weathered the strains of the crisis. I would focus instead on the characteristics of firms, assets, liabilities, and activities.

As I said, small banks play a vital role in our economy. At the same time, there are important benefits to the U.S. economy from having financial institutions with large and diverse balance sheets that can best make liquid markets for large transactions and across a broad range of assets. Large banks are best able to serve large clients in trade finance, global lending, cash management, and other aspects of capital markets.

My view is that it is a reality that large financial institutions are the ones that are best able to undertake commercial transactions for the large multinational clients that are a hallmark of the globalized economy.

Now, having said that, my view is that the Title II resolution authority in Dodd-Frank is an important step forward in addressing the phenomenon of too big to fail. Title II puts bond holders firmly on notice that they will take losses when a firm is resolved. It would be desirable for this resolution to proceed as much as possible along the lines of a bankruptcy proceeding and with as little interference from the Government as possible. And in this I would include that the Government should refrain from propping up firms for an extended period of time, and especially refrain from ordering firms that fall into Government control from taking actions for policy purposes.

Finally, the unfinished business of financial regulatory reform includes the future of Fannie Mae and Freddie Mac, regulation of money market mutual funds, and improvements to the international coordination of bankruptcies of financial firms. And I would just note that an event in the week that Lehman and AIG failed that especially deepened the severity of the crisis was the breaking of the buck by a large money market mutual fund. It was a very large fund but very far from a complex one. It was almost the simplest asset class you could imagine. And yet that was really the spark that greatly increased the severity of the crisis.

The new regulatory regime for large, complex financial institutions represents progress, but much of the new regime remains a work in progress.

Thank you very much.

Chairman BROWN. Thank you, Mr. Swagel.

Mr. Wilmarth, welcome.

STATEMENT OF ARTHUR E. WILMARTH, JR., PROFESSOR OF LAW AND EXECUTIVE DIRECTOR OF THE CENTER FOR LAW, ECONOMICS AND FINANCE (C-LEAF), GEORGE WASHINGTON UNIVERSITY LAW SCHOOL

Mr. WILMARTH. Thank you. Chairman Brown, Ranking Member Corker, distinguished Members of the Subcommittee, thank you for allowing me to participate in this important hearing.

In an article published in 2002, I warned that too big to fail was the great unresolved problem of bank supervision because it undermined both supervisory and market discipline. I noted that Congress' enactment of the Gramm-Leach-Bliley Act allowed financial conglomerates to span the entire range of our financial markets. I warned that these financial giants would bring major segments of the securities and life insurance industries within the scope of too big to fail, thereby expanding the scope and cost of Federal safety net subsidies.

I predicted that financial conglomerates would take advantage of their new powers under Gramm-Leach-Bliley and their too-big-to-fail status by pursuing risky activities in the capital markets and by increasing their leverage through capital arbitrage.

In another article written 7 years later, I pointed out the financial crisis confirmed all of my earlier predictions. As I explained, regulators in developed nations encouraged the expansion of large financial conglomerates and failed to restrain their pursuit of short-term profits through increased leverage and high-risk activities. As a result, those institutions were allowed to promote an enormous credit boom that precipitated a worldwide financial crisis.

Private sector debt in this country increased from $10 trillion in 1991 to $40 trillion in 2007, and the majority of that increase took place in the household and financial sectors. That unhealthy credit expansion, in my view, could not have happened without the financial conglomerates that Gramm-Leach-Bliley made possible.

In order to avoid a complete collapse of global financial markets, central banks and Governments in the U.S. and Europe provided more than $10 trillion of support for major banks, securities firms, and insurance companies. Those support measures, which are far from over, established beyond any doubt that too big to fail now embraces the entire financial services industry.

The Dodd-Frank Act does improve the regulation of systemically important financial institutions, or SIFIs, and certainly Chairman Bair deserves great credit for her role in making that possible. However, Dodd-Frank does not completely shut the door to future Government bailouts for creditors of SIFIs. The Fed can still provide emergency liquidity assistance through discount window lending and, in my view, through group liquidity facilities similar to the primary dealer credit facility, designed to help the largest financial institutions.

Federal home loan banks can still make collateralized advances. The FDIC can potentially use its Treasury borrowing authority and the systemic risk exception to the Federal Deposit Insurance Act to protect uninsured creditors of failed SIFIs and their subsidiary banks.

Dodd-Frank has made too-big-to-fail bailouts more difficult, but the continued existence of these avenues for financial assistance indicates that Dodd-Frank has not eliminated the possibility of too-big-to-fail bailouts. And certainly Standard & Poor's agreed with that view recently in a July 2011 report.

Dodd-Frank also relies heavily on the same supervisory tools—capital regulation and prudential supervision—that failed to prevent the banking and thrift crises of the 1980s and the current financial crisis. As you have explained, Chairman Brown, one other approach would be to break up in a mandatory way the largest banks. I am sympathetic to that approach, but I think it is unlikely, given the megabanks' enormous political clout, that Congress would vote to require involuntary break-ups absent a second and perhaps cataclysmic crisis. Professor Johnson has pointed out that it took the panic of 1907 and the Great Depression to produce the Glass-Steagall Act. I hope we do not have a second bite of the same poisoned apple.

The third possible approach, and the one I advocate, is to impose structural requirements and activity limitations that would prevent SIFIs from using the Federal safety net to subsidize their speculative activities in the capital markets and would also make it easier for regulators to separate banks from their nonbank affiliates if a SIFI fails. First, I propose a prefunded orderly liquidation fund that would require all SIFIs to pay risk-based assessments to finance the future costs of resolving failed SIFIs. We would not accept a postfunded deposit insurance fund. We know that would be far too hazardous to the welfare of bank depositors. Why should we accept a postfunded orderly liquidation fund that will deal with much more massive potential payments?

Second, we should repeal the systemic risk exception to the Federal Deposit Insurance Fund. That provides a very large potential bailout fund for uninsured creditors of failed megabanks. We should not allow that backdoor bailout device to exist. The Deposit Insurance Fund should not be exposed to that risk. Community banks cannot benefit from it. Why should they have to pay for it?

Last—and I can explain this more in response to questions—I believe we should adopt a two-tiered system of financial regulation. Traditional banks could operate much the way they do now, but they would have to restrict their activities to those that are closely related to banking. Financial conglomerates would have to adopt a narrow bank structure that would rigorously separate the FDIC-insured bank subsidiary from all of their nonbank affiliates and all their capital markets activities. That would prevent SIFIs from using FDIC-insured, low-cost funds to cross-subsidize risky speculative capital markets activities. The danger of cross-subsidization is certainly raised by exactly the derivatives transfer issue that Professor Johnson pointed out with Bank of America.

In conclusion, my proposed reforms would strip away many of the safety net subsidies currently exploited by SIFIs and would subject SIFIs to the market discipline that investors have applied in breaking up many commercial and industrial conglomerates over the past 30 years. SIFIs have never demonstrated that they can provide beneficial services to customers and attractive returns to investors without relying on safety net subsidies during good times

and Government bailouts during crises. It is long past time for financial conglomerates to prove, based on a true market test, that their claimed synergies are real and not mythical. If, as I believe, SIFIs cannot produce favorable returns when they are deprived of their current too-big-to-fail subsidies, market forces should compel them to break up voluntarily.

Thank you again for the opportunity to present this testimony.

Chairman BROWN. Thank you very much, Mr. Wilmarth, for your testimony.

I would first like to ask the Subcommittee's unanimous consent to include two excellent speeches on too big to fail in the hearing record. Former Fed Chair Paul Volcker wrote, "Three Years Later: Unfinished Business Of Financial Reform", and Federal Reserve Bank of Dallas President and CEO Richard Fisher wrote, "Taming the Too Big to Fails: Will Dodd-Frank Be the Ticket or is Lap-Band Surgery Required?" With no objection, so ordered.

I will start the questioning, and if we need to do certainly two rounds, if the witnesses are willing, we would probably like to do that.

I would like to address an issue that Senator Vitter raised at the hearing in the full Committee yesterday. Tom Hoenig points out, the just recently retired Kansas City Fed President, that the biggest banks enjoy funding advantages over their community bank competition and regional bank competition. Chairwoman Bair has shown that the biggest banks operate with less capital and more leverage.

Each of you, if you would give your opinion on the question, is this—the advantages they have to attract capital—is it due to Government support for these institutions, explicit or implicit support? Think about that question for a moment. And also, does it seem fair that Government is intervening that way, implicitly or explicitly in the market by providing the biggest banks with those subsidies? I will start with Mr. Wilmarth, if you would.

Mr. WILMARTH. I absolutely agree. I discuss this issue in my written testimony, particularly on pages six and seven. A recent study by Joseph Warburton and Deniz Anginer, "The End of Market Discipline", gives the following figures. They calculate that the implicit too big to fail subsidy gave the largest banks an annual average funding cost advantage of approximately 16 basis points before the financial crisis, increasing to 88 basis points during the crisis, peaking at more than 100 basis points in 2008. The total value of the subsidy amounted to about $4 billion per year before the crisis, increasing to $60 billion annually during the crisis, topping at $84 billion in 2008.

And they also found that the passage of Dodd-Frank did not take that subsidy away. In fact, expectations of Government support rose in 2010 compared to 2009. That study provides dramatic evidence of the size and magnitude of the subsidy that SIFIs enjoy today and have enjoyed for a number of years. Their study covered 20 years, from 1990 to 2010.

Chairman BROWN. Mr. Swagel.

Mr. SWAGEL. This is an area in which the situation is changing and will change as a result of Dodd-Frank. When I look at the funding of small banks and of large banks, and every bank is dif-

ferent, so this is a very broad statement, small banks generally fund themselves with deposits, a good thing, covered by FDIC Insurance for which they pay premiums and with FHLB advances, which are covered by a Government guarantee. So that is the funding, the main funding sources for smaller banks.

Large banks, on the other hand, pay premiums on their funding that are not deposits. So nondeposit funding now requires a premium to be paid to the FDIC even though it is not actually covered by the Deposit Insurance Fund. Then looking forward, there will be a capital surcharge for systemically important banks. And then importantly, as I discuss in my written testimony, the resolution authority under Title II is really a regime change. That will say to bondholders in the future, you will take losses. If a bank goes down, you bondholders, there are no more bailouts. There is no more 100 cents on the dollar. You will take losses. I expect, going forward, that to have a big change on funding, as well.

Chairman BROWN. Mr. Johnson.

Mr. JOHNSON. Reasonable estimates of the funding advantage for large banks range between 25 and 75 basis points, 0.25 percentage point to 0.75 percentage point. This is the same sort of funding advantage that Fannie Mae and Freddie Mac had. I do not think Fannie and Freddie were the primary cause of the financial crisis in 2008, but there is no question that they took excessive risks. They had far too much leverage. They were too powerful politically and they blew themselves up at great cost to the American taxpayer. Who are the Government Sponsored Enterprises of today? It is the too-big-to-fail banks with a massive, unfair, nontransparent, and extremely dangerous funding advantage.

Chairman BROWN. Ms. Bair.

Ms. BAIR. Yes. We have been—I have been personally concerned about this for a long time and the funding differentials remain much worse after 2008 as a result of the crisis and the bailout strategies that were employed.

Phil is right. There is a difference in how small banks fund themselves and large banks, but even if you look at the comparative costs that they pay for deposits, there is a differential, and so, clearly, we have a problem. I think we do not end too big to fail until we convince the market and specifically the bondholders that they are not going to get bailed out anymore. That cheap debt that the large banks can issue right now is a big driver of their funding advantages. The rating agencies have eliminated some of the bump-up that they give large banks now based on the assumptions of implied Government support, but we still have a long ways to go. We do not end too big to fail until we convince the market that it is gone.

I would also add, to echo Art's comments during his opening statement, I also supported a prefunded reserve during Dodd-Frank and one of the reasons we wanted to do that, we wanted to calibrate the assessment based on the funding differential. And as we ended too big to fail over time, that funding difference would have narrowed the assessment. But in the near term, it could have helped end this advantage that they had. We got the fund through the House, not through the Senate. But I do think that would have been an advantage of having the prefunded reserve.

Chairman BROWN. OK. Thank you.

Senator Corker.

Senator CORKER. Thank you, Mr. Chairman.

Mr. Johnson, you, I know, have made quite a name for yourself talking about this issue. You are somewhat entertaining. I would say on the 23(a) issue you mentioned, that actually is not the case, just for what it is worth. The transfer from Merrill Lynch to B of A was actually below the 10 percent threshold. But you might just want to take note of that.

But let me, Sheila, you feel like that we, based on the Title II resolution, you feel like that we have solved the too-big-to-fail issue, is that correct?

Ms. BAIR. I think the tools are there to end too big to fail.

Senator CORKER. But you would agree that if we had a systemic failure where multiple institutions, we have not dealt with that, is that correct?

Ms. BAIR. Well, I think Dodd-Frank provides the ability for the Fed under 13(3) to provide systemic support to solvent institutions if you have some type of external shock, for instance, if the European banking system goes down——

Senator CORKER. Right.

Ms. BAIR. ——I do not think we should hold our banks for that——

Senator CORKER. And there is almost no regime that can deal with systemic——

Ms. BAIR. Right. You have to have some flexibility for that. We would have liked actually higher hurdles for 13(3), but it is much better now. There are much better disclosure requirements and required explanations to Congress, so it has improved a bit.

Senator CORKER. Good. Thank you. You, like me, answer fully.

On the Volcker issue we were talking about where banks at the end should not make or lose money off transactions, it was interesting to me that Volcker excluded Treasury. So do you include Treasuries in that, that banks should not buy Treasuries and make or lose money off of that, and why did we exclude Treasuries? Is that because the Treasury Department actually hated Volcker and they did not want to be impacted themselves by it? Why did we do that, briefly, if you could.

Ms. BAIR. I do not know, maybe because it has traditionally been a fairly—not a highly——

Senator CORKER. Well, you can make or lose a lot of money on Treasuries.

Ms. BAIR. You can, and certainly if interest rates start going north at some point, which they probably will, you could probably lose a lot of money. So I do not know the rationale. We were not there——

Senator CORKER. So, really, banks, though, should not own Treasuries to make or lose. They should not own——

Ms. BAIR. Well, I think if they are buying a lot of Treasuries as a speculative bet, they should not, absolutely not. If they are buying Treasuries to keep liquid assets on hand, if they are using it to collateralize repos, that is probably OK. But, no, if they are taking big positions in Treasuries to make money, they should not do that.

Senator CORKER. So I am actually still trying to understand where we need to be on the size of these institutions, and I did think that the amendment offered on the floor, had no hearings and was not well thought out at the time, but I think we are all kind of evolving and learning.

How small is small? I mean, we have 15—of the 15 largest banks in the world, we have two of those and we have a Government that borrows huge amounts of monies nonstop because of our lack of discipline and we need banks to actually buy those Treasuries for us. We need primary dealers.

So, Mr. Johnson, briefly, what size should be the right size when we have—you know, we dominate the world as far as GDP. We have two of the largest 15 banks in the world, not the top. What is the right size?

Mr. JOHNSON. Well, Senator, on the size comparisons, I would urge us all to be careful, because if you are comparing banks under U.S. GAAP with European banks, for example, under IFRS, their accounting system, for a bank that has a large derivative book, that would be understanding the U.S. GAAP bank. So I think if you do the correct numbers, and I am happy to go through this with your staff, we actually have many more of the big banks—we have some of the biggest banks in the world on that basis.

On size, I believe the Brown-Kaufman amendment would have rolled back the largest six banks to, roughly speaking, the size they had in the mid-1990s. Goldman Sachs, for example, in 1998 was a $200 billion bank. It was about $280 billion in today's money. It was one of the world's leading investment banks, absolutely great business——

Senator CORKER. So give me the number. I mean, what is the size?

Mr. JOHNSON. Two percent of GDP was the size cap for investment-type banks under Brown-Kaufman and 4 percent of GDP was the size cap proposed for retail-type banks and that is eminently sensible. Between 300—this is not risk-weighted. There is no risk-weighting gaming here because that gets out of hand. So let us say between $300 billion and $600 billion total assets.

Senator CORKER. And Mr. Swagel, I know that I personally was highly involved in Title II and worked closely with Chairman Bair. One of the pieces we did not really ever have the opportunity to deal with properly was bankruptcy. Are there things in Title II that you think ought to be altered to take into account a large highly complex bankruptcy?

Mr. SWAGEL. Thank you. I worry about the amount of discretion that is left to Government policy makers within Title II. One can look at the derivative book, and there are proposals about whether derivatives should be stayed or not stayed and essentially kept out of the resolution—a change in the bankruptcy code, so that is one area to look at.

One other area that I am really the most concerned about is, as I said, the discretion that policy makers have within the resolution authority. It is meant to follow a bankruptcy-like proceeding with an order of priority for creditors, and the FDIC has said that they will do that. But ultimately, it is really up to the discretion of the

regulator, and it is really the difference between a judicial system like bankruptcy and a political one, which ultimately Title II is.

Senator CORKER. Thank you. I know my time is up and look forward to the second round.

Chairman BROWN. Thank you.

Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chair.

I wanted to turn, Ms. Bair, to page two of your testimony, when you note essentially that—let me see here—shareholders were not wiped out before the Government took exposure. I think people still kind of wonder why, even under those emergency circumstances, why did shareholders not take a loss before the taxpayer did? And as we look back on it with a little bit of distance now, is there a clear explanation that, a sort of explanation I can share with my constituents when they ask the question why their task funds were put at risk but shareholders did not take a loss?

Ms. BAIR. Well, I think that is what it means to bail out an institution. You keep the institution open. You preserve value even at the shareholder—the common equity level. And shareholders did take loss when the market punished them, but the Government did not impose losses. That is what a bailout is. You keep the institution open. And I think we did it because we did not have tools outside of insured banks. We did not have tools to resolve the entity in a holistic way. Lehman did obviously wipe out the shareholders, but the bankruptcy was highly disruptive. WAMU, the shareholders were wiped out. That was a good example of the FDIC resolution process working in a way that imposed discipline on shareholders and bondholders, took a haircut, as well. But I think the legal tools were not there.

I think looking back, hindsight is always 20/20, and I say this because I want to make sure we do not make the same mistakes again going forward if we ever, God forbid, get into a kind of situation like that again. But I think perhaps the Government could have been a little more muscular. There was no obligation on the Government to come in and bail out an AIG or whoever, and so, you know, insisting that at least counterparties who were made whole or bondholders who were made whole as well as shareholders should have voluntarily taken some additional losses or set up bad bank structures where their liabilities would have funded the bad assets, I think those were mechanisms that we did not explore. We did not have time, and I just wish we had. But the point is, we were behind the curve and we did not have a lot of information and had to make decisions quickly and the easiest thing to do was just to keep the institution open and prop it up.

Senator MERKLEY. Well, thank you. The reason I raised that is because later in your testimony, you flag it as a key indicator related to too big to fail, and hopefully I am not pulling this out of context, but we cannot end too big to fail unless we can convince the market that shareholders and creditors will take losses if the institution in which they have invested fails. So I just wanted to flag that as an indication of the future.

You also note in your testimony that many large financial institutions found trading assets, that is proprietary trading, to be much easier and more profitable than going through the hard work

of developing and writing standards for loans that the institutions plan to keep on their books. And this is kind of—this goes right to the heart of the Volcker Rule. Do we provide a discount window and insurance for depositors in order to have and support institutions that provide loans to maintain liquidity to families and businesses, or are these type of advantages going to be applied to carry advantages into the high-risk trading world, and does that high-risk trading, as important as it is in aggregating capital and allocating capital, belong outside of that framework.

I believe I am reading into your comments that you believe it should be outside that framework, but I wanted to make sure that you had a chance to comment on that.

Ms. BAIR. Well, I think—well, trading assets can be a broad category, and not all trading assets would be viewed as proprietary under the Volcker Rule. But I think securitization, for instance, a lot of this is driven by securitization, so you are originating loans or buying loans, mortgage loans originated by others, but securitizing them and then buying back the securities. A lot of that is responsible for the growth in trading assets, and, of course, that process is accompanied by a loss of underwriting discipline in the process.

So I do think that insured losses are there to extend credit to the real economy and I think that makes loans and services that are incidental to the provision of credit to the real economy. And if it does not pass that test, then no, I would rather it not be outside of insured banks, and I know Dodd-Frank is what it is and the Volcker Rule provisions are as they are, but it might have been easier in retrospect to try to think, instead of trying to say what we do not want insured banks and affiliates to do, try to think what we want insured banks to do and recognize that there are some legitimate functions, financial services functions performed by securities affiliates that do involve some position taking, Market making and investment banking are two prime examples, but make sure those are kept outside—insulated from the insured institution and, frankly, supported by higher capital, not lower capital.

So I do. I am a traditionalist and I think insured deposits should be there for credit support for the real economy and things that go beyond that should not be in the bank.

Senator MERKLEY. Do I have time to restate my understanding of what Sheila just said? Do I understand you to say it would have been easier, if you will, to say this is the business, the business of lending, is what the commercial banks are in——

Ms. BAIR. Right.

Senator MERKLEY. ——and that if you want to do wealth management, if you want to do market making, if you want to do those things, all of that should be outside the framework, and then we should not have the complexities of trying to distinguish market making from proprietary trading.

Ms. BAIR. I think that is right. It is very difficult, I think, to know where that line is. You are going to have gray areas, so I would force those outside the insured bank. I think you can keep them within the larger holding company structure so long as there is a good firewall and you have higher capital supporting that ac-

tivity. But, again, my preference would be to force them outside of the insured bank, yes.

Senator MERKLEY. Thank you, and I know you have thoughts on this which I hope to come back to during additional time. Thank you.

Chairman BROWN. Thanks, Senator Merkley.

Senator Moran.

Senator MORAN. Chairman Brown, thank you. Thank you all for your presence here today. I wish we would do more of this in which we take a broader picture, a more, perhaps, thoughtful opportunity to discuss these issues. They are somewhat new to me in the sense I have never been on the Banking Committee before and I want to raise just a couple of topics in the time that I have.

This may be for you, Mr. Secretary, and really for any panel member who would like to respond, but you indicate in your testimony the key element for addressing too big to fail is that bondholders take losses. Is there anything in Dodd-Frank that now causes investors in banks in the United States to believe that they will take a loss should a failure occur? What did Dodd-Frank do to emphasize that message? So the question, I guess, is are we better off with Dodd-Frank than we were before on this issue?

Mr. SWAGEL. I will be very quick. I think the answer is yes, that the orderly liquidation authority means that the equity holders, the shareholders will be wiped out and then if the Government puts money in and there are any losses to the Government, bondholders will get clawbacks retroactively. So I think that is it.

Senator MORAN. So is there evidence that bondholders, investors, and, therefore, the management of financial institutions are behaving differently because they now believe that potential exists? What evidence is there that that message has been received and, therefore, conduct has changed?

Mr. SWAGEL. Right. So the evidence I know of is the one that Chairman Bair mentioned, that the rating agencies have said, we are changing our view of these institutions because of less support as a result of OLA, orderly liquidation authority. I think it is too early to say that funding is more expensive. Now, that is something that we are all going to be looking at going forward.

Senator MORAN. But nothing, no evidence at this point that management would have a different discussion. In a board room, you are going to have a different conversation about the risk that the bank is willing to take because, oh my gosh, Dodd-Frank passed and our bondholders or investors may be at risk. I mean, are we at that level?

Mr. SWAGEL. I think we are. Again, it is hard to know because it is so new and it has never been used so we do not know exactly how it is going to take place. But I think going forward, bondholders, especially of risky institutions, will exercise much more scrutiny. In a sense, there will be more of a "let us flee to the exit." As soon as a firm gets into trouble, bondholders are going to say, hey, we are getting close to the red line. We want to be out of here.

Senator MORAN. Sheila Bair, being a Kansan, demonstrated her agreement with you by body language——

[Laughter.]

Senator MORAN. ——but I also think that Mr. Johnson perhaps indicated that that was not the case. Did I read your body language? Do you have something that you would like to——

Mr. JOHNSON. Yes, Senator. I strongly disagree. I talk to people—I agree that this is new territory and I agree with the intention here. But I talk to a lot of people in the financial sector, including people who work in and around these big banks. I do not think their attitudes have changed at all. There is still the perception of too big to fail. As Ms. Bair said, it is all about the market perception. Does the market think that JPMorgan Chase or Bank of America or Citigroup or Wells Fargo or Goldman or Morgan Stanley could fail, and I talk to people in the market and they tell me no.

I ask audiences whenever I address them, who in the room thinks that Goldman Sachs, for example—a hypothetical example—who thinks Goldman Sachs could fail so the bondholders lose their money? I asked it at a conference recently that Professor Wilmarth organized. Typically, no more than one person in the audience raises his or her hand, and it turns out that one person is engaging in wishful thinking.

Senator MORAN. Let me ask perhaps what I hope is not a timely question, but very well may turn out to be. My assumption would be that financial institutions in Europe are at some risk. What has happened as a result of Dodd-Frank that limits the ability for U.S. banks to also become more at risk because of the challenges of the financial circumstances in Europe or elsewhere in the world?

I asked a slightly different question yesterday of Government officials. I was trying to figure out, it seems to me just a perspective that too big to fail, there are still institutions that are just as large as they ever were, perhaps even larger, so that the common perception of too big to fail has not changed. I mean, I do not know that Kansans would see the evidence that we have a lot of smaller institutions. In fact, as Sheila Bair would have—could testify, we have fewer smaller institutions as a result of bank closures, and it often seems that it is the small banks that are, in many ways, paying the price, even though they present no systemic risk.

And so my question is, have we done something that reduces the chances that what happens elsewhere in the world affects our financial institutions, and at the same time, is there a regulatory arbitrage—there is probably a better phrase for that than what I have said—between the two, between banking institutions or financial institutions that are chartered in the United States and chartered someplace else in the world? Do we get all the burden of the additional regulations but still have to worry about the consequences of a bank failure that is less regulated, perhaps, elsewhere in the world, but we get the stuff that flows from their failure? Anyone.

Mr. JOHNSON. Senator, I would commend to your attention Taunus Corporation, which is the eighth or ninth largest bank holding company in the United States. It is a wholly owned subsidiary of Deutsche Bank. It is 77-to-one times leveraged. Deutsche Bank itself is a very highly leveraged global corporation. Public news reports say that the U.S. regulators have asked for additional capital to be put into Taunus because they regard the leverage as

excessive in today's environment because of the situation in Europe. It has not happened.

And I think the problem is exactly what you just put your finger on, that we are no less vulnerable, perhaps more vulnerable now to this incredible disaster in and around the banking system in Europe. It is going to spill over to us in many ways through counterparty risk in derivatives, for example. But Taunus Corporation is a spectacular in our faces demonstration of these risks becoming bigger, not getting smaller.

Senator MORAN. Mr. Chairman, I do not know whether your rules are that they get to answer my question as long as I ask it within the 5 minutes, or if my 5 minutes is up before they respond, but——

Chairman BROWN [gesturing].

Senator MORAN. Mr. Chairman, thank you. I know the Professor was nodding and——

Mr. SWAGEL. I will be very brief. I think two things have changed. One is Dodd-Frank, the Financial Stability Oversight Council, and again, I think that can get somewhat at the AIG problem of cracks in the system, in the regulatory system. I suspect the regulators, the members of the FSOC, have been very diligent about looking at the exposure of American banks to European problems. I would have hoped they would have done that before Dodd-Frank, but I suspect they are really on top of it now to the extent they can be.

Number two is not Dodd-Frank but our financial system is better capitalized, is in better shape, is less risky than it was before the crisis. That is not a solution, but at least it is progress.

Ms. BAIR. May I say something? Just a couple of things. I think Simon and I are talking to different people. I talk to a lot of bondholders and I think they are very aware of Dodd-Frank and very aware of the strong rules that the FDIC has put forward and the strong rhetoric coming out of a lot of the leadership, not just from me, when I was in my Government position. I think they are very focused on this and understanding what the ramifications will be and understanding that they will be at risk of loss. I think the rating agencies are reflecting that by providing downgrades. They used to give a bump-up and there is still a little bit of that left. But I think it is starting to change the mindset of bondholders.

With regard to Europe, I would just say that Dodd-Frank cannot fix everything that is beyond our borders. I do think that certain jurisdictions, like the United Kingdom, are serious about resolution authority and I think we are making progress there. The FSB just recently came out, with heavy input from the FDIC, with a framework for a multinational resolution regime. There are tools that can be used now for cross-border failures and the Lehman paper, I think, is instructive in terms of one of the approaches that could be used for cross-border resolution, pending development of a broader multinational resolution regime.

I would also say that there were some regulators warning early on about problems in Europe. Back in 2006, my first Basel Committee meeting as Chairman of the FDIC, I went to them and I said, you need to have a leverage ratio. They had started implementing the Basel II advanced approaches and they were lowering

the capital levels substantially with what is called a risk-weighted approach. Leverage ratios are an absolute constraint on leverage. We have had one here for a long time and it really—it saved our bacon during the crisis.

But Europe has refused to do that. They have quite different attitudes about the relationship between regulators and banks and what is appropriate in terms of the capital regime and I think they are learning now, but I think there were U.S. regulators who were trying to advocate and prevent some of the problems we are seeing now in Europe many years ago.

Chairman BROWN. Thank you, Senator Moran.

We will begin a second round of questions, if my colleagues want to join in that.

I assume some of you saw or at least heard of the "60 Minutes" piece on Sunday might. They ran two segments of the three segments on the show questioning the whole issue of whether—why none of these bank executives from Countrywide to any of the larger institutions went to prison, raising the question of the complexity of these institutions. Is the Government too timid, in part because they do not want to lose a case? Was there outside pressure on the Justice Department? That seemed to be answered probably no on that, but no one knows for sure, I guess, or we do not know for sure. Was the Government simply the—when you think of a Government lawyer making $150,000 matched up against a battery of lawyers making significantly more money than that and more experienced in dealing with the complexity of these institutions.

It sort of brings me to this next question. The Financial Crisis Inquiry Commission report noted that the largest U.S. bank in 2007 had a $2 trillion balance sheet with more than 2,000 subsidiaries. Today, that bank is now under $2 trillion, but there are now two banks that, I guess, JPMorgan Chase is over $2 billion as is Bank of America. Andy Haldane from the Bank of England said that calculating the regulatory capital ratio of the average large bank under the Basel regime would require over 200 million calculations.

Professor Wilmarth cited a study that investors tend to look at banks' credit ratings, which include the likelihood of Government support, to make their investment decisions. Chairman Bair mentions that the rating agencies have begun to remove the bump-up they assign to the credit ratings of large financial institutions based on their previous assumption of Government support.

It may lead to the conclusion that too big to fail just means too big to manage, too big to regulate. Are the markets, when making investment decisions, are they looking at the perceived level of Government support for these banks when they make these decisions? Is it too complicated for the market to make it any other way? Chairman Bair.

Ms. BAIR. Well, I think that—I think there is not—or we are transitioning out of that, but I think in the lead-up to the crisis, too big to fail was very much a factor in making investment decisions. And then, of course, in 2009 with the stress test, we pretty much told everybody, if you are above $100 billion, we are going

to backstop these institutions. And so, clearly, that capital raising was based on an assumption of Government protection.

So now in Dodd-Frank we are trying to transition back out of that and get rid of all that moral hazard that we created with the bailouts that continued well into 2009, but it is going to take some time. My sense is that if we can convince the market that it is gone, you are going to see market pressure for these institutions to downsize because these bondholders cannot understand everything that is going on inside of a multinational entity with over 2,000 legal entities.

And as a parallel process to that, I hope that the Fed and the FDIC will be very aggressive in requiring structural changes so that some of them have 20 legal entities as opposed to 2,000 and making sure those legal entities are rationalized with their business lines, so if they need to break off and sell the mortgage servicing operation or the credit card operation or the derivatives dealer or whatever, it is feasible to do that if the institution comes under distress.

Chairman BROWN. Do you think that is a natural evolution, natural in the sense within the——

Ms. BAIR. I think it is——

Chairman BROWN. ——context of what we did with Dodd-Frank?

Ms. BAIR. I think shareholders and bondholders, to some extent, have seen value in these large institutions based on their implied Government subsidies. Once that is gone, I am not so sure they are going to see value anymore with these very large institutions, and you might even see shareholders think that they can unlock value if some of these entities are broken up. They might be worth more in separate entities that are easier to manage and easier to understand on the investing——

Chairman BROWN. Is that happening, Mr. Johnson, in your mind?

Mr. JOHNSON. No, sir——

Chairman BROWN. Or will it happen?

Mr. JOHNSON. Well, not until you end too big to fail, effectively. I agree with Ms. Bair totally on the objective here and exactly on the mechanism. But if you read the speeches of the CEOs, what do the CEOs say to their shareholders? What do they communicate to the market? And I cover these in detail and I am happy to send you and your staff examples. Mr. Vikram Pandit, for example, the head of Citigroup, says he wants to make Citi bigger, more global, operate in more markets, and from the, again, the on-the-record comments of Mr. Timothy Geithner, the Treasury Secretary, he thinks that having our banks go out and become more global, take more risk in emerging markets, for example, he thinks that is a good idea.

Well, it was not a good idea in the 1970s when Citigroup under Walter Wriston bulked up on loans to Latin America, Communist Poland, and Communist Romania, leading in large part to the crisis of 1982 in this country and around the world. Citibank back then was a much smaller bank. It is more than five times the size now. But that is what they want—that is what the executives want to do. That is what they are saying to the market. And I do not

yet see the market pressure on them to break up. Ms. Bair is absolutely correct. That is the litmus test.

Chairman BROWN. Ms. Bair, do executives not want to do that? They all want to grow their institutions. They all want bigger market share. So why is Dodd-Frank pushing them in the other direction through their shareholders and bondholders?

Ms. BAIR. Well, if you increase their capital requirements, I would like to have higher capital requirements. I would like to have at least another 10 percent of the long-term unsecured debt on top of the higher capital requirements. I think you make it more expensive for them to fund themselves, that is going to make it more difficult to grow. It is going to make it more expensive to attract investment dollars. They are going to have to have really good management and convince the investment community that the management knows what they are doing and they have control of their institution and are managing the risk of that institution well. And I think all but the very best managed are not going to be able to make that kind of showing.

So it is hard and I do think it is important for the Government to be sending all the signals, the right signals. And I do not think there should be any ambiguity by anybody in the U.S. Government, wherever they are, that we do not view it as a good in and of itself to keep these institutions alive just because they are big and we do not——

Chairman BROWN. Are we sending those messages?

Ms. BAIR. Well, I think Simon has referred to some of the statements that I think send mixed signals to the market and I do think it is important for the Government to speak with one voice on this. Again, I want the market to drive this. I think—and I would certainly have no objection to your amendment, and given where we are, maybe that is the fastest way to eliminate this threat. But I would prefer that the market drive the appropriate size of these institutions and my sense is if we can convince the market there are no more Government subsidies, you will get significant pressure for them to downsize and break up on their own.

Chairman BROWN. Professor Wilmarth, you have something to say to that?

Mr. WILMARTH. I want to reiterate the importance of the 2009 stress tests, because not only did Federal regulators say, "we will provide any capital needed to allow 19 largest banks to survive," and they actually put capital into GMAC when GMAC could not raise any, they also said, "we are not going to apply the prompt corrective action sanctions against these banks for being undercapitalized," even though those are nondiscretionary sanctions that must be applied by statute. In contrast, there have been hundreds of PCA orders issued against community banks. Unlike the megabanks, community banks got no wiggle room if they were undercapitalized.

Now, the other thing I want to say is that the Dexia rescue which just happened in Europe, provide strong evidence that we have not ended too big to fail. Every time we see the markets under stress, and when major banks that are heavily involved in the markets are under stress, the Governments do everything possible to maintain stability, to prop them up. The Fed just opened

major swap lines to get dollars to European banks. We now know that the Fed not only provided help to European banks by bailing out AIG, they were also giving huge amounts of liquidity assistance to European banks throughout the financial crisis. So this European crisis has been bubbling along under the surface ever since 2008, 2009, but it was kept relatively quiet until last year.

Everything we see the Fed doing is designed to prop up and stabilize and make sure none of these large institutions go down. And so I align myself with Professor Johnson. When I see Federal regulators actually force a bank of the size of Citigroup or Bank of America into what looks like nationalization, where all the shareholders are gone, and where bondholders take major haircuts, then I will begin to believe that too big to fail has ended. But I do not think you can find such an example, other than Lehman, which I think everyone now admits they are sorry they allowed to fail. Other than Lehman, where can you find an example where an institution was taken that way? RBS in Britain, yes, was nationalized. We have not done it here. We have not done the complete nationalization, wipe out the shareholders, impose major haircuts on bondholders, for any of the top six banks.

Chairman BROWN. Mr. Swagel.

Mr. SWAGEL. I would just add, another way to demonstrate to markets that firms will be allowed to fail is to take the living will process seriously, to say, we do not want a firm to fail, but we are ready. We as a Nation, we as regulators, and the firms themselves have to be ready, as well.

Chairman BROWN. Well said. Last comment, then Senator Corker.

Mr. JOHNSON. You could simplify these banks massively under the living will provision so that you could make it easier for them to fail, simple enough to fail as a criteria. I do not think we have seen any progress yet on that front either.

Chairman BROWN. Thanks. Senator Corker.

Senator CORKER. I think this has been interesting. Mr. Wilmarth, are you saying then that you do not think the Fed should open swap lines right now to Europe? I think if Europe failed, it would be a little bit of an issue for us. Are you saying that is what you would like to see happen?

Mr. WILMARTH. No. I am not opposed to it. I am just saying that as long as these behemoths exist, it is inevitable that regulators will feel they have to support them. In other words, it is a chicken-and-egg problem.

Senator CORKER. But is it really the behemoths, or is it the countries? We in essence have urged all banks to buy sovereign debt.

Mr. WILMARTH. Well, I think you are right. The problem is, as financial institutions become very large—and Professor Johnson has explained this eloquently—there becomes a synergistic relationship between Governments and these major banks. And not surprisingly, the Governments support the banks, and then they want the banks to buy the sovereign debt. And it becomes, I think, an incestuous relationship.

I thought letting Lehman fail was a terrible mistake. I think when you are in the soup, you should not turn up the heat and make things worse. But the problem is, can we begin to change the

system going forward? The United Kingdom, as I mentioned in my written testimony, through the report of the Independent Commission on Banking, which the Cameron government has pledged to enact, they would ring-fence the insured depositories from everything else, and they would say, "We are going to make sure there is no cross-subsidization." The ICB has also indicated that they want to make sure that the market will force nonbank capital market subsidiaries to increase their capital because investors in those subsidiaries will know that they are not going to get protection from deposit insurance and other aspects of the safety net.

We could do that here. I think that is the way going forward to actually convince the market. We should protect the so-called utility banks, as the English call them. The utility banks which take deposits, make loans to households and small- and medium-sized enterprises, do traditional fiduciary services, we should protect those. But everything else in the financial conglomerate should not be protected and investments in nonbank affiliates will have to be priced at market.

And so I think going forward we could change, but we have not gone to the extent where the market believes that, in fact, we would separate the institutions in that manner.

Senator CORKER. Mr. Johnson.

Mr. JOHNSON. Senator, I am opposed to the swap lines. This is the euro zone. It is a reserve currency area. They have one of the most credible central banks in the world. They are basically trying—they are transferring credit risk to the Federal Reserve, and they hope to do it to the U.S. taxpayer. You will, I think, shortly see stories about ECB loans to the IMF that will be turned around and lent back to Europe. The IMF's capital—16 percent of it is your capital, the U.S. taxpayers' capital—is absolutely on the line here. It is a culture of bailouts.

Now, I agree with you that we have encouraged banks to lend to sovereigns, and that is part of the irresponsibility, and the Europeans have done that in a——

Senator CORKER. Well, they have to set aside no capital for that. I mean, it is totally—

Mr. JOHNSON. It is ludicrous, Senator. No argument. But my point is they should sort this out for themselves. It is their problem. They got themselves into it. We have created a culture of bailouts at the level of the major central banks in the world in this instance where we are providing them with these swap lines so that we can keep it off their balance sheet so they will not be accountable to their taxpayers fully for the mess they have gotten themselves into. It is crazy. It makes no sense. We should not be participating on that basis.

Senator CORKER. Do you agree with that, Chairman?

Ms. BAIR. Actually, I would be more sympathetic to what the Fed is doing here. I do think that there is a broader economic reason. As demand for dollars has increased, that has a potential to hurt our export market. A lot of international trade—most of it is done with U.S. dollars. Europe is a huge export market, and we want to make sure that there is plenty of dollar credit availability in Europe. Also many European banks lend to developing countries in dollars that buy our exports.

So I do think that there is a reason beyond just stabilizing the financial sector that can help the real economy, and I think that is what drove the Fed's decision. So on that I—as much as I abhor bailouts, I do not really view that as a bailout move, and I have some sympathy for what the Fed did there.

Senator CORKER. So as I listen, it seems to me that, you know, when we talk about too big to fail, we are talking about several different things. One—and I do not think we have answered this in our country—are there institutions that are allowed to get too big and too complex that they threaten our system? And I do not think that has been dealt with, and nobody has come up with the right answer. Do they add more merit than negative? And, obviously, there are people here on the panel that think yes, some people say no.

It seems to me, though, when you talk about failing, it means lots of things. I really do not have a question that in a one-off situation, a bank, no matter how big it is, fails, my sense is that the bond holders and certainly the equity know they are toast. I mean, I do not think that—is there somebody that disagrees with that, that if we have a one-off situation, not a systemic failure but a one-off situation, X large bank fails, are there people here that believe that Title II would not be instituted in a one-off situation?

Mr. JOHNSON. Yes, Senator, I believe that if Goldman Sachs would have failed, hypothetically, right now this week, the Government, the Federal Reserve, the authorities, would do whatever it could in this environment, with the economy as it is, with elections coming up, all of these people would work very hard to make sure that—they would take out management and shareholders possibly this time. I agree with that. But——

Senator CORKER. Well, now——

Mr. JOHNSON. No, no, but the key question, Senator, is the creditors. Do the creditors face losses, the bond holders? As you and your——

Senator CORKER. So you are saying that you do not believe if the U.S. taxpayers had a loss the clawback position would be taken into account? You do not think that would happen?

Mr. JOHNSON. I do not believe the creditors of Goldman Sachs would lose any money.

Senator CORKER. Chairman?

Ms. BAIR. I absolutely think and know it would be used in a one-off situation. There is no doubt in my mind. And, you know, I think, you know, when I hear Title II does not work, the resolution authority does not work, I hear that from two sides. I hear it from Simon, whom I respect deeply, who really wants to just break up the banks now, so, you know, let us say resolution authority does not work, and really the only solution is to break up the banks. Then I hear it from some of the weaker institutions who want to continue the assumption of Government bailouts so it cannot work. It can work in a one-off situation, it absolutely can, and would be used.

I would also like to echo—and I have been saying this for a long time. The living will rule is a tremendous tool to get these institutions to restructure themselves, to create more operating subsidiaries that would be smaller, that might align themselves more with

your idea of what the appropriate size of a financial institution should be, which would make it much easier to resolve them, much less costly, and efficient to resolve them. And I do think this is a powerful tool over time to—these large institutions can be resolved now in a one-off situation, but going forward, it will make it less costly and more efficient if we can get them to rationalize their business lines with their legal entities and simplify their legal structures.

Senator CORKER. Yes, sir?

Mr. WILMARTH. I would caution that as we have allowed the banks to get larger, more complex, more interconnected, you do not get one-off problems, because when one of these big guys gets in trouble, inevitably either through spillover or contagion or because they are all pursuing the same high-risk activities, they are all in trouble. When you look at the history of the 1970s, the 1980s, the early 1990s, the 2000s, banks during those periods did not get into trouble one at a time. They got in trouble in groups, and the problem is now that the group has gotten smaller in number and bigger in size and more interconnected, more opaque, and so my view is that inevitably we will not have a problem with just one big financial conglomerate. We will have a problem with multiple conglomerates. And we will not be able to allow any of them to fail in your definition under those circumstances.

Senator CORKER. Well, but I would say then, if you broke up, let us say, the largest institutions, you created thirty $400 to $500 billion institutions, if you had a systemic crisis, you would do exactly the same thing. They would be incredibly interconnected, even maybe more so at that size. And so are you telling me that if we had a systemic crisis in this country and every bank in the country was under $500 billion, you are telling me that we would not do exactly the same thing you would with four or five large banks? I absolutely believe we would do exactly the same thing. Somebody argue against that.

Ms. BAIR. I think that if we had a repeat of the 2008 situation, with the authorities we have now, you would have a combination. It is pretty obviously the outliers—the multiple doses of bailout assistance, and those that really just needed liquidity support. The ones that were insolvent would go into a resolution. The ones that were not would get liquidity support under 13-3 from the Fed, possibly debt guarantees from the FDIC as approved by Congress, and I think you would have a combination.

But you are right, if the system is having wider problems, there are going to be some subset of insolvent institutions that should go into a bankruptcy-like resolution and the rest should get liquidity support until we get out of it.

Mr. JOHNSON. Senator, the evidence from banking crises around the world is typically—yes, a meteor can strike the Earth, I grant you that. But typically it is not the case that all of the medium-size financial institutions fail at the same time. Their portfolios do differ.

So I think this hypothetical that if we broke them up they would all become exactly the same and fail at exactly the same moment is extreme.

Senator CORKER. I am just saying that a systemic crisis, a systemic crisis, when you say the big guys all do the same size, well, you know, the banks that are all $500 billion are going to be doing the same thing, too. You are not going to change human behavior. You are not going to change the market.

And so all I am saying is that—and I am not arguing against—by the way, I am still learning on the size issue. I do not think we as a country have come to grips with large, highly complex, systemic risk organizations. But I am just saying that if you have a systemic crisis, like Europe totally fails and contagion comes this way, if every bank in our country was under $500 billion or were under the construct we are in right now, you would still have the same issues to deal with, is all I am saying. Do you agree or disagree?

Mr. JOHNSON. I agree with that statement, Senator.

Senator CORKER. OK.

Chairman BROWN. Senator Moran.

Senator MORAN. I do not know exactly my question here, but to follow up on what Senator Corker is talking about, everything that I have read about the discussions about the collapse in 2008 suggests to me that the Federal Reserve, perhaps the FDIC, the Treasury Department were all worried about the confidence of others. And so they all were interrelated, even though each bank may have been different. And so to separate the financial institutions, if I am right in what I have read, the goal being of those who saw that we needed to bail out the financial institutions, it was that we cannot let this spread so that there is a lack of confidence in the system.

And so you have got to take care of this institution because if it goes, there is going to be a run on the next institution. Again, I do not know what went on in those discussions in those rooms, but at least what I read as being reported as to what occurred suggests that a failure of one—it is perhaps what the professor was saying, that it does not happen in isolation, that you cannot have the—you would not have the scenario, the example that you described in which one major financial institution failed with no consequence to anyone else, if there is this genuine concern about the confidence in the system with a failure.

And so I do not know how you separate—how you get rid of the systemic risk when you have so few large players, all of which seem to be interrelated, at least in the psyche of those who do business with that institution. Professor.

Mr. WILMARTH. Yes. In thinking about the possibility of encouraging banks to slim down and to become less complex, in other words, to break up—we should go back to the 1980s and 1990s when we had a very thriving investment banking industry and a commercial banking industry, and they actually tended to offset each other. When one was in trouble, the other could help. And you saw that in 1987, for example, with the stock market crash, and you saw it going the other way during the 1998 Asian crisis, that each side could offset each other, and they were not all in the same things, that the securities firms tended to do something different from what commercial banks were doing. And so you did not have huge chunks of the system all exposed to the same risk.

Senator MORAN. Is that not an argument then against the Volcker Rule, which then would spread the risks among two separate kinds of banking activities?

Mr. WILMARTH. No, the idea is that you do not want to have all the capital markets risks and all the lending risks residing together, which is what we now have. Under the ICB's proposal in the U.K., if capital markets mistakes are made, they will not automatically take down your so-called utility banking.

Of course, the other thing is if creditors believe that there will not be any cross-subsidization from utility banking and from the FDIC, the Federal safety net, over to what the English call "casino banking," which is wholesale capital markets, then investors who put money into the capital markets through bonds and whatever are going to price that risk much differently than if they think the Government is going to cross-subsidize from utility banking into casino banking.

So, I agree that we are in a bad space right now, and we have to decide how we get out of that space so we are in a better position next time. I believe that if we move the two segments apart into utility and casino with strong firewalls in between, first of all, you would not get cross-subsidization. Second, I think eventually specialist institutions would begin to reemerge. People would conclude that there is no advantage to being tied to a bank if I am a capital markets guy; let us go back to being the old Goldman Sachs.

In the 1990s, our pure investment banks were beating the pants off everybody in Europe. They were the best at what they did.

Senator MORAN. What is the advantage of being tied together?

Mr. WILMARTH. Cross-subsidization, in my view.

Senator MORAN. So we know it happens. That is——

Mr. WILMARTH. That is my view. It is pure cross-subsidization, the fact that too big to fail is not just covering banks.

Senator MORAN. When you say cross-subsidization, you mean the support by the Federal Government, the FDIC——

Mr. WILMARTH. Yes.

Senator MORAN. The Federal Reserve.

Mr. WILMARTH. Too big to fail covers this. Until 1999, at least you could argue that too big to fail only covered the banking system. After 1999, it became clear that it covered all segments of the financial markets.

Senator MORAN. I am happy as long as the Chairman allows you to——

Mr. SWAGEL. I was going to add, I am as puzzled as you are by some of that, that it seems like it is an argument not just against the Volcker Rule but also against the repeal of—the reinstitution of Glass-Steagall since, you know, the activities that cross the Glass-Steagall line can balance each other out, and that would suggest that it is useful to have them under the same roof.

Just the other thought I had was on your original question about confidence and the discussions inside the Treasury. It is exactly right that banks exist, financial institutions exist on confidence, and imagine if Lehman and/or Bear Stearns has 2 percentage points more capital, or 4 or 5. It would not have mattered. I mean, once markets lost confidence—and that really was the point of the

TARP, of the CPP, the capital injections, and the FDIC's loan guarantees at the same time, was to boost confidence in the entire system as a whole.

Mr. JOHNSON. Just to add, Senator, the Europeans are on their way to nationalizing their banking system. It is a complete disaster. These are nationalized universal banks that are going to try and do everything—these slimmed down or more specialized American investments banks that Professor Wilmarth wants to take us back to will absolutely dominate that market. Of course they will. It is American capitalism at work. Taking away the cross-subsidization is going to help them be tougher and win in that global marketplace. The Europeans have no chance.

Chairman BROWN. Ms. Bair, last word.

Ms. BAIR. Yes, I just wanted to get back to your earlier comment about the arguments used during 2008. I must say, to be honest, I think those arguments were overused, and it was frustrating to me that we did not have good analysis. I kept hearing this, we cannot let one institution go down, everybody else is going to go down. I never really got what I considered hard analysis to back that up.

But in a crisis situation, you err on the side of doing more as opposed to doing less because if you do not do enough, you could have a very big problem on your hand. But one of the things I emphasized in my testimony was the credit exposure report provision of Dodd-Frank. This is part of the living will requirement as well as the heightened prudential supervision standards the Fed is supposed to impose on large institutions. Under the credit exposure reports, the institutions have to identify their major credit exposures. In other words, they have to say, "If I go down, who else is going to go down? Or what other institutions are out there if they get in trouble, it is going to get me into trouble?" We did not have that kind of information. It is essential—I think that is one of the priority items in Dodd-Frank to get that rule out there and get that information and limit those exposures as a preventative measure.

Senator MORAN. Mr. Chairman, thank you. Let me critique your selection of witnesses to your face.

Chairman BROWN. Yes, sir.

Senator MORAN. You could not have made it more difficult by finding sides that do not agree at all with each other. I am looking for the answer, and I get the arguments.

Chairman BROWN. But they all look good.

Senator MORAN. Agreed.

Chairman BROWN. All right. We are going to do something a little unorthodox here. I have to leave. Senator Corker has a couple more questions that he is going to ask, so thank you for joining us. If the witnesses can stay another 5 or 10 minutes. I have got a conference call I have got to do. And I appreciate it so much. If there are any questions from the Committee, any letters or any questions to submit in writing, if you will give up to 5 business days, if you would answer those, and I turn it over to Senator Corker.

Senator CORKER [presiding]. Thank you. I appreciate it.

You know, I think if you went and talked to Goldman today, they would tell you they would be more than glad to move back to the way things were and only went public because of what occurred. I

mean, my sense is they would strongly love to see us in Washington separate the two as it was pre-1999.

But let me just ask a question. Pre-1999, there still existed prop trading on the banking side, right? I mean, I think that is a myth that people have that prop trading did not occur in the banking side. Go ahead.

Mr. WILMARTH. Yes, I have been a big critic for a long time of the fact that we allow derivatives in the insured bank. Financial derivatives are synthetic securities.

Senator CORKER. But they were there, prerepeal of Glass-Steagall.

Mr. WILMARTH. Yes, and I think that was one of the big things that broke down Glass-Steagall. I think the Fed and the OCC were quite intentional in allowing the spreading and proliferation of derivatives as synthetic securities and synthetic insurance to break down both the Glass-Steagall Act and the Bank Holding Company Act barriers between insurance, securities, and banking.

My proposal is that if you adopt my narrow bank utility/casino approach, derivatives do not belong on the utility side of banking. They belong on the casino side because they are a capital markets activity.

Senator CORKER. So you would actually propose something more stringent than where we were in 1998.

Mr. WILMARTH. Yes, certainly in the sense that if you want to do both—if you want to be a financial conglomerate doing both traditional banking and wholesale banking, yes, I am being tougher in the derivatives area than the Fed and the OCC were in the 1990s. But I think, frankly, since derivatives have ended up being in the midst of every one of these big crises going back to the 1980s, somewhere you find a derivatives connection, it seems to me it is about time we took that step.

Senator CORKER. So you used the words "straight banking" and "casino." I assume the casino piece is a pejorative term.

Mr. WILMARTH. That is what the English call it. "Wholesale banking" is a more neutral term. Thank you.

Senator CORKER. Which is more risky? I mean, it is a serious question. It seems to me the lending piece is a more risky side of the equation, is it not?

Mr. WILMARTH. We have certainly seen that if you do not supervise lending well, you will come to regret it. And certainly part of the story of the last crisis, as well as the previous ones, is a failure to supervise lending by regulators. But I think the key point that made everything worse is that we have allowed our desire to protect the traditional banking function to cross-subsidize the capital markets. And so the capital markets no longer price bonds of financial institutions in the way that they would if it was truly a market and risk was priced without a Government subsidy. The pricing has been distorted because if you are dealing with the largest institutions, bond holders will not price that risk the way they would if you were dealing with a pure Goldman Sachs without any banking connection, just a pure wholesale merchant bank, as Professor Johnson has explained.

Senator CORKER. Go ahead, sir.

Mr. JOHNSON. Senator, I think you asked the right question: Which is more risky? We have seen cycles where it goes either way, absolutely. But, remember, part of the argument for the development of these megaconglomerates was this would diversify risk. We have not seen that. In fact, they have actually concentrated risk. And I think Professor Wilmarth has a very important point when he says you want to have different players, a more decentralized system actually, to go back to one of the points Mr. Swagel made at the beginning, a more decentralized system with more different people. You cannot just have one group or one person or one small set of executives make these big mistakes, if they are mistakes, that bring down the system or threaten to bring down the system or put a credible threat on Sheila Bair's desk. That is what you want to avoid.

And in terms of the value of these conglomerates to society, what have they brought to the table? I know of no study, none, that shows economies of scale or scope in banking above $100 billion in total assets. And we are talking about $1, $2, $3 trillion banks. So we have gone way beyond where the economies of scale and scope are. And it would be great—perhaps that you should bring Goldman Sachs down here to testify under oath that they would be delighted to go back to a broken-up smaller bank system. That would be incredibly helpful.

Senator CORKER. I am, by the way, surmising. I am not speaking on their behalf.

Mr. JOHNSON. I understand. But that would be a very helpful statement if they would like to go on the record.

Senator CORKER. Let me ask a question. On the issue of Volcker—I know that is not the subject of this, but I know Sheila brought it up in her testimony. It does appear to me that Volcker as written is not written in a way that really deals with the issue in an appropriate manner. Is that agreed by all four panelists?

Ms. BAIR. Yes, I do, I think it is somewhat at cross purposes. I really do. I think there are two different issues. There are safety and soundness issues. Obviously, you do not want any kind of high-risk activity, whether it is lending or anything else. But there is a separate question of what Government wants—what is the appropriate use of insured deposits? I think we would all agree that if the FDIC got a deposit insurance application of somebody wanting to bring in broker deposits to take speculative bets on Greek debt, we would not view that as an appropriate business plan for insured depository institutions.

There has been a long-standing understanding that pure prop trading or speculative trading is not an appropriate use of deposits, and I think over time it has become harder and harder to know where the line is, and the fact that Volcker goes—to not only to the insured bank but to the affiliates of insured banks, which can be securities firms when we got rid of Glass-Steagall, I think that is extremely hard. But there are really two separate issues. One is safety and soundness. We have got that covered. The other is: What is the appropriate use of insured deposits? And I am not sure there is clarity on that point in the framework now.

Mr. JOHNSON. Senator, I worked with proprietary trading in a major global investment bank in 1997 and 1998, and I would

strongly urge you not to have those activities in an important part of the financial system. It was pure speculation, and they lost a lot of money. "Other people's money" was their attitude. I think that is——

Senator CORKER. But do you think Volcker as written addresses that issue?

Mr. JOHNSON. I think the act is fine. I think what we are seeing coming from the regulators is not going to do as much good at all, unfortunately. That is my read of the process.

Senator CORKER. Yes, I sure would love your written comments about a better way for the regulators to deal with the text.

Mr. JOHNSON. I would be happy to provide those.

Senator CORKER. Yes sir?

Mr. SWAGEL. I just think that the Volcker Rule is meant to solve a problem that did not really matter in the crisis and does not clearly exist and would be very difficult to solve even if it did exist because it is so difficult to tell what is prop trading from what is normal market making. And I think the hundreds of pages from the regulators, they are doing their best, but in some sense that reflects it.

Senator CORKER. You think that is one of the reasons treasurys were excluded?

Mr. SWAGEL. Exactly. I mean, in some sense, the U.S. Government is in the business of selling Treasury securities and it would be kind of awkward to exclude a big demander, a big buyer of Treasuries.

Senator CORKER. Yes, sir?

Mr. WILMARTH. It seems to me that the ring-fencing approach advocated by the Independent Commission on Banking, like the narrow banking approach I have talked about, attacks the issue from the other way around, which is exactly the issue that Chairman Bair has identified. We should define the activities that we think are so important to the unique functions of banks that they deserve Federal safety net protection. We should put those activities within the ring-fenced, insulated bank. And then, I do not think repeal of Glass-Steagall would be necessary because if you did what the Independent Commission on Banking has proposed, or my narrow bank approach has proposed, the market will determine whether, in fact, it makes sense to keep these two different functions together. If the market does not believe that financial conglomerates provide attractive returns to investors without Government subsidies, conglomerates will break up voluntarily. It is essential that you put all the capital markets activities, including market making, including underwriting, including prop trading, including derivatives, in the wholesale bank, which cannot be subsidized by the Federal safety net. You have to make people believe that investors will bear the risks of those activities and the market will price those risks. I am not saying it is simple. But it is much more conceptually straightforward to view it that way. And since the U.K. is moving in that direction, and London and New York are the two leading financial markets, why shouldn't we join in? If the two markets that dominate the world adopted that approach, Europe might also do so because it has to figure out a new way forward. I think we have a chance to convince people that there is a

better way to attack these issues and begin to restrain the safety net instead of wrapping the entire financial markets with the too-big-to-fail guarantee.

Senator CORKER. So that Chairman Brown allows me to do this again when he has to make a conference call, I just want to ask one more question. It seems to me that the risk-weighted nature of the way we look at assets that we are—that Governments put in place through regulators, that has driven us to where we are. And I am wondering how you all would feel about just doing away with risk weighting period where we do not drive people to sovereigns saying they are risk free, we do not drive people to mortgage-backed securities where it is 50-percent risk weighted. What would be your response to that? And, Sheila, you are giving me no body language, so answer the question.

[Laughter.]

Ms. BAIR. OK. Well, I am a big fan of leverage ratio. I would like to see—it is 5 percent here. I would love to see it higher, and I would certainly love the international leverage ratio to be higher, which it is not being implemented in Europe, and there is no sign that it will be anytime soon.

I think leverage ratios can be gamed, too. I think you need both. But absolute constraints on leverage should be your starting point, and then any capital additive to that should be based on if there is excessive risk on the bank's balance sheet or riskier assets on the bank's balance sheet.

If you do not have some type of risk measure for capital as well with the leverage ratio, you will provide incentives for them to use the highest-risk, highest-yielding assets. So you need a combination. But the constraint on absolute leverage should be the starting point and risk-based should be above that.

Mr. JOHNSON. I agree with you completely, Senator, on this point. I think we should have a 30-percent capital requirement where capital is not relative to risk-weighted assets. And I hear laughter around me, but——

Senator CORKER. It sounds like a railroad.

Mr. JOHNSON. If you go back historically, the history of U.S. banking, before we had Federal guarantees of any kind, before the creation of the Federal Reserve, these are the kinds of capital levels that we used to have across the country in small banks and in big banks. This is what commodity trading firms with a lot of risk and no Government guarantee have in terms of capital. It is just equity funding. We are asking them to be more funded with equity, less funded with debt. We have become a very debt-centric society, Senator, and I think we should back away from that.

Senator CORKER. We give tax benefits to debt and penalize equity, no question.

Yes, sir?

Mr. SWAGEL. I would just note that in the pre-FDIC era, it is true banks had a lot more capital. They had signs in the windows saying here is how much surplus capital we have. And we still had banking panics and banking crises, and really that is why the FDIC was created, to prevent that. You know, I think the crisis showed us we need more capital, and we definitely do not want to

follow the Europeans in there and sort of march—the race to the bottom in less capital.

What the right number is, that is the key question. And my point is that there is an effect on activity. Going from where we are now to 30 percent or 50 or whatever it is, that would have an effect, and it is really the tradeoff between safety and economic vitality.

Mr. WILMARTH. I think your instinct is absolutely right. I think the risk weightings have done much more mischief than good. It seems to me that a very strong leverage ratio focused on equity capital as opposed to all these hybrid instruments that do not stand up under stress is the most important thing.

The second most important thing is to adopt a very good approach that would prevent excessive credit exposures or excessive credit concentrations or asset concentrations. That is harder to legislate across the board, but if supervisors were given strong tools to work with in controlling credit concentrations, asset concentrations, and they were able to enforce those against specific banks, then, if you trust your regulators and give them enough power, they should be able to see that particular banks are too much focused on one asset class or one type of credit exposure. But it is hard to legislate a mathematical formula and say that all sovereigns are risk free or all mortgages are only 50-percent risk weighted. We have seen what those types of formulas did.

It seems to me the whole Basel II methodology needs to be taken back down to the foundation, and we need to think again about how we assess the risks of individual institutions.

Senator CORKER. Well, listen, you all have been great witnesses. I thank you for your time. I thank the majority Committee for being sports and letting me do this, and the meeting is adjourned. Thank you.

[Whereupon, at 3:48 p.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF SHEILA C. BAIR

SENIOR ADVISOR, PEW CHARITABLE TRUSTS

DECEMBER 7, 2011

Chairman Brown, Ranking Member Corker, and distinguished Members of this Subcommittee: It is my pleasure to address you today at this hearing entitled "A New Regime for Regulating Large, Complex Financial Institutions".

There is no single issue more important to the stability of our financial system than the regulatory regime applicable to large financial institutions. I would hope that by now there is general recognition of the role certain large, mismanaged institutions played in the lead-up to the financial crisis, and the subsequent need for massive, governmental assistance to contain the damage caused by their behavior. The disproportionate failure rate of large, so-called systemic entities stands in stark contrast to the relative stability of smaller, community banks of which less than 5 percent have failed. As our economy continues to reel from the financial crisis, with high unemployment and millions losing their homes, we cannot afford a repeat of the regulatory and market failures which allowed this debacle to occur.

There is nothing inherently wrong with size in and of itself. In many business areas, large institutions can achieve significant economies and public benefits. However, size should be driven by market forces, not implied Government subsidies. Capital allocation should be determined by investors pursuing sound, innovative business models which promise sustainable returns based on acceptable risk tolerances. It should not be based on highly leveraged bets which promise privatization of benefits but socialization of losses if those bets fail. With the implied Government support provided to Fannie Mae, Freddie Mac, and so-called too-big-to-fail financial institutions, the smart money fed the beasts and the smart money proved to be right. As failures mounted, the Government blinked and opened up its check book. Creditors and trading partners were made whole. Many executives and board members survived. In most cases, the Government didn't even wipe out shareholders before taking exposure.

Implied Government subsidies of large financial institutions not only produce an unstable financial system, but they also skew allocation of capital away from other, more stable business sectors. As the charts in the appendix to my testimony show, beginning in the mid-1990s, the assets of financial firms grew much more rapidly than "real economy" assets, with financial firm assets peaking in 2007. Most of this growth was concentrated in the 30 largest institutions. From 2000 to 2008, leverage increased dramatically among large U.S. investment banks and large European and U.K. institutions. Fortunately, for U.S. commercial banks, leverage remained flat—primarily because the FDIC successfully blocked implementation of the Basel II advanced approaches for setting bank capital. These trends in growth and leverage were not accompanied by increases in traditional lending to support the nonfinancial sector. Rather, portfolio lending fell significantly as many large financial institutions found trading assets to be much easier and more profitable than going through the hard work of developing and applying sound underwriting standards for loans these large financial institutions planned to keep on their books. Regulators for the most part did not try to constrain these trends, but left the market largely to regulate itself. In some cases, for instance with the repeal of Glass-Steagall and passage of the Commodity Futures Modernization Act, Congress explicitly told the regulators "hands off." As free markets became free-for-all markets, compensation rose, skyrocketing past wages paid to equally skilled employees in other fields. This enticed many of our best and brightest to forego careers in areas like engineering and technology to heed the siren song of quick, easy money from an overheated, over-leveraged financial industry.

In recognition of the harmful effects of too big to fail policies, a central feature of the Dodd-Frank statute is the creation of a resolution framework which going forward will impose losses and accountability on shareholders, creditors, boards, and executives when mismanaged institutions fail. Under Title II of Dodd-Frank, the Government can now resolve systemic bank holding companies and nonbank entities using the same time tested tools the FDIC has used to resolve failing banks for decades. Such tools were not available during the 2008 crisis. I am very proud of the fact that the FDIC has already put into place regulations spelling out the process that will be used under Title II to resolve large financial institutions, including making clear the bankruptcy-like claims priority schedule that will impose losses on shareholders and creditors, not on taxpayers. We cannot end too big to fail unless we can convince the market that shareholders and creditors will take losses if the institution in which they have invested fails. For this reason, when I chaired the FDIC, we made the claims priority rules a first order of business after Dodd-Frank

was enacted, and I am very pleased that the ratings agencies have begun to remove the "bump up" they assign to the credit ratings of large financial entities based on their previous assumption of Government support.

Another central feature of ending too big to fail is the Dodd-Frank requirement that large bank holding companies and nonbank systemic entities submit to both the Federal Reserve Board and the FDIC their resolution plans demonstrating how those financial firms could be resolved in a bankruptcy proceeding during a crisis without systemic disruptions. Rules implementing this so-called "living will" requirement were recently finalized by the FDIC and the FRB, with the first round of living will submissions required of the largest institutions next summer. The Dodd-Frank standard of resolvability in bankruptcy is a very tough one, and my sense is that all of the major banks will need to make significant structural changes to achieve it. In particular, they will need to do much more to rationalize their business lines with their legal entities, which will make it much easier for the FDIC—or a bankruptcy court—to hive off and sell healthy operations, while maintaining troubled operations in a "bad bank" which can be worked off over time. Aligning business lines with legal entities will also have important safety and soundness benefits. In particular, it will make it easier for distressed banks to sell operations to either raise capital or wind themselves down absent Government intervention. Finally, rationalizing and simplifying legal structures will improve the ability of boards and management to understand and monitor activities in these large banks' far-flung operations. In this regard, I hope regulators will also give some consideration to requiring strong intermediate boards and managers to oversee major subsidiaries. Many of these centralized boards and management do not have a comprehensive understanding of what is going on inside their organizations. This was painfully apparent during the crisis.

One element of Dodd-Frank's living will provision that has not yet been implemented by the agencies is the requirement for credit exposure reports. Credit exposure reports are also required as part of Dodd-Frank's mandate to the Federal Reserve Board to impose heightened prudential standards on large bank holding companies and other systemic entities. Credit exposure reports are essential to make sure regulators understand crucial interrelationships between distress at one institution and its potential to cause major losses at other institutions. This type of information was missing during the crisis. I know that many Members of this Subcommittee heard the same arguments that I heard during the crisis—that bailouts were necessary or the "entire system" would come down. But we never really had good, detailed information about the derivatives counterparties, bondholders, and others who we were ultimately benefiting from the bailouts and why they needed protecting. For those concerned about the potential "domino" effect of a large bank failure, it is essential not only to identify, understand, and monitor these exposures but also to limit them in advance to contain any possible contagion. I would urge the FDIC and FRB to complete this final piece of the living will rule as soon as possible.

Resolution authority and planning are important to make sure the Government is prepared and has the right legal tools to handle a large institution when it fails. And make no doubt; there will always be failures, though hopefully they will be rare. No amount of prudential regulation will be able to eliminate the risk of failures. As I have discussed, resolution authority and planning also entail prophylactic benefits by improving regulatory and management understanding of these large institutions and by giving the investor community stronger incentives to conduct stringent due diligence before committing their investment dollars. A final prophylactic benefit emanates from the harshness of the resolution process, and it is a harsh process, particularly for boards and management who not only lose their jobs but are subject to a 2-year clawback of all of their compensation. This will give them strong incentives to avoid Title II resolution by raising capital or selling their operations, even if the terms seem unfavorable. More than one commentator has observed that Lehman Brothers' management had multiple opportunities to sell the firm, albeit at punitive pricing, but refused to do so because they thought—unrealistically—that their firm was worth more and that. also, the Government would come in and provide assistance, as it had with the much smaller Bear Sterns. With Title II, large financial firms now know their fate if they fail, and it is not a pretty one. Bailouts are prohibited and there will be no exceptions. If they can't right their own ship, they will sink with it.

As important as resolution authority is, it obviously cannot substitute for high quality prudential supervision. We must do all that we can to prevent failures while at the same time recognizing that a healthy financial services sector needs reasonable latitude to innovate and take risks. Recognizing that there will always be some measure of risk taking in any profit-making endeavor, it is essential that we make

sure our financial institutions have thick enough cushions of capital to absorb unexpected losses when they occur. Excessive leverage was a key driver of the 2008 crisis as it has been for virtually every financial crisis in history. The perils of too much borrowing in creating asset bubbles, and the massive credit contractions that occur once the bubbles pop, have been learned and then forgotten throughout every major financial cycle. These perils were forgotten again in the early 2000s during the so-called golden age of banking when instead of acting to raise capital requirements and implement strong mortgage lending standards, regulators stood by and effectively lowered capital minimums among U.S. investment banks and European institutions through implementation of Basel II.

We need to correct those mistakes through timely implementation of Basel III and the so-called "SIFI surcharges" which taken together, strengthen the definition of high quality capital and also impose risk based ratios as high as 9.5 percent on our largest institutions. In the near term, given the obvious flaws in the way banks risk-weight assets under Basel II, regulators' primary focus should be on constraining absolute leverage through an international leverage ratio that is significantly higher than the Basel Committee's proposed 3 percent standard. We must also not backtrack on agreements to maintain stringent standards for true tangible common equity. Both Basel III as well as the Collins amendment in Dodd-Frank phase-out the use of hybrid debt instruments for Tier 1 capital because these instruments proved to have no real loss absorbing capacity during the crisis. Fortunately, in the U.S. at least, there seems to be emerging consensus that convertible debt instruments should also not count as Tier 1 capital. I deeply fear that so-called "cocos," if ever triggered, would likely cause a run on the issuing bank instead of stabilizing it.

Many industry advocates continue to argue that higher capital requirements will inhibit lending. It is true that equity capital is marginally more expensive than debt. This is due, in part, to the "too big to fail" doctrine as well as the favored tax treatment of debt over equity. But this is not a reason to allow them to keep leveraging up. It is fallacy to think that thinly capitalized institutions will do a better job of lending. Throughout the crisis, better capitalized community banks maintained stronger loan balances than their large bank competitors. A large financial institution nearing insolvency will quickly pull credit lines and cease lending to maintain capital. This is why we had such a severe recession. On the other hand, a well capitalized bank will keep functioning even when the inevitable business cycle turns downward. There may be some small, incremental increase in the cost of credit from higher capital levels in good times, but the benefit of stability in bad times more than outweighs those costs.

If there is any question as to why we need strongly capitalized banks, one need look no further than Europe where lax capital regulation has resulted in a highly leveraged banking system that is poorly positioned to absorb losses associated with its sovereign debt crisis. I know some American bank CEOs have complained about the higher capital standards we have in the U.S.—and they are right—in part. Capital regulation is much tougher here and I hope it's going to get even tougher. But do we want the European banking system? That system is now so fragile it is doubtful that even the strongest banks could raise significant new capital from non-government sources. The choices in Europe are not pretty. They can let a good portion of their banking system fail or they can commit to massive financial assistance through a combination of ECB bond buying and loans and guarantees from the IMF and stronger Eurozone countries. Frankly, I don't know which is worse.

Liquidity is another area which needs more attention from regulators, both in the U.S. and internationally. In the years leading up to the crisis, financial institutions became more and more reliant on cheap, short-term credit, which they would use to fund longer term, illiquid mortgage-related assets. Much of this credit was provided by money market mutual funds. As the market began to lose confidence in the values of those assets, creditors refused to keep extending credit which caused widespread funding shortages. Money market mutual funds in particular took flight at the first sign of trouble to keep from "breaking the buck."

Though financial institutions have made significant progress in extending the average maturities of their liabilities, this has been driven in part by market conditions. We need to put strong rules in place on the liability side of the balance sheet to prevent a recurrence of the liquidity failures of 2008. For instance, we need to dramatically toughen the types of collateral than can be used to secure repos and other short term loans. We should also think about caps on the amount of short term debt that financial institutions can use to fund their balance sheets, as well as the establishment of minimum requirements for the issuance of long term debt. And finally, money market mutual funds should be required to use a floating NAV which should substantially reduce this highly volatile source of short term funding.

A final preventative measure I would like to discuss is the Volcker Rule. The basic construct of the Volcker Rule is one that I strongly support. FDIC insured banks and their affiliates should make money by providing credit intermediation and related services to their customers, not by speculating on market movements with the firm's funds. However, to some extent this basic construct is at odds with Congress' 1999 repeal of Glass-Steagall, which allowed insured banks to affiliate with securities firms, and—let's be honest—making money off of market movements is one of the things that securities firms have long done. Recognizing these competing policy priorities, Congress recognized exceptions from the Volcker Rule for traditional securities activities such as market making and investment banking. But the line between these exceptions and prohibited proprietary trading is unclear.

I fear that the recently proposed regulation to implement the Volcker Rule is extraordinarily complex and tries too hard to slice and dice these exceptions in a way that could arguably permit high risk proprietary trading in an insured bank while restricting legitimate market making activities in securities affiliates. I believe that the regulators should think hard about starting over again with a simple rule based on the underlying economics of the transaction, not on its label or accounting treatment. If it makes money from the customer paying fees, interest, and commissions, it passes. If its profitability or loss is based on market movements, it fails. And the inevitable gray areas associated with market making and investment banking should be forced outside of the insured bank and supported by higher capital given the greater risk profile of those activities.

In addition, the new rules should require executives and boards to be personally accountable for monitoring and compliance. Bank leadership needs to make it clear to employees that they are supposed to make money by providing good customer service, not by speculating with the firm's funds.

Complex rules are easy to game and difficult to enforce. We have too much complexity in the financial system already. If regulators can't make this work, then maybe we should return to Glass-Steagall in all of its 32 page simplicity.

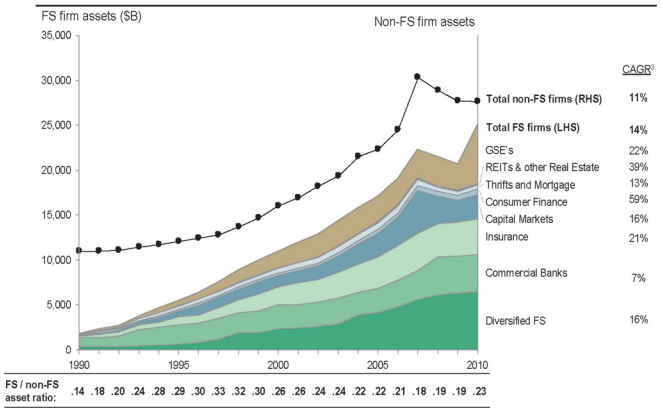
Much work remains to be done to rein in the types of activities undertaken by large financial institutions that caused our 2008 financial crisis. However, through robust implementation of a credible resolution mechanism, strong capital and liquidity requirements, and curbs on proprietary trading, we can once again make our financial system the envy of the world and an engine of growth for the real economy.

That concludes my testimony. Thank you again for the opportunity of testifying.

Appendix:

Financial service firm assets have grown faster than non-financial service firm assets

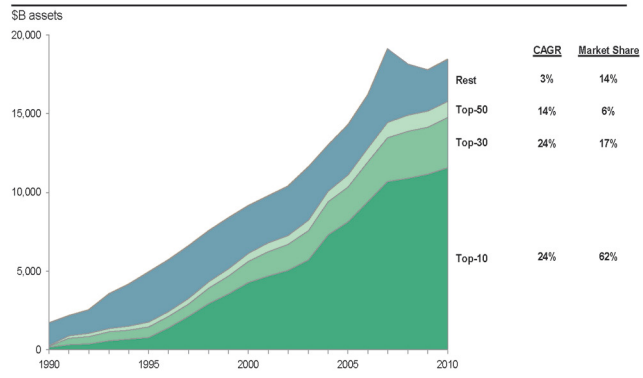
Total assets for FS firms[1] and non-FS firms[2] (1990 – 2010)



1. Includes all publically traded financial service firms as well as GSE's (FICO and FCS excluded due to lack of data). 2. Includes all publically traded non-financial service firms. 3. CAGR stands for compound annual growth rate. Source: Capital IQ.

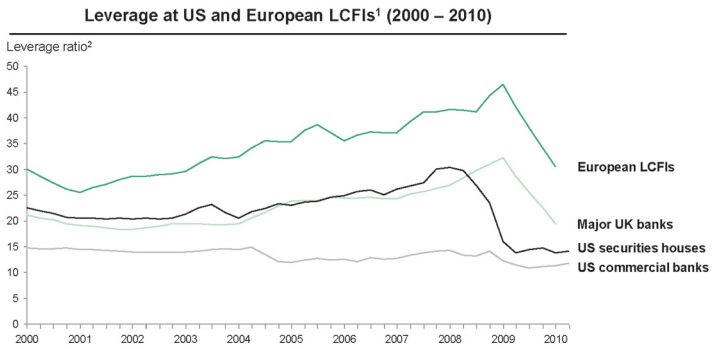
Growth in financial service firm assets has been driven by the largest firms

Total assets for FS firms[1] by size (1990 – 2010)



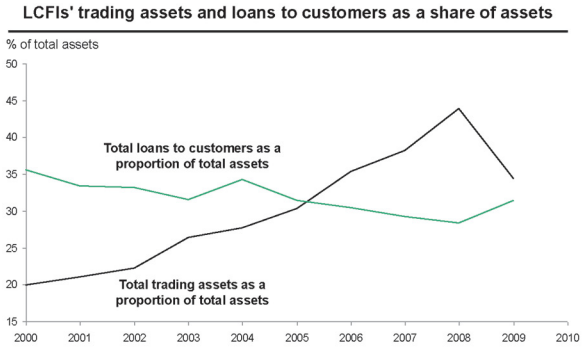
1. Includes all publically traded financial service firms, but excludes GSEs. Firm size measured by 2010 assets.
Source: Capital IQ.

During the 2000s, asset growth was fueled by leverage, both in the US and in Europe



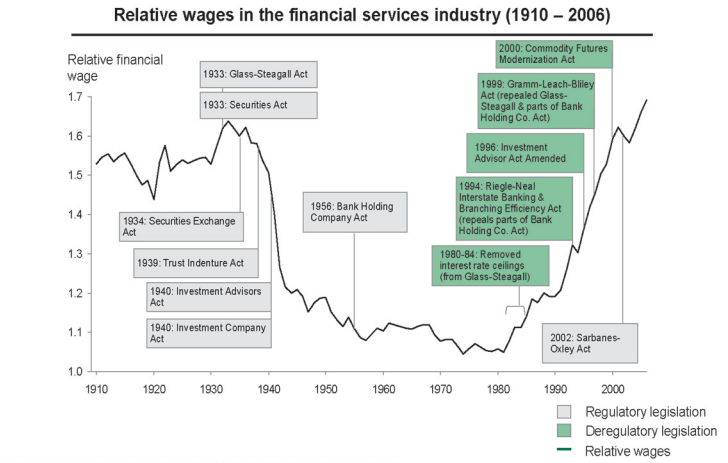
1. LCFI stands for large, complex financial institution.
2. Leverage equals assets over total shareholder equity net of minority interests.
Note: Analysis does not adjust for accounting differences.
Source: Haldane, Brennan, Madouros (2010).

Primarily, asset growth resulted from increases in trading assets and not loans to customers



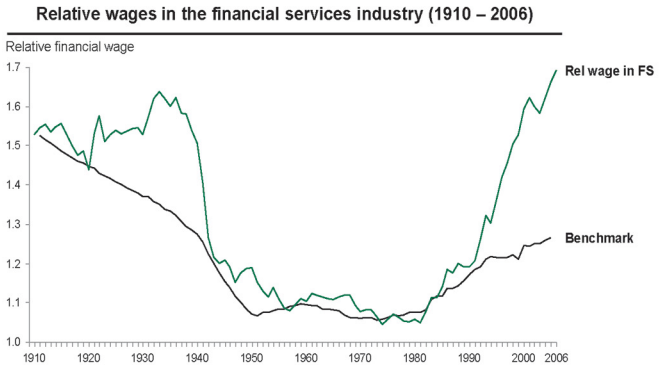
Note: Includes all US commercial bank LCFIs, European LCFIs, and UK LCFIs.
Source: Haldane, Brennan, Madouros (2010).

FS industry's relative wage responds to regulatory and deregulatory actions



Note: Relative wage = the ratio of the actual wages in the Financial Sector to the Non Farm Private Sector
Source: "Wages & Human capital in the US Financial Industry: 1909-2006" by Thomas Philippon and Ariell Reshef, December 2008

FS industry wages are high both in a historic sense as well as relative to their estimated benchmark level



Note: Relative wage = the ratio of the actual wages in the Financial Sector to the Non Farm Private Sector
Source: "Wages & Human capital in the US Financial Industry: 1909-2006" by Thomas Philippon and Ariell Reshef, December 2008

PREPARED STATEMENT OF SIMON JOHNSON

RONALD A. KURTZ PROFESSOR OF ENTREPRENEURSHIP, MIT SLOAN SCHOOL OF MANAGEMENT

DECEMBER 7, 2011

Main Points

1. Recent adjustments to our regulatory framework, including the "Dodd-Frank Wall Street Reform and Consumer Protection Act", have not fixed the core problems that brought us to the brink of complete catastrophe in fall 2008: [1]
   - Powerful people at the heart of our financial system still have the incentive and ability to take on large amounts of reckless risk—through borrowing large amounts relative to their equity. When things go well, a few CEOs and a small number of others get huge upside—estimated at over $2 billion from 2000 to 2008 at the top 14 U.S. financial institutions.
   - When things go badly, society, ordinary citizens, and taxpayers get the downside, including more than 8 million jobs lost and a medium-term increase in debt-to-GDP of at least $7 trillion (roughly 50 percent of GDP).
2. This is a classic recipe for financial instability and fiscal calamity.
3. Our six largest bank holding companies currently have assets valued at close to $9.5 trillion, which is around 62.5 percent of GDP (using the latest available data, from end of Q3, 2011). The same companies had balance sheets worth around 55 percent of GDP before the crisis (*e.g.,* 2006) and no more than 17 percent of GDP in 1995.
4. With assets ranging from around $800 billion to nearly $2.5 trillion (under U.S. GAAP), these bank holding companies are perceived by the market as "too big to fail," meaning that they are implicitly backed by the full faith and credit of the U.S. Government. They can borrow more cheaply than their competitors—estimates place this advantage between 25 and 75 basis points—and hence become larger.
5. In public statements, top executives in these very large banks discuss their plans for further global expansion—presumably increasing their assets further while continuing to be highly leveraged. In its public statements, the U.S. Treasury appears to endorse this strategy.
6. In this context, the Troubled Asset Relief Program (TARP) played a significant role preventing the deep recession of 2008–09 from becoming a full-blown Great Depression, primarily by providing capital to financial institutions that were close to insolvency or otherwise under market pressure. But these actions further distorted incentives at the heart of Wall Street. Neil Barofsky, the Special Inspector General for the Troubled Assets Relief Program put it well in his January 2011 quarterly report, emphasizing: "perhaps TARP's most significant legacy, the moral hazard and potentially disastrous consequences associated with the continued existence of financial institutions that are 'too big to fail.'"
7. To see just the fiscal impact of the finance-induced recession, consider changes in the CBO's baseline projections over time. In January 2008, the CBO projected that total Government debt in private hands—the best measure of what the Government owes—would fall to $5.1 trillion by 2018 (23 percent of GDP). As of January 2010, the CBO projected that over the next 8 years, debt would rise to $13.7 trillion (over 65 percent of GDP)—a difference of $8.6 trillion.
8. Most of this fiscal damage is not due to the Troubled Assets Relief Program—and definitely not due to the part of that program which injected capital into failing banks. Of the change in CBO baseline, 57 percent is due to decreased tax revenues resulting from the financial crisis and recession; 17 percent is due to increases in discretionary spending, some of it the stimulus package necessitated by the financial crisis (and because the "automatic stabilizers" in the

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[1] Simon Johnson, Ronald Kurtz Professor of Entrepreneurship, MIT Sloan School of Management; Senior Fellow, Peterson Institute for International Economics; and cofounder of *http://BaselineScenario.com.* This testimony draws on joint work with James Kwak, particularly *13 Bankers: The Wall Street Takeover and The Next Financial Meltdown,* and Peter Boone, including *Europe on the Brink.* Please access an electronic version of this document, *e.g.,* at *http://BaselineScenario.com*, where we also provide daily updates and detailed policy assessments. For additional affiliations and disclosures, please see: *http://baselinescenario.com/about/*.

United States are relatively weak); and another 14 percent is due to increased interest payments on the debt—because we now have more debt. [2]

9. In effect, a financial system with dangerously low capital levels—hence prone to major collapses—creates a nontransparent contingent liability for the Federal budget in the United States. It also damages the nonfinancial sector both directly—when there is a credit crunch, followed by a deep recession—and indirectly through creating a future tax liability.

10. In principle, Section 165 of Dodd-Frank strengthens prudential standards for large, interconnected financial institutions—including "nonbanks." In practice, all the available evidence suggests that big banks and other financial institutions are still seen as Too Big To Fail. This is not a market; it is a large-scale, nontransparent, and unfair Government subsidy scheme. It is also very dangerous.

11. There is nothing in the Basel III accord on capital requirements that should be considered encouraging. Independent analysts have established beyond a reasonable doubt that substantially raising capital requirements would not be costly from a social point of view (*e.g.,* see the work of Anat Admati of Stanford University and her colleagues).

12. But the financial sector's view has prevailed—they argue that raising capital requirements will slow economic growth. This argument is supported by some misleading so-called "research" provided by the Institute for International Finance (a lobby group). The publicly available analytical work of the official sector on this issue (from the Bank for International Settlements and the New York Fed) is not convincing—if this is the basis for policymaking decisions, there is serious trouble ahead.

13. Even more disappointing is the failure of the official sector to engage with its expert critics on the issue of capital requirements. This certainly conveys the impression that the regulatory capture of the past 30 years (as documented, for example, in *13 Bankers*) continues today—and may even have become more entrenched.

14. There is an insularity and arrogance to policy makers around capital requirements that is distinctly reminiscent of the Treasury-Fed-Wall Street consensus regarding derivatives in the late 1990s—*i.e.,* officials are so convinced by the arguments of big banks that they dismiss out of hand any attempt to even open a serious debate.

15. The purpose of the Volcker Rule (section 619 of Dodd-Frank, but also sections 620 and 621) is to restrict activities by large banks that have implicit Government support. The legislative intent is to create an eminently sensible failsafe mechanism—to prevent speculative "proprietary trading" by banks that have implicit Government support.

16. Unfortunately, the draft Volcker Rule-related regulations give undue primacy to preserving market structure "as is." In particular, the Federal Reserve seems inclined to keep universal banks engaged in securities trading, regardless of the consequences for systemic risk. There are too many regulator created loopholes and exemptions. Systemically important nonbank financial companies should be included within the scope of the Rule. There should be better communication of what is and what is not proprietary trading—to ensure consistency across firms and integration with their reporting systems. There needs to be guidance on what constitutes significant loss and substantial risk. We also have no clear picture regarding how compliance would be enforced.

17. In any case, the Volcker Rule is a complement not a substitute for any other reasonable measures taken to reduce the dangers inherent in large-scale financial institutions.

18. Section 622 of Dodd-Frank, "Concentration Limits on Large Financial Firms" also held considerable promise—aiming to ensure that no one firm be able to

[2] *See also,* the May 2010 edition of the IMF's cross-country fiscal monitor for comparable data from other industrialized countries, *http://www.imf.org/external/pubs/ft/fm/2010/fm1001.pdf.* The box on debt dynamics shows that mostly these are due to the recession; fiscal stimulus only accounts for 1/10 of the increase in debt in advanced G20 countries. Table 4 in that report compares support by the Government for the financial sector across leading countries; the U.S. provided more capital injection (as a percent of GDP) but lower guarantees relative to Europe.

"merge and consolidate" in such a way as to raise its share of "aggregate consolidated liabilities of all financial companies" above 10 percent. Unfortunately, there appears to be little or no willingness on the part of regulators for turning this in real rules that can be enforced. Big is still beautiful, it appears, in the eyes of key members of the Financial Stability Oversight Council.

19. Next time, when our largest banks get into trouble, they may be beyond Too Big To Fail. As seen recently in Ireland and as may now happen in other parts of Europe, banks that are very big relative to an economy can become "too big to save"—meaning that while senior creditors may still receive full protection (so far in the Irish case), the fiscal costs overwhelm the Government and push it to the brink of default (or beyond).

20. The fiscal damage to the United States in that scenario would be immense, including through the effect of much higher long term real interest rates. It remains to be seen if the dollar could continue to be the world's major reserve currency under such circumstances. The loss to our prestige, national security, and ability to influence the world in any positive way would presumably be commensurate.

21. In 2007–08, our largest banks—with the structures they had lobbied for and built—brought us to the verge of disaster. TARP and other Government actions helped avert the worst possible outcome, but only by providing unlimited and unconditional implicit guarantees to the core of our financial system. At best, this can only lead to further instability in what the Bank of England refers to as a "doom loop." At worst, we are heading for fiscal disaster and the loss of reserve currency status.

22. During the Dodd-Frank legislative debate, there was an opportunity to cap the size of our largest banks and limit their leverage, relative to the size of the economy. Unfortunately, the Brown-Kaufman Amendment to that effect was defeated on the floor of the Senate, 33–61, in part because it was opposed by the U.S. Treasury. [3]

Resolution Under Dodd-Frank

The U.S. economic system has evolved relatively efficient ways of handling the insolvency of nonfinancial firms and small- or medium-sized financial institutions. It does not yet have a similarly effective way to deal with the insolvency of large financial institutions. The dire implications of this gap in our system have become much clearer since fall 2008 and there is no immediate prospect that the underlying problems will be addressed by the regulatory reform proposals currently on the table. In fact, our underlying banking system problems are likely to become much worse.

In spring 2010, during the Dodd-Frank financial reform debate—Senator Ted Kaufman of Delaware emphasized repeatedly on the Senate floor that the proposed "resolution authority" was an illusion. His point was that extending the established Federal Deposit Insurance Corporation (FDIC) powers for "resolving" (jargon for "closing down") financial institutions to include global megabanks simply could not work.

At the time, Senator Kaufman's objections were dismissed by "experts" both from the official sector and from the private sector. The results are reflected in Title II of Dodd-Frank, "Orderly Liquidation Authority."

Now these same people (or their close colleagues) are arguing resolution cannot work for the country's giant bank holding companies. The implication, which these officials and bankers still cannot grasp, is that we need much higher capital requirements for systemically important financial institutions.

Writing in the March 29, 2011, edition of the *National Journal,* Michael Hirsch quotes a "senior Federal Reserve Board regulator" as saying:

> Citibank is a $1.8 trillion company, in 171 countries with 550 clearance and settlement systems," and, "We think we're going to effectively resolve that using Dodd-Frank? Good luck!

The regulator's point is correct. The FDIC can close small- and medium-sized banks in an orderly manner, protecting depositors while imposing losses on share-

[3] *See, http://baselinescenario.com/2010/05/26/wall-street-ceos-are-nuts/,* which contains this quote from an interview in New York Magazine: "'If enacted, Brown-Kaufman would have broken up the six biggest banks in America,' says the senior Treasury official. 'If we'd been for it, it probably would have happened. But we weren't, so it didn't.'"

holders and even senior creditors. But to imagine that it can do the same for a very big bank strains credulity.

And to argue that such a resolution authority can "work" for any bank with significant cross-border is simply at odds with the legal facts. The resolution authority granted under Dodd-Frank is purely domestic, *i.e.,* it applies only within the United States. The U.S. Congress cannot make laws that apply in other countries—a cross-border resolution authority would require either agreement between the various Governments involved or some sort of synchronization for the relevant parts of commercial bankruptcy codes and procedures.

There are no indications that such arrangements will be made—or that there are serious intergovernmental efforts underway to create any kind of cross-border resolution authority, for example, within the G20.

For more than a decade, the International Monetary Fund has been on the case of the eurozone to create a cross-border resolution mechanism of some kind within their shared currency area. But European (and other) Governments do not want to take this kind of step. Rightly or wrongly, they do not want to credibly commit to how they would handle large-scale financial failure—preferring instead to rely on various kinds of ad hoc and spontaneous measures. The adverse consequences are apparent for all to see in Europe at present; yet there is still no move to establish a viable cross-border resolution authority.

I have checked these facts directly and recently with top Wall Street lawyers, with leading thinkers from left and right on financial issues (U.S., European, and others), and with responsible officials from the United States and other relevant countries. That Senator Kaufman was correct is now affirmed on all sides.

Even leading figures within the financial sector are candid on this point. Hirsch quotes Gerry Corrigan, former head of the New York Federal Reserve Bank, and an executive at Goldman Sachs since the 1990s.

> In my judgment, as best as I can recount history, not just the last 3 years but the history of mankind, I can't think of a single case where we were able execute the orderly wind-down of a systemically important institution—especially one with an international footprint.

It is most unfortunate that Mr. Corrigan did not make the same point last year—for example, when he and I both testified before the Senate Banking Committee on the Volcker Rule (in February 2010).

In fact, rather ironically in retrospect, Mr. Corrigan was among those arguing most articulately that some form of "Enhanced Resolution Authority" (as he called it) could actually handle the failure of Large Integrated Financial Groups (again, his terminology).

The "resolution authority" approach to dealing with very big banks has, in effect, failed before it even started.

And standard commercial bankruptcy for global megabanks is not an appealing option—for reasons that Anat Admati has explained. The only people who are pleased with the Lehman bankruptcy are bankruptcy lawyers. Originally estimated at over $900 million, bankruptcy fees for Lehman Brothers are now forecast to top $2 billion (more detail on the fees here).

It's too late to reopen the Dodd-Frank debate—and a global resolution authority is a chimera in any case. But it's not too late to affect policy that matters. The lack of a meaningful resolution authority further strengthens the logic behind the need for larger capital requirements, as these would provide stronger buffers against bank insolvency.

The Federal Reserve has yet to announce the precise percent of equity funding—*i.e.,* bank capital—that will be required for systemically important financial institutions (so-called SIFIs). Under Basel III, national regulators set an additional SIFI capital buffer. The Swiss National Bank is requiring 19 percent capital and the Bank of England is moving in the same direction. The Fed should also move towards such capital levels or—preferably—beyond.

Unfortunately, there are clear signs that the Fed's thinking—both at the policy level and at the technical level—is falling behind this curve.

It is not too late to listen to Senator Kaufman. In his capacity as chair of the Congressional Oversight Panel for TARP during 2011 (*e.g.,* in this hearing), Mr. Kaufman argued consistently and forcefully for higher capital requirements. This would work as a global approach to make banking safer. Unfortunately, making progress on this issue with European countries will be much delayed—at least until the eurozone has sorted out its combined fiscal-monetary-financial disaster.

The best approach for the United States today would be to make all financial institutions small enough and simple enough so they can fail—*i.e.,* go bankrupt—without adversely affecting the rest of the financial sector. The failures of CIT Group

in fall 2009 and MF Global in fall 2011 are, in this sense, encouraging examples. But the balance sheets of these institutions were much smaller—about $80 billion and $40 billion, respectively—than those of the financial firms currently regarded as Too Big To Fail.

PREPARED STATEMENT OF THE HONORABLE PHILLIP L. SWAGEL

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DECEMBER 7, 2011

Chairman Brown, Ranking Member Corker, and Members of the Committee, thank you for the opportunity to testify on the new regime for regulating large, complex financial institutions. I am a professor at the University of Maryland's School of Public Policy and a faculty affiliate of the Center for Financial Policy at the Robert H. Smith School of Business at the University of Maryland. I am also a visiting scholar at the American Enterprise Institute and a senior fellow with the Milken Institute's Center for Financial Understanding. I was previously Assistant Secretary for Economic Policy at the Treasury Department from December 2006 to January 2009.

Failures in the regulation of large complex financial institutions played an important role in the financial crisis. Many large American financial firms required substantial assistance from the Federal Government, including capital injections and asset guarantees through the TARP and access to a range of liquidity facilities from the Federal Reserve. At the same time, the main problems in subprime housing that gave rise to the crisis arose outside the most heavily regulated parts of the financial system among nonbank mortgage originators, Fannie Mae and Freddie Mac, and participants in the so-called shadow banking system.

Indeed, a broad view of the crisis shows failures by market participants at all levels of the financial system: sophisticated asset managers who bought subprime mortgage-backed securities (MBS) without understanding what was inside or demanding more information; securitizers who put those faulty securities together; rating agencies that stamped them as AAA; bond insurers who covered them; originators who made the bad loans in the first place; mortgage brokers who facilitated the process; and so on, including crucial deficiencies at the Government-Sponsored Enterprises (GSEs) of Fannie Mae and Freddie Mac. (Unfortunately one must also add to the list of failures the actions of some home buyers in providing inaccurate information on mortgage applications or in signing on the dotted line for a house they could not afford—though of course there was someone on the other side of each of these transactions willing to extend the loan.)

Moreover, the severe credit strains that ensued following the failure of Lehman Brothers in September 2008 were made considerably worse by problems in money market mutual funds—large, to be sure, but hardly a complex type of financial institution. The new regulatory regime for large, complex financial institutions is a vital part of lessening the likelihood of future crises, but it is important to keep in mind that there were many contributors to recent events beyond these firms and that an undue focus on this one element risks missing out on others.

Getting the right balance between financial market regulation and dynamism, including the possibility of failure and creative destruction, is an essential element of fostering a more robust economic recovery and a strong U.S. economy into the future. The slow recovery from the recent recession reflects many factors, including the drag on demand from deleveraging by consumers and firms, the negative impact of policy and regulatory decisions, and the overhang of uncertainty about future taxes, health and energy costs, and so on. But drag from the financial system is likely playing a role as well, with many families and businesses still finding constrained access to credit. While loans were too readily available before the crisis, a danger today is that the pendulum has swung too far in the other direction. The caution of market participants in putting capital at risk could be exacerbated by uncertainty over the impact of ongoing financial regulatory changes. This uncertainty will weigh on the financial sector and the economy.

Detecting and Avoiding Future Problems in the New Regulatory Regime

Regulators did not detect problems in the financial system and act upon the mounting stresses in time to avert the crisis. This reflects failures by the regulators (as was evident in the problems at institutions such as Countrywide, WAMU, IndyMac, and many other firms) and shortcomings and gaps in the regulatory system (as revealed, for example, in the case of AIG, in which no regulator had an adequate line of sight over the activities of the financial products division). This latter

problem of the fragmented nature of the U.S. regulatory system was long-understood; indeed, the Treasury Department under the direction of Secretary Paulson in early 2008 put out a thoughtful blueprint to reshape U.S. regulatory system by function.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) includes important provisions that will help avoid future problems and improve the likelihood of detecting them as they arise. Dodd-Frank further provides authorities with tools to deal with severe problems when necessary. The new regulatory regime has the promise of improvement over the one that failed to prevent the recent financial crisis. But much of the change embodied in Dodd-Frank remains to be finalized by regulators, some provisions of the Act do not seem to contribute positively to an improved regulatory regime, and there are still important missing elements in the legislation, notably with respect to reform of the housing finance system and of money market mutual funds.

Improved capital standards and more robust liquidity requirements in both the Dodd-Frank Act and through the Basel III process will help make large, complex financial institutions more robust to losses and thereby help to avoid future crises. While it is hard to imagine that 2 or 4 percentage points of additional capital would have saved Lehman Brothers or Bear Stearns once investors lost confidence in those institutions, more capital will help deepen the buffer in the future before confidence is lost. As discussed below, however, there are costs as well as benefits to increased capital requirements—the challenge for regulators (and for society) is to find the balance.

The establishment of the Financial Stability Oversight Council (FSOC) and the Office of Financial Research (OFR) make it more likely that regulatory authorities will detect building problems. The FSOC in particular will help avoid a repetition of the problems evident in oversight of AIG, where risky activities at one division slipped between the cracks in the sense that no regulator had clear responsibility. Going forward, all systemically important financial institutions will be subject to bank-like regulation. Dodd-Frank further empowers the regulatory agencies acting jointly, but especially the Federal Reserve, to look across firm activities and across industry participants to watch for mounting risks. This will help get at the issue that subprime lending was not necessarily a problem for many individual industry participants (though it was for some such as Countrywide and WAMU), but subprime lending taken together across firms posed a risk to the financial sector.

The Office of Financial Research likewise has the potential to help regulators obtain and analyze information across firms and asset classes. Asking for information involves costs, however, and it will be important for the OFR to avoid overly burdensome requests. But the potential is there to help detect systemic risk. Moving forward with a system for a uniform legal entity identifier would help foster greater transparency and allow regulators and firms themselves to better measure and monitor risks. Such transparency can help beyond just immediate tracking of performance because improved availability of information would be expected to affect firms' reputational capital. For example, information that allows investors to more readily link, say, poorly performing loans back to particular originators would provide powerful reputational incentives for better lending performance.

It is impossible to avoid or detect all problems—regulators are only human after all—but these provisions will help.

The benefits of other aspects of the Dodd-Frank Act are less clear in terms of helping to safeguard the financial system against future crises. I would see the so-called Volcker Rule as falling into this category. Proprietary trading does not appear to have a contributing factor in the crisis, and indeed, revenues from this activity helped to offset losses in other areas and thus stabilize some financial firms. It is difficult in practice to distinguish proprietary trading from the normal market-making activities of a broker dealer—a difficulty that is perhaps reflected in the voluminous attempt of the regulatory agencies to define the rule. A poorly implemented Volcker Rule could reduce liquidity in financial markets and thus raise costs and decrease investment in the broader economy. Indeed, the flat exemption of trading in Treasury securities from the rule illustrates the potential downside. Removing this activity from large financial institutions could have had a meaningful negative impact on demand for Treasury securities and thus lead to increased yields and higher costs for public borrowing. The same concern applies to other activities that will be affected by the rule—all investors and savers will be affected. And investors and savers are not just large, complex financial institutions, but include workers whose pension funds and 401(k)s invest in these securities. Families will have less access to credit and thus less ability to buy homes, cars, and put children through college. Businesses will find it harder to borrower, which will make it harder for them to do research and development, make capital investments, and create jobs.

Asset prices will be pushed down, which will punish investors and savers. It is not clear what problem this rule is meant to solve, making it likely that this aspect of the new regulatory regime for large, complex financial institutions strikes a poor tradeoff between the gains from the regulation and the impairment to markets and overall economic vitality.

The impact of many other provisions is unclear because rules are still to be determined or finalized. The new regime for derivatives, including the increased role for clearinghouses and exchanges in derivative transactions, has the potential to usefully strengthen transparency and thus improve the overall financial regulatory regime, including for large, complex financial institutions. On the other hand, it difficult to understand the benefits of the so-called Lincoln Amendment that requires some derivatives-related activities to be spun off into separately capitalized entities. Part of the value of large financial institutions to markets and the broader economy is the ability to conduct a wide range of transactions, including making markets in derivatives. Indeed, the decision by the Obama administration to exempt the foreign exchange market from these aspects of Dodd-Frank suggests that the Administration shares the concern that these provisions likewise do not strike an appropriate balance between the benefits and the costs in terms of diminished economic vitality.

The Benefits of Large Financial Institutions

The tradeoff between increased regulation and economic vitality applies as well to regulations under Section 165 of the Dodd-Frank Act relating to enhanced supervision and prudential standards (many of which are not yet final). Heightened capital requirements provide an increased margin of safety for firms to absorb losses (though this does not necessarily reduce the impact of the failure on the broader financial system once a large firm burns through the added capital). But requiring firms to hold more capital is not free—there is an impact on financial intermediation and thus on the economy that must be kept in mind. Importantly, the empirical evidence is that real-world banks react to binding capital requirements mainly by reducing assets—by making fewer loans—rather than by adding capital. There is a tradeoff, unlike in the theoretical construct in which there are no frictions and a firm's capital structure (the mix of debt and equity in the enterprise) does not matter. In the real world, the tax system favors debt over equity and the bankruptcy system (including the new resolution mechanism discussed below) imposes costs on market participants. These realities are at odds with the assumptions in recent academic work calling for considerably higher capital requirements.

An overly large increase in required capital might impose considerable costs on financial firms and the broader economy without a commensurate increase in financial stability. Banks with very high capital requirements would be less apt to perform the role of providing liquidity services such as through demand deposits and other types of short-term financing. Moreover, increased capital requirements would drive lending activity once again out of the banking system into the less-regulated "shadow banking system." Increased capital would make banks safer, but these firms would no longer perform the functions that society expects of them and risk-taking will migrate outside the regulated banking sector.

The new regulatory regime should also pay attention to the differential impact of financial reforms proceeding at different paces and in various ways across countries. Capital requirements are measured against risk-weighted assets, but financial institutions in Europe (especially) appear to have considerably more aggressive weightings in terms of denoting assets as less risky than is the case in the United States. This means that European firms hold less capital than U.S. competitors with similar assets, thus distorting the competitive balance between firms across borders. This is not to say that the United States should follow Europe in a race-to-the-bottom of lower risk weightings and less capital. The Basel process would be a natural channel through which to ensure that U.S. firms are not disadvantaged.

Similar considerations apply to new liquidity standards, which should take into account the actual characteristics of assets during the recent crisis. GSE securities, for example, have been essentially guaranteed by the Federal Government since Fannie Mae and Freddie Mac were taken into conservatorship in September 2008 and thus remained liquid throughout the crisis. Advances from the Federal Home Loan Banks (FHLBs) were likewise important sources of liquidity for many U.S. financial institutions during the crisis. Until there is a change in the GSEs or FHLBs, these recent experiences should inform the use of such assets in meeting heightened liquidity requirements.

The process by which large, complex financial institutions will undergo annual capital assessments (stress test) has already proved a valuable addition to the prudential regulatory toolkit. The 2009 stress tests, for example, provided an important signal to market participants that key financial institutions would not be national-

ized and thus lifted a barrier to renewed private sector investment in financial firms. The key going forward is to develop realistic scenarios against which to test bank balance sheets. An overly optimistic scenario is not a test, while an unduly pessimistic one could turn into a nontransparent mechanism by which to restrict financial firms' capital distributions—which would ultimately affect firms' ability to attract capital.

Similarly, the process of drawing up so-called living wills could be useful (so long as the undertaking is not extraordinarily burdensome), even though it is inevitable that plans made ahead of time will not be perfectly applicable in a crisis.

The Value of Large, Complex Financial Institutions

The regulatory regime brought about by the Dodd-Frank Act places new burdens on large firms and requires them to hold more capital and have more robust access to liquidity. But the Act does not seek to break up large financial institutions or to reinstitute broader barriers to their activities such as by reinstituting the Glass-Steagall separation of commercial and investment banking. This is appropriate.

The end of the Glass-Steagall restrictions is not well correlated with the failures evident in the recent financial crisis. Bear Stearns and Lehman Brothers both failed, but these firms had remained investment banks. JPMorgan Chase, on the other hand, combined investment banking and commercial banking and yet weathered the strains of the crisis relatively well. The problems revealed by the crisis seem to be in the riskiness of the activities themselves—subprime lending, for example—and not in the combination of commercial and investment banking.

The aftermath of the crisis has meant increased scale for the largest of the surviving institutions. This has both benefits and costs. Among the potential costs are that the failure of a large financial institution could have important impacts on markets and the broader economy. At the same time, there are benefits to the U.S. economy from having large financial institutions, including important advantages to society arising from economies of scope and of scale. A recent study from the Clearing House Association (for which I am a member of the academic advisory committee) discusses and quantifies these benefits.[1] The benefits of scope and scale go together, as banks that are large banks in both size (scale) and footprint (scope) are best able to undertake commercial transactions for large multinational corporations. This reflects the evolution of the globalized economy, as large banks have a relatively strong ability to offer financial products to large customers with specific needs, including in trade finance, global lending, and cash management. Smaller banks can offer these services, but the Clearing House Association study shows that there are benefits to having banks large enough to do them on a scale commensurate with the largest corporate customers.

Similar benefits of scope and scale apply to capital market activities outside of commercial banking, including offering and arranging derivatives-related transactions and investment banking. These benefits reflect the fact that firms with large and diverse balance sheets can best make liquid markets for large transactions and across a broad range of assets. Large financial institutions are best positioned to stand ready as a market-maker to buy and sell assets, including derivatives that allow the beneficial transfer of risk by end users. Sometimes it is helpful and necessary to have a large balance sheet to put to work. Taken together, the benefits for society through increased economic efficiency resulting from the scale and scope of large banks are estimated at 50 to 100 billion dollars per year.

The diversity of small and large institutions and in other dimensions is a feature of the U.S. financial system. Different sizes of U.S. financial institutions stand ready to deal with different types of customers and products. Large banks are essential for firms requiring large amounts of financing—transactions undertaken by large global companies involving multiple billions of dollars of financing. Foreign banking systems are typically far more concentrated than that of the United States—and large foreign banks would stand ready to serve U.S. multinationals in the event that the larger U.S. banks were dismantled. And as with excessive capital requirements, policy actions that diminished the capacities of large U.S. banks could well lead some financial business to move to the less-regulated shadow banking system.

It should be kept in mind that smaller banks present risks—something illustrated in the U.S. savings and loan crisis of the late 1980s and reflected in other countries in the more recent crisis. In Spain, for example, the large banks have been broadly stable (perhaps more so than the sovereign), while smaller and less-diversified financial institutions have been in severe distress.

The diversity of the U.S. financial system is reflected in the different ways that institutions fund themselves. Smaller banks tend to fund their activities using low-

[1] The study is available on *http://www.theclearinghouse.org/index.html?f=073071.*

cost deposits that benefit from the FDIC guarantee and with FHLB advances that likewise have a Federal guarantee. Larger institutions that fund with a greater diversity of sources now pay deposit insurance premiums on nondeposit liabilities even though these liabilities are not actually covered by the FDIC. Larger institutions, especially the so-called globally systemically important banks but also possibly including U.S. banks that are not designated as globally systemic, will face increased capital requirements. The diversity of funding sources is again a strength of the U.S. system; the point here is that it is important to avoid overstating the potential funding advantage of larger financial institutions. This is especially the case going forward with the new resolution authority in the Dodd-Frank Act that makes meaningful changes to the notion that some institutions will be rescued by Government action and thus that market participants will be willing to fund these firms at lower costs. This idea of "too big to fail" is discussed next.

Dealing With a Future Financial Crisis: Resolution Authority

The Title II resolution authority will have important effects on large, complex financial institutions and on the providers of funding to these institutions. For bondholders and other nondeposit funders, the Dodd-Frank resolution authority puts them on notice that they should expect to take losses in the event that a firm fails and is taken into resolution. Resolution authority could well involve the deployment of Government resources (later to be repaid by market participants) to support a firm and slow its demise. But the outcome is virtually certain to involve losses for bondholders, unlike what generally happened during the crisis.

For better or worse, the Title II authority will be used in the event that a large complex financial institution fails. After all, it is difficult to imagine another TARP facility to intervene in the financial sector. The authorities in Title II give Government officials some TARP-like ability to put money into failing firms, and the experience of the recent crisis is that policy makers are likely to use these authorities to avoid the full impact of the collapse of a large systemically significant firm. This likelihood in turn will affect the behavior of market participants today. In this way, Title II makes for a profound change in the regulatory environment facing large, complex financial institutions, including a meaningful change from the past belief that institutions were too big to fail.

It is hard to know precisely how the resolution authority will be used, notably because the authority is likely to be exercised in a time of broad financial market stress when regulators face a variety of challenges. For making changes to the concept of too big to fail, what matters most is the ability of the FDIC in undertaking the resolution to make *ex post* clawbacks from bondholders to cover losses after shareholder equity is wiped out. Indeed, the FDIC has been clear that bondholders should not expect to get additional payments through use of the Dodd-Frank resolution authority—it is more likely the opposite. This can take place even if the FDIC initially uses Government funds to keep a firm in operation in resolution—this might occur, for example, if the FDIC seeks to preserve the "franchise value" of a large firm while it arranges a sale of the firm or of components to new owners. Another possible outcome is that the FDIC uses the Title II authorities to arrange a debt-for-equity swap that recapitalizes the failing firm (or perhaps some parts of it) in a new form and with new management and shareholders (namely, the former bondholders). Such a debt-for-equity recapitalization would be similar to a prepackaged Chapter 11 reorganization under the bankruptcy code, though the Title II authorities would allow this to be done faster and with funding provided by the Government (though eventually paid back by private market participants). It should be noted that much of this was already possible with the regular bankruptcy process and that it remains an open question as to whether Title II will make policy makers more likely to intervene in markets. That is, Title II could help limit the notion of too big to fail but give rise to more Government interference that has other negative impacts on the economy.

The key element for addressing too big to fail is that bondholders take losses. This is likely to be the case, given that the ability to do this is clear in the legislation. In contrast to the resolution of WAMU by the FDIC in the fall of 2008, the imposition of (possibly substantial) losses will not be a surprise to bondholders and therefore should not cause massive spillover effects that adversely impact the ability of other firms to fail. The key is that Title II makes clear that bondholders will take losses.

It must be kept in mind that there are other, possibly troublesome, effects from the new authority. The certainty of losses in resolution will give providers of funding to banks an incentive to flee at early signs of trouble. This sort of run from failing institutions is an important disciplining device, but the regime change could mean a more hair trigger response than previously and thus inadvertently prove de-

stabilizing. This would be the case if market participants move away from long-term funding of financial institutions because of the increased possibility of losses.

The ability of policy makers to deploy public resources in the resolution process also gives rise to concerns that firms taken into resolution could be used for policy purposes. Losses to the Government are ultimately borne *ex post* by the bondholders once the equity of the firm is exhausted, which seems likely to be the case. The legislation seeks to narrow the scope of action for the FDIC in resolution by guaranteeing bondholders that they will receive as much in resolution as would have been the case under bankruptcy, but this still gives scope for actions to use the firm under resolution. In a sense, the resolution authority provides Government officials with an open checkbook to act through the troubled firm, with bondholders picking up the tab. This is not an empty concern; witness, for example, efforts to have the GSEs undertake loss-making policy activities which would then be offset by new capital injections from the Treasury. The funds under Title II would come first from bondholders and then from assessments on other market participants rather than from taxpayers, but the concern is over the ability of the Government to act and transfer resources without a vote of the Congress. This concern remains even if it bondholders on the hook rather than taxpayers.

Finally, the resolution authority will be incomplete and perhaps unworkable until there is more progress on the international coordination of bankruptcy regimes.

Conclusion

The new regulatory regime for large, complex financial institutions will be a vast change from the system before the financial crisis. Important aspects of the change are for the good, including changes that address the phenomenon under which some firms were too big to fail. But there is still much that is unclear in the workings of the new regulatory regime and much rulemaking to be done.

It is important to keep in mind that many of the changes will involve costs as well as benefits. Higher capital and liquidity requirements, for example, will impose costs on financial institutions that will affect lending activity and thus the overall economy. Changes are still desirable in the wake of the crisis; the key is to be cognizant of the tradeoffs involved and avoid regulatory requirements that provide inadequate benefits relative to the costs involved.

This tradeoff applies to discussions about the role of large, complex financial institutions in the U.S. financial system and the broader economy. These institutions provide important benefits for financial markets and for the economy. Changes that lessen their role or impair their functioning would have meaningful costs to society.

Finally, there are important aspects of financial regulatory reform that were not accomplished in the Dodd-Frank legislation and that pertain to the regulatory regime for large, complex financial institutions. The unfinished business of regulatory reform notably includes the future of the housing finance system, including Fannie Mae and Freddie Mac, reforms to money market mutual funds, and changes to the oversight of broader aspects the collateralized lending that takes place in the so-called shadow banking system. If anything, some provisions of Dodd-Frank could make the shadow banking system larger as activities migrate (or are forced to migrate) out of the more heavily regulated large financial institutions.

PREPARED STATEMENT OF ARTHUR E. WILMARTH, JR.

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DECEMBER 7, 2011

HEARING ON "ENHANCED SUPERVISION: A NEW REGIME FOR REGULATING LARGE, COMPLEX FINANCIAL INSTITUTIONS," ON DECEMBER 7, 2011, BEFORE THE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER PROTECTION OF THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS, UNITED STATES SENATE

WRITTEN TESTIMONY OF ARTHUR E. WILMARTH, JR.
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Washington, D.C.

Thank you very much for inviting me to participate in this important hearing. My testimony will address the following topics related to the regulation of large, complex financial institutions ("LCFIs"): (1) the extraordinary governmental assistance provided to "too big to fail" ("TBTF") financial institutions during the financial crisis, (2) the dangerous distortions in our financial markets created by explicit and implicit subsidies for TBTF institutions, (3) the inadequacy of the regulatory regime established by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") to solve the TBTF problem, and (4) a proposed new set of regulatory reforms that would require systemically important financial institutions ("SIFIs") to internalize the costs of their risk-taking and prevent SIFI-owned banks from transferring their safety net subsidies to their nonbank affiliates.

My proposed approach, which relies on the "narrow bank" concept, would create a true "market test" for SIFIs. I believe that test would cause many SIFIs to break up voluntarily if they could not produce satisfactory returns to investors after losing their access to extensive public subsidies. My proposed approach is similar to (a) a recent report by the U.K. Independent Commission on Banking (the "Vickers Report"), which advocates a "ring-fencing" concept that would require financial conglomerates to separate their "utility" retail banking operations from

their "casino" wholesale activities in the capital markets, and (b) proposed "core banking" legislation introduced by Senator (then-Representative) Charles Schumer in 1991.

1. TBTF Financial Institutions Received Extraordinary Governmental Assistance during the Financial Crisis

The federal government provided massive amounts of financial assistance to LCFIs during the financial crisis. The Troubled Asset Relief Program ("TARP") provided $290 billion of capital assistance to the 19 largest U.S. banks (each with more than $100 billion of assets) and the largest U.S. insurance company, American International Group ("AIG"). Federal regulators enabled the same 19 banks and GE Capital (a huge finance company owned General Electric) to issue $290 billion of FDIC-guaranteed, low-interest debt. In contrast, smaller banks (with assets under $100 billion) received only $41 billion of TARP capital assistance and issued only $11 billion of FDIC-guaranteed debt.[1]

The Federal Reserve System ("Fed") also provided massive amounts of credit assistance to financial institutions through a series of emergency lending programs. The total amount of Fed emergency credit reached a single-day peak of $1.2 trillion in December 2008. The Fed extended the vast majority of this emergency credit to large U.S. and European banks and provided very little help to smaller institutions. The highest daily amount of the Fed's

[1] Arthur E. Wilmarth, Jr., "Reforming Financial Regulation to Address the Too-Big-to-Fail Problem," 35 *Brooklyn Journal of International Law* 707, 737-38 (2010) [hereinafter Wilmarth, "Reforming Financial Regulation"], available at http://ssrn.com/abstract=1645921. Federal regulators took an extraordinary step in allowing GE Capital to issue $55 billion of FDIC-guaranteed, low-interest debt securities. GE Capital issued the debt securities by virtue of its ownership of two FDIC-insured depository institutions (a thrift and an industrial bank) located in Utah. Regulators granted GE Capital special permission to participate in the FDIC's debt guarantee program even though GE Capital was not a bank holding company and therefore did not meet the general terms and conditions for participation in the program. Indeed, GE Capital could not become a bank holding company because its parent, General Electric, is an industrial conglomerate that is barred by statute from owning banks. *Id.* at 738 n.122, 774 n.260.

emergency credit to the ten largest U.S. commercial and investment banks reached $669 billion, representing more than half of the daily peak amount for all Fed lending programs.[2]

The Fed and the Treasury also supported financial institutions and the financial markets by purchasing more than $1.5 trillion of direct obligations and mortgage-backed securities ("MBS") issued by government-sponsored enterprises ("GSEs"). In combination, the federal government provided more than $6 trillion of support to financial institutions during the financial crisis, if such support is measured by the peak amounts of outstanding assistance under TARP capital programs , Fed emergency lending programs, FDIC debt guarantees, and other asset purchase and guarantee programs.[3] European nations similarly provided more than $4 trillion of financial support to their financial institutions by the end of 2009.[4]

Federal regulators acted most dramatically in rescuing LCFIs that were threatened with failure. U.S. authorities bailed out two of the three largest U.S. banks – Bank of America ("BofA") and Citigroup – as well as AIG. In addition, federal regulators provided financial support for emergency acquisitions of two other major banks (Wachovia and National City), the two largest thrifts (Washington Mutual ("WaMu") and Countrywide), and two of the five largest securities firms (Bear Stearns and Merrill Lynch). Regulators also approved emergency conversions of two other leading securities firms (Goldman Sachs and Morgan Stanley) into

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[2] Bradley Keoun & Phil Kuntz, "Wall Street Aristocracy Got $1.2 Trillion in Secret Fed Loans," *Bloomberg.com*, Aug. 22, 2011; Bob Ivry, Bradley Keoun & Phil Kuntz, "Secret Fed Loans Helped Banks Net $13 Billion," *Bloomberg.com*, Nov. 27, 2011.

[3] The "high-water mark" of the combined programs, based on the largest outstanding amount of each program at any one time, was $6.3 trillion. The federal government's maximum potential exposure under those programs was $23.9 trillion. Office of the Special Inspector General for the Troubled Asset Relief Program ("SIGTARP"), Quarterly Report to Congress, July 21, 2010, at 116-19, 118 tbl. 3.1.

[4] Adrian Blundell-Wignall et al., "The Elephant in the Room: The Need to Deal with What Banks Do," 2 *Organization for Economic Co-operation & Development Journal: Financial Market Trends*, Vol. 2009, No. 2, at 1, 4-5, 14, 15 tbl.4, *available at* http://www.oecd.org/dataoecd/13/8/44357464.pdf (stating that the U.S. provided $6.4 trillion of assistance to financial institutions through capital infusions, asset purchases, asset guarantees, and debt guarantees as of October 2009, while the United Kingdom and European nations provided $4.3 trillion of such assistance).

bank holding companies ("BHCs"), thereby placing those institutions under the FRB's protective umbrella.[5]

The federal government further publicly guaranteed that none of the 19 largest banks would be allowed to fail. When federal regulators announced their "stress tests" in early 2009, they declared that the Treasury Department would provide any additional capital that was needed to ensure the survival of all 19 banks. Regulators also stated that they would not impose regulatory sanctions on the top 19 banks under the "prompt corrective action" ("PCA") regime established by Congress in 1991, despite the non-discretionary nature of those sanctions. Instead of issuing public enforcement orders, regulators entered into private and confidential "memoranda of understanding" with BofA and Citigroup despite the gravely weakened conditions of both banks. Thus, federal regulators gave white-glove treatment to the 19 largest banks and unequivocally promised that they would survive.[6]

In stark contrast, federal regulators imposed PCA orders and other public enforcement sanctions on hundreds of community banks and allowed many of those institutions to fail.[7] Almost 350 FDIC-insured depository institutions failed between January 1, 2008 and March 31, 2011.[8] Only one of those institutions – WaMu, a large thrift institution – had more than $50 billion of assets.[9] In view of the massive TBTF assistance that the federal government provided to our largest banks, it is small wonder that those banks enjoy a decisive advantage in funding costs over smaller banks. As FDIC Chairman Sheila Bair pointed out in a speech on May 5,

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[5] Arthur E. Wilmarth, Jr., "The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-to-Fail Problem," 89 *Oregon Law Review* 951, 958-59, 983 (2011) [hereinafter Wilmarth, "Dodd-Frank"], available at http://ssm.com/abstract=1719126.
[6] *Id.* at 958-59, 983; Wilmarth, "Reforming Financial Regulation," *supra* note 1, at 712-13, 743-44.
[7] Wilmarth, "Reforming Financial Regulation," *supra* note 1, at 744, 744 n.145.
[8] 5 *FDIC Quarterly* No. 2 (2011), at 16 (Table II-B).
[9] 2 *FDIC Quarterly* No. 4 (2008), at 14 (referring to the failure of Washington Mutual Bank, with $307 billion of assets, on Sept. 25, 2008).

2011, "In the fourth quarter of [2010], the average interest cost of funding earning assets for banks with more than $100 billion in assets was about half the average for community banks with less than $1 billion in assets."[10]

When the federal government finally promised to help community banks, it failed to deliver. On February 2, 2010, President Obama announced a new program that would use $30 billion of TARP funds to assist community banks in making small business loans.[11] However, in September 2011, the Treasury Department shut down the Small Business Lending Fund after providing only $4.2 billion – just 14% of the promised amount – to community banks. Members of Congress strongly criticized the Treasury Department for long delays in approving applications by community banks and for imposing onerous conditions on applicants.[12]

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

At the height of the financial crisis in March 2009, Fed Chairman Ben Bernanke admitted that "the too-big-to-fail issue has emerged as an enormous problem" because "it reduces market discipline and encourages excessive risk-taking" by TBTF firms.[13] Several months later, Governor Mervyn King of the Bank of England condemned the perverse incentives created by TBTF subsidies in even stronger terms. Governor King maintained that "[t]he massive support extended to the banking sector around the world, while necessary to avert economic disaster, has

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[10] Sheila C. Bair, "We Must Resolve to End Too Big to Fail," 5 *FDIC Quarterly* No. 2 (2011), at 25, 26 (reprinting speech delivered on May 5, 2011).
[11] Cheryl Bolen, "Troubled Asset Relief Program: White House Explains $30 Billion Plan To Expand Bank Loans to Small Businesses," 94 *BNA's Banking Report* 262 (Feb. 9, 2010).
[12] Kevin Wack, "Lending Fund Puts Geithner on the Defensive," *American Banker*, Oct. 19, 2011.
[13] Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve, Financial Reform to Address Systemic Risk, Speech at the Council on Foreign Relations (Mar. 10, 2009), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm.

created possibly the biggest moral hazard in history."[14] He further argued that TBTF subsidies provided a likely explanation for decisions by LCFIs to engage in high-risk strategies during the credit boom:

> Why were banks willing to take risks that proved so damaging to themselves and the rest of the economy? One of the key reasons – mentioned by market participants in conversations before the crisis hit – is that incentives to manage risk and to increase leverage were distorted by the implicit support or guarantee provided by government to creditors of banks that were seen as 'too important to fail.' . . . Banks and their creditors knew that if they were sufficiently important to the economy or the rest of the financial system, and things went wrong, the government would always stand behind them. And they were right.[15]

Industry studies and anecdotal evidence confirm that TBTF subsidies create significant economic distortions and promote moral hazard. In recent years, and particularly during the present crisis, LCFIs have operated with much lower capital ratios and have benefited from a much lower cost of funds, compared with smaller banks. In addition, credit ratings agencies and bond market investors have given preferential treatment to TBTF institutions because of the explicit and implicit government backing they receive.[16]

A recent study shows that large banks have received huge benefits from the implicit TBTF subsidy over the past two decades.[17] This study, which analyzed publicly-traded bonds issued by U.S. banks between 1990 and 2010, concluded that bond investors expected the federal government to support the largest banks throughout that period. Although the largest banks

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[14] Mervyn King, Governor of the Bank of England, Speech to Scottish Business Organizations in Edinburgh 4 (Oct. 20, 2009), *available at* http://www.bankofengland.co.uk/publications/speeches/2009/speech406.pdf [hereinafter *King 2009 Speech*]. *See also* Richard S. Carnell, Jonathan R. Macey & Geoffrey P. Miller, *The Law of Banking and Financial Institutions* 326 (4th ed. 2009) (explaining that "moral hazard" results from the fact that "[i]nsurance changes the incentives of the person insured . . . . [I]f you no longer fear a harm [due to insurance], you no longer have an incentive to take precautions against it").

[15] *King 2009 Speech*, *supra* note 144, at 3.

[16] Wilmarth, "Dodd-Frank," *supra* note 5, at 981-84 (citing studies and other evidence).

[17] A. Joseph Warburton & Daniz Anginer, "The End of Market Discipline? Investor Expectations of Implicit State Guarantees" (Nov. 18, 2011), available at http://ssrn.com/abstract=1961656.

pursued riskier strategies, they issued bonds with significantly lower yield spreads over Treasury bonds, compared to bonds issued by smaller banks.[18] Additionally, the authors found that bond investors responded significantly to Fitch's "issuer" ratings that included the expectation of governmental support for the biggest banks, but bond investors did not respond significantly to Fitch's "individual" ratings based on the standalone strength of the same banks. In other words, "investors do not price the true, intrinsic ability of a [big] bank to repay its debts, but instead price implicit government support for the bank."[19]

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

> an annual [average] funding cost advantage of approximately 16 basis points before the financial crisis, increasing to 88 basis points during the crisis, peaking at more than 100 basis points in 2008. The total value of the subsidy amounted to about $4 billion per year before the crisis, increasing to $60 billion [annually] during the crisis, topping $84 billion in 2008.[20]

Moreover, the authors found that "[t]he passage of Dodd-Frank in July of 2010 did not eliminate investors' expectations of government support. In fact, expectations of government support rose in 2010 [compared to 2009]."[21] The authors concluded that the value of the implicit TBTF subsidy to large banks was highest during times of financial crisis (i.e., the 1980s, 1997-98, 2000-02, and 2007-10). However, the subsidy "persists even during times of relative tranquility" and therefore represents "an ongoing wealth transfer" from taxpayers to large banks.[22]

The financial crisis has vividly illustrated the tendency of LCFIs to exploit their explicit safety net subsidies (i.e., federal deposit insurance and access to the Fed's discount window) and their implicit TBTF subsidy by using their access to low-cost funds to finance high-risk

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[18] *Id.* at 3, 10-11, 14-15.
[19] *Id.* at 3, 15-17.
[20] *Id.* at 4, 12.
[21] *Id.* at 19, 33 (Figure 4).
[22] *Id.* at 18-20, 33 (Figure 4).

activities.[23] As I have explained in previous articles, LCFIs were "the primary private-sector catalysts for the destructive credit boom that led to the subprime financial crisis, and they [became] the epicenter of the current global financial mess."[24] Eighteen major LCFIs – including ten leading U.S. financial institutions and eight giant foreign banks – were the dominant players in global securities and derivatives markets during the credit boom.[25] Those 18 LCFIs included most of the top underwriters for nonprime MBS, other types of asset-backed securities ("ABS") and leveraged buyout ("LBO") loans, as well as related collateralized debt obligations ("CDOs") and credit default swaps ("CDS"). Although Fannie Mae and Freddie Mac funded about a fifth of the nonprime mortgage market between 2003 and 2007, they did so primarily by purchasing nonprime mortgages and private-label MBS that were originated or underwritten by LCFIs. LCFIs provided most of the rest of the funding for nonprime home

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[23] A recent study explains that "[a] nation's financial safety net consists of whatever array of programs it uses to protect bank depositors and to keep systemically important markets and institutions from breaking down in difficult circumstances." The study further points out that, during the current financial crisis, government agencies in the U.S. and the European Union "exercised a loss-shifting 'taxpayer put' that converted most of the losses incurred by insolvent [TBTF] firms into government debt." Edward J. Kane et al., Safety-Net Benefits Conferred on Difficult-to-Fail-and-Unwind Banks in the U.S. and EU Before and During the Great Recession at 2, 4 (July 1, 2011), Paolo Baffi Center Research Paper No. 2011-95, available at http://ssrn.com/abstract=1884131.

[24] Wilmarth, "Dodd-Frank," *supra* note 5, at 977 (quoting Arthur E. Wilmarth, Jr., "The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis," 41 *Connecticut Law Review* 963, 1046 (2009) [hereinafter Wilmarth, "Financial Conglomerates"], available at http://ssrn.com/abstract=1403973).

[25] During the credit boom that led to the financial crisis, the 18 leading LCFIs in global and U.S. markets for securities underwriting, securitizations, structured-finance products and over-the-counter derivatives (the "big eighteen") included the four largest U.S. banks (BofA, JP Morgan Chase ("Chase"), Citigroup and Wachovia), the five largest U.S. securities firms (Bear Stearns ("Bear"), Goldman Sachs ("Goldman"), Lehman Brothers ("Lehman"), Merrill Lynch ("Merrill") and Morgan Stanley), the largest U.S. insurance company (AIG), and eight foreign universal banks (Barclays, BNP Paribas, Credit Suisse, Deutsche, HSBC, Royal Bank of Scotland ("RBS"), Société Générale and UBS). *See* Wilmarth, "Dodd-Frank," *supra* note 5, at 966 n.45.

mortgages, as well as much of the financing for risky credit card loans, commercial real estate ("CRE") loans and LBO loans.[26]

I have estimated that LCFIs were responsible for financing about $9 trillion of risky private-sector debt that was outstanding in U.S. financial markets in 2007 in the form of nonprime home mortgages, credit card loans, CRE loans, LBO loans and junk bonds. Even worse, LCFIs underwrote some $25 trillion of structured-finance securities and derivatives whose value depended on the performance of that risky debt, including MBS, ABS, cash flow CDOs, synthetic CDOs and CDS. Thus, LCFIs created "an invested pyramid of risk," which allowed investors to place "multiple layers of financial bets" on the performance of high-risk loans in securitized pools. Consequently, when the underlying loans began to default, the leverage inherent in this "pyramid of risk" produced losses that were much larger than the face amounts of the defaulted loans.[27]

The central role of LCFIs in the financial crisis is confirmed by the enormous losses they suffered and the huge bailouts they received. The "big eighteen" LCFIs accounted for three-fifths of the $1.5 trillion of total worldwide losses recorded by banks, securities firms and insurers between the outbreak of the financial crisis in mid-2007 and the spring of 2010.[28] The list of leading LCFIs is "a who's who of the current financial crisis" that includes "[m]any of the

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[26] *Id.* at 977-78; *see also* Phil Angelides, "Fannie, Freddie and the Financial Crisis," *Bloomberg.com*, Aug. 3, 2011 (summarizing report prepared by the staff of the Financial Crisis Inquiry Commission ("FCIC"), and stating that Fannie and Freddie were "disasters" but not the "primary cause of the crisis" because (i) the GSEs "purchased the highest-rated portions of 'private label' mortgage securities produced by Wall Street," (ii) "[w]hile such purchases added helium to the housing balloon, they represented just 10.5 percent of 'private-label' subprime-mortgage-backed securities in 2001, then rose to 40 percent in 2004, and fell back to 28 percent in 2008," (iii) "[p]rivate investors gobbled up the lion's share of those securities, including the riskier portions," and (iv) "data compiled by the FCIC for a subset of borrowers with [credit] scores below 660 shows that by the end of 2008, far fewer GSE mortgages were seriously delinquent than non-GSE securitized mortgages: 6.2 percent versus 28.3 percent").

[27] Wilmarth, "Dodd-Frank," *supra* note 5, at 966-67; Wilmarth, "Financial Conglomerates," *supra* note 24, at 988-96, 1024-41.

[28] Wilmarth, "Dodd-Frank," *supra* note 5, at 978.

firms that either went bust . . . or suffered huge write-downs that led to significant government intervention."[29] Lehman failed, while two other members of the "big eighteen" LCFIs (AIG and RBS) were nationalized and three others (Bear, Merrill, and Wachovia) were acquired by other LCFIs with substantial governmental assistance. Three additional members of the group (Citigroup, BofA, and UBS) survived only because they received costly government bailouts.[30] Chase, Goldman Sachs and Morgan Stanley received substantial infusions of TARP capital, and Goldman and Morgan Stanley quickly converted to BHCs to secure permanent access to the FRB's discount window as well as "the Fed's public promise of protection."[31]

Thus, only Lehman failed of the "big eighteen" LCFIs, but the U.S., the U.K. and European nations provided massive financial assistance to ensure the survival of at least twelve other members of the group.[32] Studies have shown that the TARP capital infusions and FDIC debt guarantees announced in October 2008 represented very large transfers of wealth from taxpayers to the shareholders and creditors of the largest U.S. LCFIs.[33] In addition, a recent

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[29] *Id.* (quoting study by Dwight Jaffee).
[30] *Id.*; Wilmarth, "Financial Conglomerates," *supra* note 24, at 1044-45 (explaining that Citigroup and BofA "received huge bailout packages from the U.S. government that included $90 billion of capital infusions and more than $400 billion of asset price guarantees," while UBS "received a $60 billion bailout package from the Swiss government").
[31] David Wessel, *In Fed We Trust: Ben Bernanke's War on the Great Panic* 217–18, 227, 236–40 (2009) (noting that Chase received $25 billion of TARP capital while Goldman and Morgan Stanley each received $10 billion); *see also* Ivry, Keoun & Kuntz, *supra* note 2 (stating that BofA's acquisition of Merrill Lynch was supported by more than $60 billion of Fed emergency credit, while Wells Fargo's takeover of Wachovia was helped by $50 billion of Fed emergency credit and Chase's acquisition of Bear was assisted by $30 billion of Fed emergency credit).
[32] Wilmarth, "Dodd-Frank," *supra* note 5, at 978-79.
[33] Elijah Brewer III & Anne Marie Klingenhagen, "Be Careful What You Wish for: The Stock Market Reactions to Bailing Out Large Financial Institutions," 18 *Journal of Financial Regulation and Compliance* 56, 57–59, 64–66 (2010) (finding significant increases in stock market valuations for the 25 largest U.S. banks as a result of Treasury Secretary Paulson's announcement, on Oct. 14, 2008, of $250 billion of TARP capital infusions into the banking system, including $125 billion for the nine largest banks); Pietro Veronesi & Luigi Zingales, "Paulson's Gift," 97 *Journal of Financial Economics* 339, 340-41, 364 (2010) (concluding that the TARP capital infusions and FDIC debt guarantees announced in October 2008 produced $130 billion of gains for holders of equity and debt securities of the nine largest U.S. banks, at an estimated cost to taxpayers of $21 to $44 billion); Eric de Bodt et al., The Paulson

study concluded that the "below-market rates" charged by the Fed on its emergency credit programs produced $13 billion of profits for the banks that participated in those programs, including $4.8 billion of earnings for the six largest U.S. banks.[34]

Given the major advantages conferred by TBTF status, it is not surprising that LCFIs have pursued aggressive growth strategies during the past two decades to reach a size at which they would be considered TBTF. All of today's four largest U.S. banks (Chase, BofA, Citigroup and Wells Fargo) are the products of serial acquisitions and explosive growth since 1990. BofA's and Citigroup's rapid expansions led them to brink of failure, from which they were saved by huge federal bailouts. Wachovia (the fourth-largest U.S. bank at the beginning of the financial crisis) pursued a similar path of frenetic growth until it collapsed in 2008 and was rescued by Wells Fargo in a federally-assisted merger. A comparable pattern of rapid expansion, collapse and bailout occurred among RBS, UBS and other European LCFIs.[35]

By helping major banks to acquire troubled LCFIs, U.S. regulators have produced domestic financial markets in which the largest banks enjoy an unhealthy dominance. In 2009, the four largest U.S. banks (BofA, Chase, Citigroup and Wells Fargo) controlled 56% of domestic banking assets, up from 35% in 2000, while the top ten U.S. banks controlled 75% of domestic banking assets, up from 54% in 2000. The four largest banks also controlled a majority

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Plan's Competitive Effects (May 2011), at 2-4, 15-21 (finding that TARP capital infusions between October 2008 and December 2009 produced significant gains for shareholders of the largest banks but imposed losses on shareholders of smaller banks by injuring the competitiveness of those banks); Congressional Oversight Panel, *February Oversight Report: Valuing Treasury's Acquisitions* (Feb. 6, 2009), at 4-8, 26-29, 36-38 (presenting a valuation study concluding that (i) TARP capital infusions into eight major banks (BofA, Citigroup, Chase, Goldman, Morgan Stanley, US Bancorp and Wells Fargo) provided an average subsidy to those banks equal to 22% of the Treasury's investment, and (ii) additional capital infusions into AIG and Citigroup under TARP provided an average subsidy to those institutions equal to 59% of the Treasury's investment), available at http://cop.senate.gov/documents/cop-020609-report.pdf.

[34] Ivry, Keoun & Kuntz, *supra* note 2 (reporting that "[d]uring the crisis, Fed loans were among the cheapest around, with funding available for as low as 0.01 percent in December 2008").

[35] Wilmarth, "Dodd-Frank," *supra* note 5, at 984-85; Wilmarth, "Reforming Financial Regulation," *supra* note 1, at 746 n.153.

of the product markets for home mortgages, home equity loans, and credit card loans. The same four banks and Goldman accounted for 97% of the aggregate notional values of OTC derivatives contracts written by U.S. banks.[36]

The combined assets of the six largest banks – the foregoing five institutions plus Morgan Stanley – were equal to 63% of U.S. GDP in 2009, compared with only 17% of GDP in 1995.[37] Nomi Prins has observed that, as a result of the financial crisis, "we have larger players who are more powerful, who are more dependent on government capital and who are harder to regulate than they were to begin with."[38] Similarly, Simon Johnson and James Kwak maintain that "the problem at the heart of the financial system [is] the enormous growth of top-tier financial institutions and the corresponding increase in their economic and political power."[39]

3. The Dodd-Frank Act Does Not Solve the TBTF Problem

In two articles written in 2002 and 2009, I warned that "the TBTF policy is the great unresolved problem of bank supervision" because it "undermines the effectiveness of both supervisory and market discipline."[40] As I pointed out in both articles, Congress' decision to enact the Gramm-Leach-Bliley Act ("GLBA") and repeal the Glass-Steagall Act in 1999 authorized the creation of large financial conglomerates that spanned the entire range of our

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[36] Wilmarth, "Dodd-Frank," *supra* note 5, at 985.

[37] Simon Johnson & James Kwak, *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown* 202-03, 217 (2010); Peter Boone & Simon Johnson, "Shooting Banks," *New Republic*, Mar. 11, 2010, at 20. *See also* Thomas M. Hoenig, President, Federal Reserve Bank of Kansas City, "It's Not Over 'Til It's Over: Leadership and Financial Regulation" (William Taylor Memorial Lecture, Oct. 10, 2010) (noting that "the largest five [U.S. BHCs] control $8.4 trillion of assets, nearly 60 percent of GDP, and the largest 20 control $12.8 trillion of assets or almost 90 percent of GDP"), *available at* http://www.kansascityfed.org/speechbio/hoenigpdf/william-taylor-hoenig-10-10-10.pdf; Ivry, Keoun & Kuntz, *supra* note 2 (reporting that "[t]otal assets held by the six biggest U.S. banks increased 39 percent to $9.5 trillion on Sept. 30, 2011, from $6.8 trillion on the same day in 2006").

[38] Wilmarth, "Dodd-Frank," *supra* note 5, at 985-86 (quoting Ms. Prins).

[39] Johnson & Kwak, *supra* note 37, at 191.

[40] Arthur E. Wilmarth, Jr., "The Transformation of the U.S. Financial Services Industry: Competition, Consolidation, and Increased Risks," 2002 *University of Illinois Law Review* 215, 475 [hereinafter Wilmarth, "Transformation"], available at http://ssrn.com/abstract=315345; *see also* Wilmarth, "Financial Conglomerates, *supra* note 24, at 1049.

financial markets. I warned that the emergence of these new financial giants would bring "major segments of the securities and life insurance industries . . . within the scope of the TBTF doctrine, thereby expanding the scope and cost of federal 'safety net' subsidies." I also warned that big financial conglomerates would take advantage of their new powers under GLBA and their presumed TBTF status by pursuing risky activities involving complex securities and derivatives, and by increasing their leverage through "capital arbitrage."[41] As I pointed out in 2009:

> Unfortunately, the [current] financial crisis has confirmed all of the foregoing predictions. Over the past decade, regulators in developed nations encouraged the expansion of large financial conglomerates and failed to restrain their pursuit of short-term profits through increased leverage and high-risk activities. As a result, LCFIs were allowed to promote an enormous credit boom, and that boom precipitated a worldwide financial crisis. In order to avoid a complete collapse of global financial markets, central banks and governments have already provided almost $9 trillion of support . . . for major banks, securities firms and insurance companies. Those support measures – which are far from over – establish beyond any doubt that the TBTF policy now embraces the entire financial services industry.[42]

The financial crisis has demonstrated that TBTF subsidies create dangerous distortions in our financial markets and our general economy, and those subsidies must be eliminated (or at least significantly reduced) in order to restore a more level playing field for smaller financial

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[41] Wilmarth, "Transformation," *supra* note 40, at 444-476 (quotes at 447, 476); *see also* Wilmarth, "Financial Conglomerates," *supra* note 24, at 1049.

[42] Wilmarth, "Financial Conglomerates," *supra* note 24, at 1049-50. In a subsequent article, I described the unprecedented credit boom that occurred in the U.S. economy between December 31, 1991 and December 31, 2007:

> Nominal domestic private-sector debt nearly quadrupled, rising from $10.3 trillion to $39.9 trillion [between 1991 and 2007], and the largest increases occurred in the financial and household sectors. Total U.S. private-sector debt as a percentage of gross domestic product ("GDP") rose from 150 % in 1987 to almost 300 % in 2007 and, by that measure, exceeded even the huge credit boom that led to the Great Depression. Financial sector debt as a percentage of GDP rose from 40 % in 1988 to 70 % in 1998 and 120 percent in 2008. Meanwhile, household sector debt grew from two-thirds of GDP in the early 1990s to 100 % of GDP in 2008.

Wilmarth, "Dodd-Frank," *supra* note 5, at 970.

institutions and to encourage the voluntary breakup of inefficient and risky financial conglomerates.[43] The financial crisis has also proven, beyond any reasonable doubt, that large financial conglomerates operate based on a hazardous business model that is riddled with conflicts of interest and prone to speculative risk-taking.[44] Accordingly, U.S. and European governments must adopt reforms to ensure that effective supervisory and market discipline is applied against LCFIs,

A few months before Dodd-Frank was enacted, I wrote an article proposing five key reforms to accomplish these objectives. My proposed reforms would have (1) strengthened existing statutory restrictions on the growth of LCFIs, (2) created a special resolution process to manage the orderly liquidation or restructuring of systemically important financial institutions ("SIFIs"), (3) established a consolidated supervisory regime and enhanced capital requirements for SIFIs, (4) created a special insurance fund to cover the costs of resolving failed SIFIs, and (5) rigorously insulated FDIC-insured banks that are owned by LCFIs from the activities and risks of their nonbank affiliates.[45]

The following sections of my testimony discuss my proposed reforms and compare those proposals to relevant provisions of Dodd-Frank. As shown below, Dodd-Frank includes a portion of my first proposal as well as the major components of my second and third proposals. However, Dodd-Frank omits most of my last two proposals. In my opinion, Dodd-Frank's omissions are highly significant and raise serious doubts about the statute's ability to prevent

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[43] *Id.* at 987. Large financial conglomerates have never proven their ability to achieve superior performance without the extensive TBTF subsidies they currently receive. Wilmarth, "Reforming Financial Regulation," *supra* note 1, at 748-49.
[44] Wilmarth, "Financial Conglomerates," *supra* note 24, at 970–72, 994–1002, 1024–50; Johnson & Kwak, *supra* note 37, at 74-87, 120-41, 193, 202-05; John Kay, *Narrow Banking: The Reform of Financial Regulation* 12–16, 41–44, 86–88 (Sept. 15, 2009) (unpublished manuscript), *available at* http://www.johnkay.com/wp-content/uploads/2009/12/JK-Narrow-Banking.pdf.
[45] Wilmarth, "Reforming Financial Regulation," *supra* note 1, at 747-79.

TBTF bailouts in the future. As explained below, a careful reading of Dodd-Frank indicates that Congress has left the door open for taxpayer-funded protection of creditors of SIFIs during future financial crises.

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

Congress authorized nationwide banking – via interstate branching and interstate acquisitions of banks by BHCs – when it passed the Riegle-Neal Interstate Banking and Branching Act of 1994 ("Riegle-Neal Act").[46] To prevent the emergence of dominant megabanks, the Riegle-Neal Act imposed nationwide and statewide deposit concentration limits ("deposit caps") on interstate expansion by large banking organizations.[47] Under the Riegle-Neal Act, a BHC may not acquire a bank in another state, and a bank may not merge with another bank across state lines, if the resulting banking organization (together with all affiliated FDIC-insured depository institutions) would hold (i) 10% or more of the total deposits of all depository institutions in the U.S., or (ii) 30% or more of the total deposits of all depository institutions in a single state.[48]

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

[46] Pub. L. No. 103-328, 108 Stat. 2338, Sept. 29, 1994.
[47] *See* House Report No. 103-448, at 65–66 (1994) (additional views of Rep. Neal and Rep. McCollum) (explaining that the Riegle-Neal Act "adds two new concentration limits to address concerns about potential concentration of financial power at the state and national levels"), *reprinted in* 1994 U.S.C.C.A.N. 2039, 2065–66.
[48] Wilmarth, "Dodd-Frank," *supra* note 5, at 988.

acquisitions of, or mergers with, banks that are "in default or in danger of default" (the "failing bank" exception).[49]

The emergency acquisitions of Countrywide, Merrill, WaMu and Wachovia in 2008 demonstrated the significance of Riegle-Neal's loopholes and the necessity of closing them. In reliance on the "non-bank" loophole, the FRB allowed BofA to acquire Countrywide and Merrill even though (i) both firms controlled FDIC-insured depository institutions (a thrift, in the case of Countrywide, and a thrift and industrial bank, in the case of Merrill), and (ii) both transactions allowed BofA to exceed the 10% nationwide deposit cap. Similarly, after the FDIC seized control of WaMu as a failed depository institution, the FDIC sold the giant thrift to Chase even though the transaction enabled Chase to exceed the 10% nationwide deposit cap. Finally, although the FRB determined that Wells Fargo's acquisition of Wachovia gave Wells Fargo control of just under 10% of nationwide deposits, the FRB probably could have approved the acquisition in any case by designating Wachovia as a bank "in danger of default."[50]

As a result of the foregoing acquisitions, BofA, Chase and Wells Fargo each surpassed the 10% nationwide deposit cap by October 2008. To prevent further breaches of the Riegle-Neal concentration limits, I proposed that Congress should extend the nationwide and statewide deposit caps to cover all intrastate and interstate transactions involving any type of FDIC-insured depository institution, including thrifts and industrial banks. In addition, I proposed that Congress should significantly narrow the failing bank exception by requiring federal regulators to make a "systemic risk determination" ("SRD") in order to approve any acquisition involving a failing depository institution that would exceed either the nationwide or statewide deposit caps.[51]

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[49] *Id.* at 988-89.
[50] *Id.* at 989.
[51] *Id.* at 989-90.

Under my proposed standard for an SRD, the FRB and the FDIC could not invoke the failing bank exception unless they determined jointly, with the concurrence of the Treasury Secretary, that the proposed acquisition was necessary to avoid a substantial threat of severe systemic injury to the banking system, the financial markets or the national economy. In addition, each SRD would be audited by the Government Accountability Office ("GAO") to determine whether regulators satisfied the criteria for an SRD, and would also be reviewed in a joint hearing held by the House and Senate committees with oversight of the financial markets (the "SRD Review Procedure"). My proposed SRD requirements would ensure much greater public transparency of, and scrutiny for, any federal agency order that invokes the failing bank exception to the Riegle-Neal deposit caps.[52]

Section 623 of Dodd-Frank does extend Riegle-Neal's 10% nationwide deposit cap to reach all interstate acquisitions and mergers involving any type of FDIC-insured depository institution. Thus, interstate acquisitions and mergers involving thrift institutions and industrial banks are now subject to the nationwide deposit cap to the same extent as interstate acquisitions and mergers involving commercial banks. However, § 623 leaves open the other Riegle-Neal loopholes because (1) it does not apply the nationwide deposit cap to intrastate acquisitions or mergers, (2) it does not apply the statewide deposit cap to interstate transactions involving thrifts or industrial banks or to any type of intrastate transaction, and (3) it does not impose any enhanced substantive or procedural requirements for invoking the failing bank exception. Hence, § 623 of Dodd-Frank closes one important loophole but fails to close other significant exemptions that continue to undermine the effectiveness of Riegle-Neal's deposit caps.[53]

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[52] *Id.* at 990. As discussed below, § 203 of Dodd-Frank establishes a similar "Systemic Risk Determination" requirement and procedure for authorizing the FDIC to act as receiver for a failing SIFI.
[53] *Id.* at 990-91.

Section 622 of Dodd-Frank authorizes federal regulators to impose a separate concentration limit on mergers and acquisitions involving "financial companies." As defined in § 622, the term "financial companies" includes insured depository institutions and their holding companies, nonbank SIFIs and foreign banks operating in the U.S. Subject to two significant exceptions described below, § 622 potentially bars any acquisition or merger that would give a "financial company" control of more than 10% of the total "liabilities" of all financial companies. This limitation on control of nationwide liabilities ("liabilities cap") was originally proposed by former FRB Chairman Paul Volcker.[54]

The liabilities cap in § 622 provides an additional method for restricting the growth of very large financial companies (e.g., Citigroup, Goldman, and Morgan Stanley) that rely mainly on funding from the capital markets instead of deposits.[55] However, the liabilities cap has two significant exceptions. First, it is subject to a "failing bank" exception (similar to the "failing bank" loophole in Riegle-Neal), which regulators can invoke without making any SRD. Second, and more importantly, the liabilities cap is not self-executing. Section 622 requires the Financial Stability Oversight Council ("FSOC") to consider (based on a cost-benefit analysis) whether the statutory liabilities cap should be modified. Section 622 also requires the FRB to implement the liabilities cap in accordance with any modifications recommended by FSOC.[56]

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

[54] *Id.* at 991.
[55] *Id.* at 991-92.
[56] *Id.* at 992.

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

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

Dodd-Frank establishes an Orderly Liquidation Authority ("OLA"), which seeks to provide a "viable alternative to the undesirable choice . . . between bankruptcy of a large, complex financial company that would disrupt markets and damage the economy, and bailout of such financial company that would expose taxpayers to losses and undermine market discipline."[57] In some respects, the OLA for SIFIs – which is similar to the FDIC's existing resolution regime for failed depository institutions[58] – resembles my earlier proposal for a special resolution regime for SIFIs.[59] However, contrary to the statute's stated purpose,[60] Dodd-Frank's OLA does not preclude future bailouts for favored creditors of TBTF institutions.

Dodd-Frank establishes FSOC as an umbrella organization with systemic risk oversight authority. FSOC's voting members include the leaders of nine federal financial regulatory agencies and an independent member having insurance experience. By a two-thirds vote, FSOC may determine that a domestic or foreign nonbank financial company should be subject to Dodd-Frank's systemic risk regime, which includes prudential supervision by the FRB and potential liquidation by the FDIC under the OLA. In deciding whether to impose Dodd-Frank's systemic risk regime on a nonbank financial company, the crucial question to be decided by FSOC is

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[57] Senate Report No. 111-176, at 4 (2010).
[58] *See* Carnell, Macey & Miller, *supra* note 14, ch. 13 (describing the FDIC's resolution regime for failed banks); Fed. Deposit Ins. Corp., "Notice of Proposed Rulemaking Implementing Certain Orderly Liquidation Authority Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act," 75 *Federal Register* 64173, 64175 (Oct. 19, 2010) (stating that "[p]arties who are familiar with the liquidation of insured depository institutions . . . will recognize many parallel provisions in Title II" of Dodd-Frank) [hereinafter FDIC Proposed OLA Rule].
[59] *See* Wilmarth, "Reforming Financial Regulation," *supra* note 1, at 754-57.
[60] *See* Dodd-Frank (preamble) (stating that the statute is designed "to end 'too big to fail' [and] to protect the American taxpayer by ending bailouts").

whether "material financial distress at the . . . nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the . . . nonbank financial company, could pose a threat to the financial stability of the United States."[61]

Dodd-Frank does not use the term "systemically important financial institution" to describe a nonbank financial company that is subject to the statute's systemic risk regime, but I will generally refer to such companies as SIFIs. Dodd-Frank treats BHCs with assets of more than $50 billion as SIFIs, and those BHCs are also subject to enhanced supervision by the FRB and potential liquidation by the FDIC under the OLA.[62] Dodd-Frank properly recognizes that – absent mandatory breakups of LCFIs – the best way to impose effective discipline on SIFIs, and to reduce the federal subsidies they receive, is to designate them publicly as SIFIs and to impose stringent regulatory requirements that force them to internalize the potential costs of their TBTF status.[63] However, it is noteworthy – and disturbing – that FSOC has not yet publicly designated any large nonbank financial firm as a SIFI, even though almost 18 months have gone by since Dodd-Frank's enactment.

As I and many others have proposed, Article II of Dodd-Frank establishes a systemic resolution process – the OLA – to handle the failures of SIFIs.[64] In order to invoke the OLA for a "covered financial company," the Treasury Secretary must issue an SRD, based on the recommendation of the FRB together with either the FDIC or the SEC (if the failing company's largest subsidiary is a securities broker or dealer) or the Federal Insurance Office (if the failing company's largest subsidiary is an insurance company). The Treasury Secretary's SRD must find that (i) the covered financial company's failure and resolution under otherwise applicable

[61] Wilmarth, "Dodd-Frank," *supra* note 5, at 993-94.
[62] *Id.* at 994 (discussing §§ 115 and 165 of Dodd-Frank).
[63] *Id.* at 994-95.
[64] Senate Report No. 111-176, at 4-6, 57-65 (2010); Wilmarth, "Reforming Financial Regulation," *supra* note 1, at 756-57.

insolvency rules (e.g, the federal bankruptcy laws) would have "serious adverse effects on financial stability," (ii) application of the OLA would "avoid or mitigate such adverse effects," and (iii) "no viable private sector alternative is available to prevent" the company's failure.[65]

I have argued that the systemic resolution process for SIFIs should embody three core principles in order to create a close similarity between that process and Chapter 11 of the federal Bankruptcy Code. Those core principles are: (A) requiring equity owners in a failed SIFI to lose their entire investment if the SIFI's assets are insufficient to pay all valid creditor claims, (B) removing senior managers and other employees who were responsible for the SIFI's failure, and (C) requiring unsecured creditors to accept meaningful "haircuts" in the form of significant reductions of their debt claims or an exchange of substantial portions of their debt claims for equity in a successor institution.[66]

Dodd-Frank incorporates the first two of my core principles. It requires the FDIC to ensure that equity owners of a failed SIFI do not receive any payment until all creditor claims are paid, and that managers responsible for the failure are removed. At first sight, Dodd-Frank also seems to embody the third principle by directing the FDIC to impose losses on unsecured creditors if a failed SIFI's assets are insufficient to pay all secured and unsecured debts. However, a careful reading of the statute reveals that Dodd-Frank allows the FDIC to provide full protection to favored classes of unsecured creditors of failed SIFIs.[67]

In its capacity as receiver for a failed SIFI, the FDIC may provide funds for the payment or transfer of creditors' claims in at least two ways. First, the FDIC may provide funding directly to the SIFI's receivership estate by making loans, purchasing or guaranteeing assets, or assuming or guaranteeing liabilities. Second, the FDIC may provide funding to establish a "bridge

[65] Dodd-Frank, *supra* note 5, at 996 (quoting § 203(b) of Dodd-Frank).
[66] *Id.* at 996-97; Wilmarth, "Reforming Financial Regulation," *supra* note 1, at 756-57.
[67] Wilmarth, "Dodd-Frank," *supra* note 5, at 997.

financial company" ("BFC"), and the FDIC may then approve a transfer of designated assets and liabilities from the failed SIFI to the BFC. In either case, the FDIC may (i) take steps to "mitigate[] the potential for serious adverse effects to the financial system," and (ii) provide preferential treatment to certain creditors if the FDIC determines that such treatment is necessary to "maximize" the value of a failed SIFI's assets or to preserve "essential" operations of the SIFI or a successor BFC. Subject to the foregoing conditions, the FDIC may give preferential treatment to certain creditors as long as every creditor receives at least the amount she would have recovered in a liquidation proceeding under Chapter 7 of the federal Bankruptcy Code.[68]

In October 2010, the FDIC issued a proposed rule to implement its authority under the OLA. In January 2011, the FDIC approved the proposed OLA rule as an interim final rule.[69] Under the OLA rule, the FDIC may provide preferential treatment to certain creditors in order "to continue key operations, services, and transactions that will maximize the value of the [failed SIFI's] assets and avoid a disorderly collapse in the marketplace."[70] The OLA rule excludes the following classes of creditors from any possibility of preferential treatment: (i) holders of unsecured senior debt with a term of more than 360 days, and (ii) holders of subordinated debt. Accordingly, the OLA rule would allow the FDIC to provide full protection to short-term, unsecured creditors of a failed SIFI whenever the FDIC determines that such protection is "essential for [the SIFI's] continued operation and orderly liquidation."[71]

The OLA rule would allow the FDIC to give full protection to short-term liabilities of SIFIs, including commercial paper and securities repurchase agreements. Those types of

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[68] *Id.* at 997-98 (citing and quoting various provisions of Article II of Dodd-Frank). *See also* FDIC Proposed OLA Rule, *supra* note 171, at 64175, 64177 (explaining Dodd-Frank's minimum guarantee for creditors of a failed SIFI).
[69] Fed. Deposit Ins. Corp., Interim final rule, 76 Fed. Reg. 4267 (Jan. 25, 2011) (adopting regulations to be codified at 12 C.F.R. Part 380) [hereinafter FDIC Final OLA Rule].
[70] FDIC Proposed OLA Rule, *supra* note 58, at 64175; FDIC Final OLA Rule, *supra* note 69, at 4211.
[71] FDIC Proposed OLA Rule, *supra* note 58, at 64177-78; FDIC Final OLA Rule, *supra* note 69, at 4211.

wholesale liabilities proved to be highly volatile and prone to creditor "runs" during the financial crisis.[72] Unfortunately, by stating that the FDIC reserves the right to provide preferential treatment to short-term creditors of failed SIFIs, but will *never* provide such treatment to holders of long-term debt or subordinated debt, the OLA rule is likely have at least two perverse results. The OLA rule (i) creates the appearance of an implicit subsidy to short-term creditors of SIFIs, and (ii) encourages SIFIs to rely even *more* heavily on vulnerable, short-term funding strategies that led to repeated disasters during the financial crisis.[73]

As indicated by the OLA rule, Dodd-Frank gives the FDIC considerable leeway to provide de facto bailouts for favored creditors of failed SIFIs. Dodd-Frank also provides a funding source for such bailouts. Section 201(n) of Dodd-Frank establishes an Orderly Liquidation Fund ("OLF") to finance liquidations of SIFIs. As discussed below, Dodd-Frank does not establish a pre-funding mechanism for the OLF. However, the FDIC may obtain funds for the OLF by borrowing from the Treasury in amounts up to (i) 10% of a failed SIFI's assets within thirty days after the FDIC's appointment as receiver, plus (ii) 90% of the "fair value" of the SIFI's assets that are "available for repayment" thereafter."[74] The FDIC's authority to borrow from the Treasury provides an immediate source of funding to protect unsecured creditors that are deemed to have systemic significance. In addition, the "fair value" standard potentially gives the FDIC considerable discretion in appraising the assets of a failed SIFI, since

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[72] *See* Zoltan Pozsar et al., "Shadow Banking" (Federal Reserve Bank of N.Y. Staff Report No. 458, July 2010), at 2-6, 46-59, available at http://ssrn.com/abstract=1645337.
[73] Wilmarth, "Dodd-Frank," *supra* note 5, at 998-99.
[74] 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).

the standard does not require the FDIC to rely on current market values in measuring the value of a failed SIFI's assets.[75]

Dodd-Frank generally requires the FDIC to impose a "claw-back" on creditors who receive preferential treatment if the proceeds of liquidating a failed SIFI are insufficient to repay the full amount that the FDIC borrows from the Treasury to conduct the liquidation. However, Dodd-Frank authorizes the FDIC to exercise its powers under the OLA (including its authority to provide preferential treatment to favored creditors of a failed SIFI) for the purpose of preserving "the financial stability of the United States" and preventing "serious adverse effects to the financial system."[76] Therefore, the FDIC could conceivably assert the power to waive its right of "claw-back" against a failed SIFI's creditors who received preferential treatment if the FDIC determines that such a waiver is necessary to maintain the stability of the financial markets.[77]

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

Dodd-Frank could potentially be interpreted as allowing the FDIC to borrow an additional $100 billion from the Treasury for use in accomplishing the orderly liquidation of a failed SIFI. Dodd-Frank states that the FDIC's borrowing authority for the OLF does not "affect" the FDIC's authority to borrow from the Treasury Department under 12 U.S.C. § 1824(a).[78] Under §1824(a), the FDIC may exercise its "judgment" to borrow up to $100 billion from the Treasury "for insurance purposes," and the term "insurance purposes" appears to include functions beyond the FDIC's responsibility to administer the Deposit Insurance Fund

[75] Wilmarth, "Dodd-Frank," *supra* note 5, at 999.
[76] Dodd-Frank § 206(1). *See also* § 210(a)(9)(E)(iii).
[77] Wilmarth, "Dodd-Frank," *supra* note 5, at 1000.
[78] Dodd-Frank § 201(n)(8)(A).

("DIF") for banks and thrifts.[79] Dodd-Frank bars the FDIC from using the DIF to assist the OLF or from using the OLF to assist the DIF.[80] However, the FDIC could conceivably assert that it has authority to borrow up to $100 billion from the Treasury under § 1824(a) for the "insurance purpose" of financing an orderly liquidation of a SIFI *outside* the normal funding parameters of the OLF. Assuming that such supplemental borrowing authority is available to the FDIC, the FDIC could use that authority to protect a SIFI's uninsured and unsecured creditors as long as such protection "maximizes" the value of the SIFI's assets or "mitigates the potential for serious adverse effects to the financial system."[81]

The "systemic risk exception" ("SRE") to the Federal Deposit Insurance Act ("FDIA") provides a further potential source of funding to protect creditors of failed SIFIs.[82] Under the SRE, the Treasury Secretary can authorize the FDIC to provide full protection to uninsured creditors of a bank in order to avoid or mitigate "serious effects on economic conditions or financial stability."[83] Dodd-Frank amended and narrowed the SRE by requiring that a bank must be placed in receivership in order for the bank's creditors to receive extraordinary protection under the SRE.[84] Thus, if a failing SIFI owned a bank that was placed in receivership, the SRE would permit the FDIC (with the Treasury Secretary's approval) to provide full protection to

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[79] Under § 1824(a), the FDIC may borrow up to $100 billion "for insurance purposes" and such borrowed funds "shall be used by the [FDIC] solely in carrying out its functions with respect to such insurance." 12 U.S.C. § 1824(a). Section 1824(a) further provides that the FDIC "*may* employ any funds obtained under this section for purposes of the [DIF] and the borrowing shall become a liability of the [DIF] *to the extent funds are employed therefor*." *Id.* (emphasis added). The foregoing language strongly indicates that funds borrowed by the FDIC under § 1824(a) do not have to be used exclusively for the DIF and can be used for other "insurance purposes" in accordance with the "judgment" of the Board of Directors of the FDIC. It could be argued that borrowing for the purpose of funding the OLF would fall within such "insurance purposes."

[80] Dodd-Frank, § 210(n)(8)(A).

[81] *Id.* § 210(a)(9)(E)(i), (iii).

[82] Wilmarth, "Dodd-Frank," *supra* note 5, at 1001 (referring to the SRE under 12 U.S.C. § 1823(c)(4)(G), as originally enacted in 1991 and as invoked by federal regulators during the financial crisis).

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

[84] *See* Dodd-Frank, § 1106(b) (amending 12 U.S.C. § 1823(c)(4)(G)).

creditors of that bank in order to avoid or mitigate systemic risk. By protecting a SIFI-owned bank's creditors (which could include the SIFI itself), the FDIC could use the SRE to extend indirect support to the SIFI's creditors.

Two provisions of Dodd-Frank limit the authority of the FRB and the FDIC to provide financial support to failing SIFIs or their subsidiary banks outside the OLA or the SRE. First, §1101 of Dodd-Frank provides that the FRB may not extend emergency secured loans under §13(3) of the Federal Reserve Act[85] except to solvent firms that are "participant[s] in any program or facility with broad-based eligibility" that has been approved by the Treasury Secretary and reported to Congress.[86] Second, § 1105 of Dodd-Frank forbids the FDIC from guaranteeing debt obligations of depository institutions or their holding companies or other affiliates except pursuant to a "widely available program" for "solvent" institutions that has been approved by the Treasury Secretary and endorsed by a joint resolution of Congress.[87]

In light of the foregoing constraints, it is difficult to envision how the FRB or the FDIC could provide loans or debt guarantees to *individual* failing SIFIs or their subsidiary banks under

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[85] 12 U.S.C. § 343. *See* Wilmarth, "Dodd-Frank," *supra* note 5, at 1002 (referring to § 13(3) as amended in 1991 and as applied by the FRB to provide emergency credit to particular firms and segments of the financial markets during the financial crisis).

[86] Dodd-Frank, § 1101(a) (requiring the Fed to use its § 13(3) authority solely for the purpose of establishing a lending "program or facility with broad-based eligibility" that is open only to solvent firms and is designed "for the purpose of providing liquidity to the financial system, and not to aid a failing financial company"). *See* Senate Report No. 111-176, at 6, 182-83 (2010) (discussing Dodd-Frank's restrictions on the FRB's lending authority under § 13(3)).

[87] Dodd-Frank, § 1105. In addition, § 1106(a) of Dodd-Frank bars the FDIC from establishing any "widely available debt guarantee program" based on the SRE under the FDI Act. In October 2008, federal regulators invoked the SRE in order to authorize the FDIC to establish the Debt Guarantee Program ("DGP"). The DGP enabled depository institutions and their affiliates to issue more than $300 billion of FDIC-guaranteed debt securities between October 2008 and the end of 2009. *See* FCIC PSR on TBTF, *supra* note 122, at 29-32. Section 1106(a) of Dodd-Frank prohibits the use of the SRE to establish any program similar to the DGP. *See* Senate Report No. 111-176, at 6-7, 183-84 (discussing Dodd-Frank's limitations on the FDIC's authority to guarantee debt obligations of depository institutions and their holding companies).

§ 1101 or § 1105 of Dodd-Frank.[88] However, the FRB could conceivably use its remaining authority under § 13(3) to create a "broad-based" program similar to the Primary Dealer Credit Facility ("PDCF") in order to provide emergency liquidity assistance to a selected *group* of LCFIs that the FRB deems to be "solvent."[89] As shown by the events of 2008, it is extremely difficult for outsiders (including members of Congress) to second-guess a regulator's determination of solvency in the midst of a systemic crisis. Moreover, regulators are strongly inclined during a crisis to make generous assessments of solvency in order to justify their decision to provide emergency assistance to troubled LCFIs.[90] Thus, during a financial crisis the FRB could potentially assert its authority under amended § 13(3) to provide emergency loans to a targeted group of troubled LCFIs that it claimed to be "solvent."

Moreover, Dodd-Frank does not limit the ability of individual LCFIs to receive liquidity support from the FRB's discount window or from Federal Home Loan Banks ("FHLBs"). The FRB's discount window (often referred to as the FRB's "lender of last resort" facility) provides short-term loans to depository institutions secured by qualifying collateral. Similarly, FHLBs – sometimes described as "lender[s] of next-to-last resort" – provide collateralized advances to member institutions, including banks and insurance companies.[91]

During the financial crisis, banks did not borrow significant amounts from the discount window due to (i) the perceived "stigma" of doing so and (ii) the availability of alternative

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[88] Wilmarth, "Dodd-Frank, *supra* note 5, at 1002.
[89] The FRB established the PDCF in March 2008 (at the time of its rescue of Bear) and expanded that facility in September 2008 (at the time of Lehman's failure). The PDCF allowed the 19 primary dealers in government securities to make secured borrowings from the FRB on a basis similar to the FRB's discount window for banks. The 19 primary dealers eligible for participation in the PDCF were securities broker-dealers; however, all but four of those dealers were affiliated with banks. As of March 1, 2008, the FRB's list of primary dealers included all of the "big eighteen" LCFIs except for AIG, Société Générale and Wachovia. Wilmarth, "Dodd-Frank," *supra* note 5, at 1002-03 n.214.
[90] *Id.* at 1002-03.
[91] *Id.* at 1003-04.

sources of credit through FHLBs and several emergency liquidity facilities that the FRB established under its § 13(3) authority. The FHLBs provided $235 billion of advances to member institutions during the second half of 2007, following the outbreak of the financial crisis. During that period, FHLBs extended almost $150 billion of advances to ten major LCFIs. Six of those LCFIs incurred large losses during the crisis and failed, were acquired in emergency transactions, or received "exceptional assistance" from the federal government. Accordingly, FHLB advances provided a significant source of support for troubled LCFIs, especially during the early phase of the financial crisis. During future crises, it seems likely that individual LCFIs will use the FRB's discount window more frequently, along with FHLB advances, because Dodd-Frank prevents the FRB from providing emergency credit to individual institutions under § 13(3).[92]

Discount window loans and FHLB advances cannot be made to banks in receivership, but they do provide a potential source of funding for troubled SIFIs or SIFI-owned banks as long as that funding is extended prior to the appointment of a receiver for either the bank or the SIFI. To the extent that the FRB or FHLBs provide such funding, at least some short-term creditors of troubled SIFIs or SIFI-owned banks are likely to benefit by obtaining full payment of their claims before any receivership is created.[93]

Thus, notwithstanding Dodd-Frank's explicit promise to end bailouts of SIFIs, federal agencies retain several powers that will permit them to protect creditors of weakened SIFIs. A more fundamental problem is that Dodd-Frank's "no bailout" pledge does not bind future Congresses. When a future Congress confronts the next systemic financial crisis, that Congress may well decide to abandon Dodd-Frank's "no bailout" position either explicitly (by amending

[92] Wilmarth, "Dodd-Frank," *supra* note 5, at 1004.
[93] *Id.* at 1004-05; *see also* 12 U.S.C. § 347b(b) (allowing the FRB to make discount window loans to "undercapitalized" banks subject to specified limitations).

or repealing the statute) or implicitly (by looking the other way while regulators expansively construe their authority to protect creditors of SIFIs). For example, Congress and President George H.W. Bush made "never again" statements when they rescued the thrift industry with taxpayer funds in 1989, but those statements did not prevent Congress and President George W. Bush from using public funds to bail out major financial institutions in 2008.[94] As Adam Levitin has observed:

> Law is an insufficient commitment device for avoiding bailouts altogether. It is impossible to produce binding commitment to a preset resolution process, irrespective of the results. The financial Ulysses cannot be bound to the mast. . . . Once the ship is foundering, we do not want Ulysses to be bound to the mast, lest [we] go down with the ship and drown. Instead, we want to be sure his hands are free – too bail.[95]

Similarly, Cheryl Block has concluded that "despite all the . . . 'no more taxpayer-funded bailout' clamor included in recent financial reform legislation, bailouts in the future are likely if circumstances become sufficiently severe."[96] Accordingly, there is a substantial probability that future Congresses will relax or remove Dodd-Frank's constraints on TBTF bailouts, or will permit federal regulators to evade those limitations, if such actions are deemed necessary to prevent failures of SIFIs that could destabilize our financial system.[97]

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

Dodd-Frank provides the FRB with consolidated supervision and enforcement authority over nonbank SIFIs comparable to the FRB's umbrella supervisory and enforcement powers with respect to BHCs and financial holding companies ("FHCs"). Dodd-Frank also requires the FRB

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[94] Wilmarth, "Dodd-Frank," *supra* note 5, at 1005.
[95] Adam J. Levitin, "In Defense of Bailouts." 99 *Georgetown Law Review* 435, 439 (2011).
[96] Cheryl D. Block, "Measuring the True Cost of Government Bailout," 88 *Washington University Law Review* 149, 224 (2010); *see also id.* at 227 ("pretending that there will never be another bailout simply leaves us less prepared when the next severe crisis hits").
[97] *See* Levitin, *supra* note 95, at 489 ("[i]f an OLA proceeding would result in socially unacceptable loss allocations, it is likely to be abandoned either for improvised resolution or for the statutory framework to be stretched . . . to permit outcomes not intended to be allowed").

(either on its own motion or on FSOC's recommendation) to adopt enhanced prudential standards for nonbank SIFIs and large BHCs "[i]n order to prevent or mitigate risks to the financial stability of the United States."[98] The enhanced standards must be "more stringent" than the ordinary supervisory rules that apply to nonbank financial companies and BHCs that are not SIFIs.[99]

Dodd-Frank requires the FRB to adopt enhanced risk-based capital requirements, leverage limits, liquidity requirements, overall risk management rules, risk concentration limits, requirements for resolution plans ("living wills") and credit exposure reports. In addition, the FRB may, in its discretion, require SIFIs to satisfy contingent capital requirements, enhanced public disclosures, short-term debt limits, and additional prudential standards.[100]

It may be very difficult for SIFIs to reach agreement with outside investors on terms for contingent capital that are mutually satisfactory. Institutional investors are not likely to purchase debt securities that will be compelled to convert into equity stock when an SIFI is in trouble unless those convertible debt securities offer comparatively high yields and/or other investor-friendly features that may not be attractive to LCFIs.[101]

Whether or not contingent capital proves to be a feasible option for attracting investment by outside investors, I believe that contingent capital should become a significant component of future compensation packages for senior managers and other key employees (e.g., risk managers and traders) of LCFIs. In contrast to outside investors, senior managers and key employees are "captive investors" who can be required, as a condition of their continued employment, to accept convertible subordinated debentures in payment of a significant portion (e.g., one-third) of their

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[98] Wilmarth, "Dodd-Frank," *supra* note 5, at 1006-07 (discussing §§ 115 and 165 of Dodd-Frank).
[99] Dodd-Frank § 161(a)(1)(A), (d).
[100] Dodd-Frank § 165(b)(1)(B).
[101] Wilmarth, "Dodd-Frank," *supra* note 5, at 1008.

annual compensation. Managers and key employees should not be allowed to make voluntary conversions of their subordinated debentures into common stock until the expiration of a minimum holding period (e.g., three years) after the termination date of their employment. Such a minimum post-employment holding period would discourage managers and key employees from taking excessive risks to boost the value of the conversion option during the term of their employment. At the same time, their debentures should be subject to mandatory conversion into common stock upon the occurrence of a designated "triggering" event of financial distress. Requiring managers and key employees to hold a significant portion of contingent capital could give them positive incentives to manage their LCFI prudently in accordance with the interests of creditors as well as longer-term shareholders. Such a requirement would also force managers and key employees to share a significant portion of the loss if their LCFI is threatened with failure.[102]

Dodd-Frank's provisions requiring consolidated FRB supervision and enhanced prudential standards for SIFIs represent valuable improvements. For at least five reasons, however, those provisions are unlikely to prevent future failures of SIFIs with the attendant risk of governmental bailouts for systemically significant creditors. First, like previous regulatory reforms, Dodd-Frank relies heavily on the concept of stronger capital requirements. Unfortunately, capital-based regulation has repeatedly failed in the past.[103] As regulators learned during the banking and thrift crises of the 1980s and early 1990s, capital levels are "lagging indicators" of bank problems[104] because (i) "many assets held by banks . . . are not traded on any organized market and, therefore, are very difficult for regulators and outside investors to value,"

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[102] Wilmarth, "Dodd-Frank," *supra* note 5, at 1008-09.
[103] *Id.* at 1009-10.
[104] 1 Fed. Deposit Insurance Corp., *History of the Eighties: Lessons for the Future* 39-40, 55-56 (1997) [hereinafter *FDIC History Lessons*].

and (ii) bank managers "have strong incentives to postpone any recognition of asset depreciation and capital losses" until their banks have already suffered serious damage.[105]

Second, LCFIs have repeatedly demonstrated their ability to engage in "regulatory capital arbitrage" in order to weaken the effectiveness of capital requirements.[106] For example, the Basel II international capital accord was designed to prevent the arbitrage techniques (including securitization) that banks used to undermine the effectiveness of the Basel I accord.[107] However, many analysts concluded that the Basel II accord (including its heavy reliance on internal risk-based models developed by LCFIs) contained significant flaws and allowed LCFIs to operate with seriously inadequate capital levels during the period leading up to the financial crisis.[108]

Third, the past shortcomings of capital-based rules are part of a broader phenomenon of supervisory failure. Regulators did not stop large banks from pursuing hazardous (and in many cases fatal) strategies during the 1980s, including rapid growth with heavy concentrations in high-risk assets and excessive reliance on volatile, short-term liabilities. During the 1980s, regulators proved to be unwilling or unable to stop risky behavior as long as banks continued to report profits.[109] Similarly, there is wide agreement that federal banking and securities regulators failed to restrain excessive risk-taking by LCFIs during the two decades leading up to the financial crisis.[110]

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[105] Wilmarth, *supra* note 40, at 459; *see also* Daniel K. Tarullo, *Banking on Basel: The Future of International Financial Regulation* 171-72 (2008).
[106] Johnson & Kwak, *supra* note 37, at 137-41; Wilmarth, *supra* note 40, at 457-61.
[107] Tarullo, *supra* note 105, at 79-83.
[108] *Id.* at 139-214 (identifying numerous shortcomings in the Basel II accord); Wilmarth, "Dodd-Frank," *supra* note 5, at 1010.
[109] *FDIC History Lessons*, *supra* note 104, at 39-46, 245-47, 373-78.
[110] *See, e.g.*, Kathleen C. Engel & Patricia A. McCoy, *The Subprime Virus* 157-223 (2011); Johnson & Kwak, *supra* note 37, at 6-10, 120-50; Arthur E. Wilmarth, Jr., "The Dodd-Frank Act's Expansion of State Authority to Protect Consumers of Financial Services," 36 *Journal of Corporation Law* 895, 897-918 (2011), available at http://ssrn.com/abstract=1891970. *See also* John C. Coffee, Jr., Bail-Ins Versus Bail-Outs: Using Contingent Capital to Mitigate Systemic Risk (Columbia Law School Center for Law & Economic Studies, Working Paper No. 380, 2010), at 17-18 (stating that "[a]greement is virtually

Fourth, repeated regulatory failures during past financial crises reflect a "political economy of regulation"[111] in which regulators face significant political and practical challenges that undermine their efforts to discipline LCFIs. A full discussion of those challenges is beyond the scope of this testimony. For present purposes, it is sufficient to note that analysts have pointed to strong evidence of "capture" of financial regulatory agencies by LCFIs during the two decades leading up to the financial crisis, due to factors such as (i) large political contributions made by LCFIs, (ii) an intellectual and policy environment favoring deregulation, and (iii) a continuous interchange of senior personnel between the largest financial institutions and the top echelons of the financial regulatory agencies.[112] Commentators have also noted that LCFIs skillfully engaged in global regulatory arbitrage by threatening to move operations from the U.S. to London or other foreign financial centers if U.S. regulators did not make regulatory concessions.[113]

Fifth, Dodd-Frank does not provide specific instructions about the higher capital requirements and other enhanced prudential standards that the FRB must adopt. Instead, Dodd-Frank sets forth general categories of supervisory requirements that the FRB either must or may address. Thus, the actual achievement of stronger prudential standards will depend upon implementation by the FRB through rulemaking, and LCFIs have marshaled an imposing array

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universal that lax regulation by all the financial regulators played a significant role in the 2008 financial crisis").

[111] Jeffrey N. Gordon & Christopher Muller, Confronting Financial Crisis: Dodd-Frank's Dangers and the Case for a Systemic Emergency Insruance Fund (Columbia Law School Center for Law & Economic Studies, Working Paper No. 374), at 26.

[112] Johnson & Kwak, *supra* note 37, at 82-109, 118-21, 133-50; *see also* Deniz Igan et al., *A Fistful of Dollars: Lobbying and the Financial Crisis* (Int'l Monetary Fund Working Paper 09/287, Dec. 2009), available at http://ssrn.com/abstract=1531520; *Sold Out: How Wall Street and Washington Betrayed America* (Essential Information & Consumer Education Foundation, Mar. 2009), available at http://www.wallstreetwatch.org/reports/sold_out.pdf.

[113] Coffee, *supra* note 110, at 18-21; Gordon & Muller, *supra* note 111, at 27.

of lobbying resources to persuade the FRB to adopt more lenient rules.[114] When Congress passed Dodd-Frank, the head of a leading Wall Street trade association declared that "[t]he bottom line is that this saga will continue," and he noted that there are "more than 200 items in [Dodd-Frank]l where final details will be left up to regulators."[115] Domestic and foreign LCFIs have already succeeded in weakening and delaying the imposition of enhanced capital standards under the Basel III accord, and they are determined to prevent U.S. regulators from adopting stronger capital requirements that would go beyond Basel III.[116]

For all of the foregoing reasons, as John Coffee has noted, "the intensity of regulatory supervision is likely to follow a sine curve: tight regulation after a crash, followed by gradual relaxation thereafter" as the economy improves and the crisis fades in the memories of regulators and the public.[117] When the next economic boom occurs, regulators will face escalating political pressures to reduce the regulatory burden on LCFIs in order to help those institutions continue to finance the boom. Accordingly, while Dodd-Frank's provisions for stronger supervision and enhanced prudential standards represent improvements over prior law, they are unlikely to prevent future failures of SIFIs and the accompanying pressures for governmental protection of systemically important creditors.[118]

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

As noted above, Dodd-Frank establishes an Orderly Liquidation Fund ("OLF") to provide financing for the FDIC's liquidation of failed SIFIs. However, Dodd-Frank does not require

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[114] Wilmarth, "Dodd-Frank," *supra* note 5, at 1012.
[115] Randall Smith & Aaron Lucchetti, "The Financial Regulatory Overhaul: Biggest Banks Manage to Dodge Some Bullets," *Wall Street Journal*, June 26, 2010, at A5 (quoting, in part, Timothy Ryan, chief executive of the Securities and Financial Markets Ass'n).
[116] Wilmarth, "Dodd-Frank," *supra* note 5, at 1010-11, 1013.
[117] Coffee, *supra* note 110, at 20-21.
[118] Gordon & Muller, *supra* note 111, at 22-23; Johnson & Kwak, *supra* note 37, at 205-08.

LCFIs to pay any assessments to pre-fund the OLF. Instead, Dodd-Frank authorizes the FDIC to borrow from the Treasury to provide the necessary funding for the OLF after a SIFI is placed in receivership.[119]

The FDIC must normally repay any borrowings from the Treasury within five years, but the Treasury may extend the repayment period in order "to avoid a serious adverse effect on the financial system of the United States."[120] Dodd-Frank authorizes the FDIC to repay borrowings from the Treasury by making ex post assessments on (i) creditors who received preferential payments (to the extent of such preferences), (ii) nonbank SIFIs supervised by the FRB under Dodd-Frank, (iii) BHCs with assets of $50 billion or more, and (iii) other financial companies with assets of $50 billion or more.[121]

Thus, Dodd-Frank relies on an ex post funding system for financing liquidations of SIFIs. That was not the case with early versions of the legislation. The financial reform bill passed by the House of Representatives would have authorized the FDIC to pre-fund the OLF by collecting up to $150 billion in risk-based assessments from nonbank SIFIs and large BHCs. The bill reported by the Senate Committee on Banking, Housing, and Urban Affairs would also have established a pre-funded OLF, albeit with a smaller "target size" of $50 billion. FDIC Chairman Sheila Bair strongly championed the concept of a pre-funded OLF.[122]

Senate Republicans repeatedly blocked consideration of the financial reform bill on the Senate floor until Senate Democrats agreed to remove the pre-funding provision. The Obama Administration never supported the pre-funding mechanism and urged Senate leaders to remove

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[119] Wilmarth, "Dodd-Frank," *supra* note 5, at 1015.
[120] Dodd-Frank, §§ 210(n)(9)(B), 210(o)(1)(B), (C) (quote).
[121] *Id.* § 210(o)(1).
[122] Wilmarth, "Dodd-Frank," *supra* note 5, at 1015-16.

it from the bill. During the House-Senate conference committee's deliberations on Dodd-Frank, House Democratic conferees tried to revive the pre-funding mechanism but their efforts failed.[123]

It is contrary to customary insurance principles to establish an OLF that is funded only after a SIFI fails and must be liquidated.[124] When commentators have considered analogous insurance issues created by the DIF, they have recognized that moral hazard is reduced when banks pay risk-based premiums that compel "each bank [to] bear the cost of its own risk-taking."[125] No one advocates a post-funded DIF today; indeed, analysts have generally argued that the DIF needs a higher level of pre-funding in order to respond adequately to systemic banking crises.[126]

In stark contrast to the FDI Act – which requires banks to pay deposit insurance premiums to pre-fund the DIF – Dodd-Frank does not require SIFIs to pay risk-based premiums to pre-fund the OLF. As a result, SIFIs receive an implicit subsidy and benefit from lower funding costs due to the protection their creditors expect to receive from the Treasury-backed OLF. SIFIs will pay nothing for that subsidy until the first SIFI fails.[127] Not surprisingly, LCFIs viewed the removal of pre-funding for the OLF from the Dodd-Frank Act as a significant "victory," because it relieved them of the burden of paying an "upfront fee" to cover the potential costs of their implicit subsidy.[128]

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[123] *Id.* at 1016-17.
[124] *See* Carnell, Macey & Miller, *supra* note 14, at 535 (noting that ordinarily "an insurer collects, pools, and invests policyholders' premiums and draws on that pool to pay policyholders' claims").
[125] *Id.* at 328.
[126] *See, e.g.,* Viral V. Acharya, Joao A.C. Santos & Tanju Yorulmazer, "Systemic Risk and Deposit Insurance Premiums," *Economic Policy Review* (Fed. Res. Bank of NY, Aug. 2010), at 89.
[127] Wilmarth, "Dodd-Frank," *supra* note 5, at 1017.
[128] Mike Ferrulo, "Regulatory Reform: Democrats Set to Begin Final Push to Enact Dodd-Frank Financial Overhaul," 94 *Banking Report* (BNA) 1277 (June 29, 2010) (reporting that the elimination of a pre-funded OLF "is seen as a victory for large financial institutions," and quoting analyst Jaret Seiberg's comment that "[t]he key for [the financial services] industry was to avoid the upfront fee").

The Congressional Budget Office estimated that Dodd-Frank would produce a ten-year net budget deficit of $19 billion, due primarily to "potential net outlays for the orderly liquidation of [SIFIs}, measured on an expected value basis."[129] To offset that deficit, the House-Senate conferees proposed a $19 billion tax on financial companies with assets of $50 billion or more and on hedge funds with managed assets of $10 billion or more. LCFIs strongly objected to the tax, and Republicans who had voted for the Senate bill threatened to block final passage of the legislation unless the tax was removed. To ensure Dodd-Frank's passage, the House-Senate conference committee reconvened and removed the $19 billion tax while substituting other measures that effectively shifted most of the legislation's estimated net cost to taxpayers and midsized banks.[130]

Thus, LCFIs and their allies were successful in defeating the $19 billion tax as well as the pre-funded OLF. As I observed in a contemporaneous blog post, "[t]he biggest banks have once again proven their political clout . . . [and] have also avoided any significant payment for the subsidies they continue to receive."[131]

A pre-funded OLF is essential to shrink TBTF subsidies for LCFIs. The FDIC should assess risk-adjusted premiums over a period of several years to establish a pre-funded OLF with financial resources that would provide reasonable protection to taxpayers against the cost of resolving failures of SIFIs during a future systemic financial crisis. As noted above, federal regulators provided $290 billion of capital assistance to the 19 largest BHCs – each with assets of more than $100 billion – and to AIG during the current crisis. Accordingly, $300 billion

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[129] Congressional Budget Office, *Cost Estimate, H.R. 4173: Restoring Financial Stability Act of 2010: As passed by the Senate on May 20, 2010* (June 9, 2010), at 6.
[130] Wilmarth, "Dodd-Frank," *supra* note 5, at 1018, 1018-19 n.287.
[131] Arthur E. Wilmarth, Jr., "Too Big to Fail=Too Powerful to Pay," *Credit Slips* (blog post on July 7, 2010), available at http://www.creditslips.org/creditslips/2010/07/too-big-to-fail-too-powerful-to-pay.html#more.

(appropriately adjusted for inflation) would be the minimum acceptable size for a pre-funded OLF, and OLF premiums should be paid by all BHCs with assets of more than $100 billion (also adjusted for inflation) and by all designated nonbank SIFIs. The FDIC should impose additional assessments on SIFIs in order to replenish the OLF within three years after the OLF incurs any loss due to the failure of a SIFI.[132]

There are four essential reasons why Congress should amend Dodd-Frank to require SIFIs to pay risk-based insurance premiums to pre-fund the OLF. First, it is unlikely that most SIFIs would have adequate financial resources to pay large OLF assessments after one or more of their peers failed during a financial crisis. SIFIs are frequently exposed to highly correlated risk exposures during a serious financial disruption, because they followed similar high-risk business strategies ("herding") during the credit boom that led to the crisis. Many SIFIs are therefore likely to suffer severe losses and to face a substantial risk of failure during a major disturbance in the financial markets. Consequently, the FDIC (i) probably will not be able in the short term to collect enough premiums from surviving SIFIs to cover the costs of resolving one or more failed SIFIs, and (ii) therefore will have to borrow large sums from the Treasury to cover short-term resolution costs. Even if the FDIC ultimately repays the borrowed funds by imposing ex post assessments on surviving SIFIs, the public and the financial markets will rightly

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[132] Wilmarth, "Dodd-Frank," *supra* note 5, at 1019-20. Jeffrey Gordon and Christopher Muller have proposed a similar "Systemic Risk Emergency Fund" with a pre-funded base of $250 billion to be financed by risk-adjusted assessments paid by large financial firms. They would also provide their proposed fund with a supplemental borrowing authority of up to $750 billion from the Treasury. Gordon & Muller, *supra* note 111, at 51-53. *See also* Xin Huang et al., "A Framework for Assessing the Systemic Risk of Major Financial Institutions," 33 *Journal of Banking & Finance* 2036 (2009) (proposing a stress testing methodology for calculating an insurance premium sufficient to protect a hypothetical fund against losses of more than 15% of the total liabilities of twelve major U.S. banks during the period 2001-2008, and concluding that the hypothetical aggregate insurance premium would have had an "upper bound" of $250 billion in July 2008).

conclude that the federal government (and, ultimately, the taxpayers) provided bridge loans to pay the creditors of failed SIFIs.[133]

Second, under Dodd-Frank's post-funded OLF, the most reckless SIFIs will effectively shift the potential costs of their risk-taking to the most prudent SIFIs, because the latter will be more likely to survive and bear the ex post costs of resolving their failed peers. Thus, a post-funded OLF is undesirable because "firms that fail never pay and the costs are borne by surviving firms."[134]

Third, a pre-funded OLF would encourage each SIFI to monitor other SIFIs and to alert regulators to excessive risk-taking by those institutions. Every SIFI would know that the failure of another SIFI would deplete the OLF and would also trigger future assessments that it and other surviving SIFIs would have to pay. Thus, each SIFI would have good reason to complain to regulators if it became aware of unsound practices or conditions at another SIFI.[135]

Fourth, the payment of risk-based assessments to pre-fund the OLF would reduce TBTF subsidies for SIFIs by forcing them to internalize more of the "negative externality" (i.e., the potential public bailout cost) of their activities. A pre-funded OLF would provide a reserve fund, paid for by SIFIs, which would shield governments and taxpayers from having to incur the expense of underwriting future resolutions of failed SIFIs.[136] Jeffrey Gordon and Christopher Muller also point out that a pre-funded OLF would reduce the TBTF subsidy by making Dodd-Frank's "liquidation threat more credible."[137] In their view, a pre-funded OLF would encourage regulators to "impos[e] an FDIC receivership" on a failing SIFI.[138] In contrast, Dodd-Frank's

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[133] Wilmarth, "Dodd-Frank," *supra* note 5, at 1020-21.
[134] *Id.* at 1021 (quoting testimony by FDIC Chairman Sheila Bair).
[135] *Id.*.
[136] *Id.* at 1021-22.
[137] Gordon & Muller, *supra* note 111, at 55.
[138] *Id.*

post-funded OLF creates a strong incentive for regulators to grant forbearance in order to avoid or postpone the politically unpopular step of borrowing from the Treasury to finance a failed SIFI's liquidation.[139]

To further reduce the potential TBTF subsidy for SIFIs, the OLF should be strictly separated from the DIF, which insures bank deposits. As discussed above, the "systemic-risk exception" ("SRE") in the FDI Act is a potential source of bailout funds for SIFI-owned banks, and those funds could indirectly support creditors of SIFIs.[140] Congress should repeal the SRE and should designate the OLF as the exclusive source of future funding for all resolutions of failed SIFIs. By repealing the SRE, Congress would ensure that (i) the FDIC must apply the FDI Act's least-cost test in resolving all future bank failures, (ii) the DIF must be used solely to pay the claims of bank depositors, and (iii) non-deposit creditors of SIFIs could no longer view the DIF as a potential source of financial support. By making those changes, Congress would significantly reduce the implicit TBTF subsidy currently enjoyed by SIFIs.[141]

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

Dodd-Frank contains three sections that are intended to prevent the federal "safety net" for banks[142] from being used to support risky nonbanking activities connected to the capital markets. As discussed below, none of those sections is likely to be effective. The first provision (the Kanjorski Amendment) is unwieldy and constrained by stringent procedural requirements. The other two provisions (the Volcker Rule and the Lincoln Amendment) are riddled with

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[139] *Id.* at 41, 55-56.
[140] Wilmarth, "Dodd-Frank," *supra* note 5, at 1022-23.
[141] *Id.* at 1023.
[142] The federal "safety net" for banks includes (i) federal deposit insurance, (ii) protection of uninsured depositors and other uninsured creditors in TBTF banks under the SRE, and (iii) discount window advances and other liquidity assistance provided by the FRB as lender of last resort. *See* Wilmarth, "Dodd-Frank," *supra* note 5, at 1023 n.308.

loopholes and have long phase-in periods. In addition, the implementation of all three provisions is subject to broad regulatory discretion and is therefore likely to be influenced by aggressive industry lobbying.

(a) The Kanjorski Amendment

Section 121 of Dodd-Frank, the "Kanjorski Amendment," was originally sponsored by Representative Paul Kanjorski. Section 121 provides the FRB with potential authority to require large BHCs (with more than $50 billion of assets) or nonbank SIFIs to divest high-risk operations. However, the FRB may exercise its divestiture authority under § 121 only if (i) the BHC or nonbank SIFI "poses a grave threat to the financial stability of the United States" and (ii) the FRB's proposed action is approved by at least two-thirds of FSOC's voting members.[143] Additionally, the FRB may not exercise its divestiture authority unless it has previously attempted to "mitigate" the threat posed by the BHC or nonbank SIFI by taking several, less drastic remedial measures.[144] If, and only if, the FRB determines that all of those remedial measures are "inadequate to mitigate [the] threat," the FRB may then exercise its residual authority to "require the company to sell or otherwise transfer assets or off-balance-sheet items to unaffiliated parties."[145]

The FRB's divestiture authority under § 121 is thus a last resort, and it is restricted by numerous procedural requirements (including, most notably, a two-thirds FSOC vote). The Bank Holding Company Act ("BHC Act") contains a similar provision, under which the FRB can force a BHC to divest a nonbank subsidiary that "constitutes a serious risk to the financial

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[143] Dodd-Frank, § 121(a).
[144] Under § 121(a) of Dodd-Frank, before the FRB may require a breakup of a large BHC or nonbank SIFI, the FRB must first take all of the following actions with regard to that company: (i) imposing limitations on mergers or affiliations, (ii) placing restrictions on financial products, (iii) requiring termination of activities, and (iv) imposing conditions on the manner of conducting activities.
[145] Dodd-Frank, § 121(a)(5). *See* Senate Report No. 111-176, at 51-52 (explaining § 121).

safety, soundness or stability" of any of the BHC's banking subsidiaries.[146] The FRB may exercise its divestiture authority under the BHC Act without the concurrence of any other federal agency, and the FRB is not required to take any intermediate remedial steps before requiring a divestiture. However, according to a senior Federal Reserve official, the FRB's divestiture authority under the BHC Act "has never been successfully used for a major banking organization."[147] In view of the much greater procedural and substantive constraints on the FRB's authority under the Kanjorski Amendment, the prospects for an FRB-ordered breakup of a SIFI seem remote at best.

(b) The Volcker Rule

Section 619 of Dodd-Frank, the "Volcker Rule," was originally proposed by former FRB Chairman Paul Volcker.[148] As approved by the Senate Banking Committee, the Volcker Rule would have generally barred banks and BHCs from (i) sponsoring or investing in hedge funds or private equity funds and (ii) engaging in proprietary trading – i.e., buying and selling securities, derivatives and other tradable assets for their own account. Thus, the Volcker Rule sought to prohibit equity investments and trading activities by banks and BHCs except for "market making" activities conducted on behalf of clients.[149]

The Senate committee report explained that the Volcker Rule would prevent banks "protected by the federal safety net, which have a lower cost of funds, from directing those funds to high-risk uses."[150] The report endorsed Mr. Volcker's view that public policy does not favor having "public funds – taxpayer funds – protecting and supporting essentially proprietary and

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[146] 12 U.S.C. § 1844(e)(1).
[147] Hoenig October 10, 2010 Speech, *supra* note 37, at 4.
[148] Wilmarth, "Dodd-Frank," *supra* note 5, at 1025 .
[149] The Senate committee bill required the FSOC to conduct a study and to make recommendations for implementation of the Volcker Rule through regulations to be adopted by the federal banking agencies. Senate Report No. 111-176, at 8-9, 90-92 (2010).
[150] *Id.* at 8-9.

speculative activities."[151] The report further declared that the Volcker Rule was directed at "limiting the inappropriate transfer of economic subsidies" by banks and "reducing inappropriate conflicts of interest between [banks] and their affiliates."[152] Thus, the Senate report made clear that a primary goal of the Volcker Rule was to prevent banks from spreading their federal safety net subsidies to nonbank affiliates engaged in capital markets activities.

LCFIs vehemently opposed the Volcker Rule as embodied in the Senate committee bill.[153] However, the Volcker Rule – and the financial reform bill as a whole – gained significant political momentum from two events related to Goldman. First, the SEC filed a lawsuit on April 16, 2010, alleging that Goldman defrauded two institutional purchasers of interests in a CDO that Goldman structured and marketed. The SEC charged that Goldman did not disclose to the CDO's investors that a large hedge fund, Paulson & Co., helped to select the CDO's portfolio of MBS while intending to short the CDO by purchasing CDS from Goldman. The SEC alleged that Goldman knew, and did not disclose, that Paulson & Co. had an "economic incentive" to select MBS that it expected to default within the near-term future. The institutional investors in the CDO lost more than $1 billion, while Paulson & Co. reaped a corresponding gain. Goldman subsequently settled the SEC's lawsuit by paying restitution and penalties of $550 million.[154]

Second, on April 27, 2010, the Senate Permanent Subcommittee on Oversight interrogated Goldman's chairman and several of Goldman's other current and former officers during an eleven-hour hearing. The Subcommittee also released a report charging, based on

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[151] *Id.* at 91 (quoting testimony by Mr. Volcker). The Senate report also quoted Mr. Volcker's contention that "conflicts of interest [are] inherent in the participation of commercial banking organizations in proprietary or private investment activity. . . . When the bank itself is a 'customer,' i.e., it is trading for its own account, it will almost inevitably find itself, consciously or inadvertently, acting at cross purposes to the interests of an unrelated commercial customer of a bank." *Id.* (same).
[152] *Id.* at 90.
[153] Wilmarth, "Dodd-Frank," *supra* note 5, at 1026.
[154] Wilmarth, "Dodd-Frank," *supra* note 5, at 1026-27.

internal Goldman documents, that Goldman aggressively sold nonprime mortgage-backed investments to clients in late 2006 and 2007 while Goldman was "making huge and profitable bets against the housing market and acting against the interest of its clients." The allegations against Goldman presented in the SEC's lawsuit and at the Senate hearing provoked widespread public outrage and gave a major political boost to the Volcker Rule and the reform legislation as a whole.[155]

Nevertheless, large financial institutions continued their aggressive lobbying campaign to weaken the Volcker rule during the conference committee's deliberations on the final terms of Dodd-Frank. The conference committee accepted a last-minute compromise that significantly weakened the Volcker Rule and "disappointed" Mr. Volcker.[156] The final compromise inserted exemptions in the Volcker Rule that allow banks and BHCs (i) to invest up to 3% of their Tier 1 capital in hedge funds or private equity funds (as long as a bank's investments do not exceed 3% of the total ownership interests in any single fund), (ii) purchase and sell government securities, (iii) engage in "risk-mitigating hedging activities," (iv) make investments through insurance company affiliates, and (v) make small business investment company investments. The compromise also delayed the Volcker Rule's effective date so that banks and BHCs will have (A) up to seven years after Dodd-Frank's enactment date to bring most of their equity investing and proprietary trading activities into compliance with the Volcker Rule, and (B) up to twelve years to bring "illiquid" investments that were in existence on May 1, 2010, into compliance with the Rule.[157]

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[155] *Id.* at 1027.
[156] *Id.* at 1028 (quoting John Cassidy, "The Volcker Rule: Obama's economic adviser and his battles over the financial-reform bill," *New Yorker*, July 26, 2010, at 25).
[157] *Id.* (discussing § 13(d) of the BHC Act, added by Dodd-Frank, § 619).

Probably the most troublesome aspect of the Volcker Rule is that the Rule attempts to distinguish between prohibited "proprietary trading" and permissible "market making." The Rule defines "proprietary trading" as "engaging as a principal for the trading account of the banking entity," but the Rule allows "[t]he purchase, sale, acquisition, or disposition of securities and other instruments . . . on behalf of customers."[158] Distinguishing between proprietary trading and market making is notoriously difficult,[159] and analysts predict that large Wall Street banks will seek to evade the Volcker Rule by shifting their trading operations into so-called "client-related businesses."[160] Moreover, the parameters of "proprietary trading," "market making" and other ambiguous terms in the Volcker Rule – including the exemption for "[r]isk-mitigating hedging activities"[161] – are yet to be determined. Those terms will be defined in regulations to be issued jointly by the federal banking agencies, the CFTC and the SEC.[162]

Mr. Volcker has urged regulators to adopt "[c]lear and concise definitions [and] firmly worded prohibitions" to carry out "the basic intent" of § 619.[163] However, LCFIs have deployed formidable political and regulatory influence in pursuit of the opposite result.[164] Given the

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[158] Dodd-Frank, § 619 (enacting new § 13(d)(1)(D) & (h)(4) of the BHC Act).
[159] *See* Carnell, Macey & Miller, *supra* note 14, at 130, 528-29 (describing the roles of "dealers" (i.e., proprietary traders) and "market makers" and indicating that the two roles frequently overlap).
[160] Nelson D. Schwartz & Eric Dash, "Despite Reform, Banks Have Room for Risky Deals," *New York Times*, Aug. 26, 2010, at A1; *see also* Michael Lewis, "Wall Street Proprietary Trading Under Cover," *Bloomberg.com*, Oct. 26, 2010; Jia Lynn Yang, "Major banks gird for 'Volcker rule,'" *Washington Post*, Aug. 14, 2010, at A08.
[161] Dodd-Frank, § 619 (adding new § 13(d)(1)(C) of the BHC Act). *See* Dash & Schwartz, *supra* note 160 (reporting that "traders [on Wall Street] say it will be tricky for regulators to define what constitutes a proprietary trade as opposed to a reasonable hedge against looming risks. Therefore, banks might still be able to make big bets by simply classifying them differently").
[162] Dodd-Frank § 619 (adding new § 13(b) of the BHC Act).
[163] Cheyenne Hopkins, "Volcker Wants a Clear, Concise Rule," *American Banker*, Nov. 3, 2010, at 3.
[164] Cheyenne Hopkins, "Bankers Seek Ways to Gut Prop Trading Ban," *American Banker*, Nov. 19, 2010, at 1 ("If the banking industry has its way, regulators would give financial institutions so many exceptions from the Volcker Rule's limits on risky activities that it might as well not exist at all"). *Cf.* Cassidy, *supra* note 156 (quoting Anthony Dowd, Mr. Volcker's personal assistant, who stated that the financial services industry deployed "fifty-four lobbying firms and three hundred million dollars . . . against us" during congressional consideration of Dodd-Frank).

Volcker Rule's ambiguous terms and numerous exemptions that rely on regulatory implementation, as well as its long phase-in period, many commentators believe that the Rule probably will not have a significant impact in restraining risk-taking by major banks or in preventing them from exploiting their safety net subsidies to fund speculative activities.[165]

(c) The Lincoln Amendment

Section 726 of Dodd-Frank, the "Lincoln Amendment," was originally sponsored by Senator Blanche Lincoln. In April 2010, Senator Lincoln, as chair of the Senate Agriculture Committee, included the Lincoln Amendment in derivatives reform legislation, which was passed by the Agriculture Committee and subsequently was combined with the Senate Banking Committee's regulatory reform bill. As adopted by the Agriculture Committee, the Lincoln Amendment would have barred dealers in swaps and other OTC derivatives from receiving assistance from the DIF or from the Fed's discount window or other emergency lending facilities.[166]

Senator Lincoln designed the provision to force major banks to "spin off their derivatives operations" in order "to prevent a situation in which a bank's derivatives deals failed and forced taxpayers to bail out the institution."[167] The Lincoln Amendment was "also an effort to crack down on the possibility that banks would use cheaper funding provided by deposits insured by

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[165] Cassidy, *supra* note 156 (stating that "[w]ithout the legislative purity that Volcker was hoping for, enforcing his rule will be difficult, and will rely on many of the same regulators who did such a poor job the last time around"); Christine Harper & Bradley Keoun, "Financial Reform: The New Rules Won't Stop the Next Crisis," *Bloomberg BusinessWeek*, July 6-11, 2010, at 42, 43 (quoting William T. Winters, former co-chief executive officer of Chase's investment bank, who remarked: "I don't think [the Volcker Rule] will have any impact at all on most banks"); Simon Johnson, "Flawed Financial Bill Contains Huge Surprise," *Bloomberg.com*, July 8, 2010 (stating that the Volcker Rule was "negotiated down to almost nothing"); Bradley Keoun & Dawn Kopecki, "JP Morgan, Citigroup, Morgan Stanley Rise as Bill Gives Investment Leeway," *Bloomberg.com*, June 25, 2010 (quoting analyst Nancy Bush's view that the final compromise on the Volcker Rule meant that "the largest banks' operations are largely left intact").

[166] Wilmarth, "Dodd-Frank," *supra* note 5, at 1030.

[167] Richard Hill, "Derivatives: Conferees Reach Compromise: Banks Could Continue to Trade Some Derivatives," 42 *Securities Regulation & Law Report* (BNA) 1234 (June 28, 2010).

the FDIC, to subsidize their trading activities."[168] Thus, the purposes of the Lincoln Amendment – insulating banks from the risks of speculative activities and preventing the spread of safety net subsidies – were similar to the objectives of the Volcker Rule, but the Lincoln Amendment focused on dealing and trading in derivatives instead of all types of proprietary trading.[169]

The Lincoln Amendment provoked "tremendous pushback . . . from Republicans, fellow Democrats, the White House, banking regulators, and Wall Street interests."[170] Large banks claimed that the provision would require them to furnish more than $100 billion of additional capital to organize separate derivatives trading subsidiaries.[171] A prominent industry analyst opined that the provision "eliminates all of the advantages of the affiliation with an insured depository institution, which are profound."[172] Those statements reflect a common understanding that, as discussed below, bank dealers in OTC derivatives enjoy significant competitive advantages over nonbank dealers due to the banks' explicit and implicit safety net subsidies. The Lincoln Amendment was specifically intended to remove those advantages and to force major banks to conduct their derivatives trading operations without reliance on federal subsidies.[173]

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[168] Robert Schmidt & Phil Mattingly, "Banks Would Be Forced to Push Out Derivatives Trading Under Plan," *Bloomberg.com*, April 15, 2010.
[169] Wilmarth, "Dodd-Frank, *supra* note 5, at 1031.
[170] Hill, *supra* note 167; *see also* Stacy Kaper & Cheyenne Hopkins, "Key Issues Unresolved as Reform Finishes Up," *American Banker*, June 25, 2010, at 1 (reporting that "banks have vigorously opposed [the Lincoln Amendment], arguing it would cost them millions of dollars to spin off their deriviatives units. Regulators, too, have argued against the provision, saying it would drive derivatives trades overseas or underground, where they would not be regulated").
[171] Agnes Crane & Rolfe Winkler, "Reuters Breakingviews: Systemic Risk Knows No Borders," *New York Times*, May 3, 2010, at B2.
[172] Schmidt & Mattingly, *supra* note 168 (quoting Karen Petrou).
[173] *Id.*; *see also* Crane & Winkler, *supra* note 335 (observing that "Senator Blanche Lincoln . . . says there should be a clear division between banking activities that the government should support or at least provide liquidity to, and riskier business that it should not").

As was true with the Volcker Rule, the House-Senate conference committee agreed to a final compromise that significantly weakened the Lincoln Amendment.[174] As enacted, the Lincoln Amendment allows an FDIC-insured bank to act as a swaps dealer with regard to (i) "[h]edging and other similar risk mitigating activities directly related to the [bank's] activities," (ii) swaps involving interest rates, currency rates and other "reference assets that are permissible for investment by a national bank," including gold and silver but not other types of metals, energy, or agricultural commodities, and (iii) credit default swaps that are cleared pursuant to Dodd-Frank and carry investment-grade ratings.[175] In addition, the Lincoln Amendment allows banks up to five years to divest or spin off nonconforming derivatives operations into separate affiliates.[176]

Analysts estimate that the compromised Lincoln Amendment will require major banks to spin off only ten to twenty percent of their existing derivatives activities into separate affiliates.[177] In addition, banks will able to argue for retention of derivatives that are used for "hedging" purposes, an open-ended standard that will require much elaboration by regulators.[178] As in the case of the Volcker Rule, commentators concluded that the Lincoln Amendment was

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[174] Devlin Barrett & Damien Paletta, "The Financial-Regulation Overhaul: A Fight to the Wire as Pro-Business Democrats Dig In on Derivatives," *Wall Street Journal*, June 26, 2010, at A10; David Cho et al., "Lawmakers guide Wall Street reform into homestretch: Industry left largely intact," *Washington Post*, June 26, 2010, at A01; Edward Wyatt & David M. Herszenhorn," Accord Reached for an Overhaul of Finance Rules," *New York Times*, June 26, 2010, at A1. *See also supra* notes 156-57 and accompanying text (discussing last-minute compromise that weakened the Volcker Rule).

[175] Dodd-Frank, § 716(d); *see also* Hill, *supra* note 167; Heather Landy, "Derivatives Compromise Is All About Enforcement," *American Banker*, June 30, 2010, at 1;Wyatt & Herszenhorn, *supra* note 174.

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

[177] Harper & Keoun, *supra* note 165; Smith & Lucchetti, *supra* note 115.

[178] Wyatt & Herszenhorn, *supra* note 174.

"greatly diluted,"[179] "significantly weakened,"[180] and "watered down,"[181] with the result that "the largest banks' [derivatives] operations are largely left intact."[182]

The requirement that bank must clear their trades of CDS in order to be exempt from the Lincoln Amendment is potentially significant.[183] However, there is no clearing requirement for other derivatives (e.g., interest and currency rate swaps) that reference assets permissible for investment by national banks ("bank-eligible" derivatives). Consequently, banks may continue to trade and deal in OTC derivatives (except for CDS) without restriction under the Lincoln Amendment if those derivatives are bank-eligible.[184] In addition, as discussed above, all "proprietary trading" by banks in derivatives must comply with the Volcker Rule as implemented by regulators.

4. Banks Controlled by Financial Holding Companies Should Operate as "Narrow Banks" so that They Cannot Transfer Their Federal Safety Net Subsidies to Their Nonbank Affiliates

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

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[179] Johnson, *supra* note 165.
[180] Hill, *supra* note 167 (quoting the Consumer Federation of America).
[181] Smith & Lucchetti, *supra* note 115.
[182] Keoun & Kopecki, *supra* note 165 (quoting analyst Nancy Bush).
[183] Title VII of Dodd-Frank establishes comprehensive clearing, reporting and margin requirements for a wide range of derivatives. *See* H.R. Rep. No. 111-517, at 868-69 (2010) (Conf. Rep.), *reprinted in* 2010 U.S.C.C.A.N. 722, 725-26; Senate Report No. 111-176, at 29-35, 92-101 (2010); Alison Vekshin & Phil Mattingly, "Lawmakers Agree on Sweeping Wall Street Overhaul," *Bloomberg.com*, June 25, 2010 (summarizing Title VII). Major financial institutions have engaged in heavy lobbying since Dodd-Frank's enactment to weaken the regulatory implementation of Title VII. *See, e.g.,* Robert Schmidt & Sial Brush, "Banks Seek Exemption from Dodd-Frank for Foreign-Exchange Swaps," *Bloomberg.com*, Nov. 24, 2010; "Wall Street Lobbyists Besiege CFTC to Shape Derivatives Trading Regulation," *Bloomberg.com*, Oct. 14, 2010.
[184] Wilmarth, "Dodd-Frank," *supra* note 5, at 1034 (discussing Dodd-Frank, § 716(d)(2)).

As shown below, a highly effective way to prevent the spread of federal safety net subsidies from banks to their affiliates involved in the capital markets would be to create a two-tiered structure of bank regulation and deposit insurance. The first tier of "traditional" banking organizations would provide a relatively broad range of banking-related services, but those organizations would not be allowed to engage, or affiliate with firms engaged, in securities underwriting or dealing, insurance underwriting, or derivatives dealing or trading. In contrast, the second tier of "narrow banks" could affiliate with "nontraditional" financial conglomerates engaged in capital markets activities (except for private equity investments). However, "narrow banks" would be prohibited from making any extensions of credit or other transfers of funds to their nonbank affiliates, except for lawful dividends paid to their parent holding companies. The "narrow bank" approach provides the most politically feasible approach for ensuring that banks cannot transfer their safety net subsidies to affiliated companies engaged in speculative activities in the capital markets, and it is therefore consistent with the objectives of both the Volcker Rule and the Lincoln Amendment.[185]

a. The First Tier of Traditional Banking Organizations

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

[185] The following description of my proposal for a two-tiered structure of bank regulation and deposit insurance is adapted from Wilmarth, "Dodd-Frank," *supra* note 5, at 1034-52. For discussions of similar "narrow bank" proposals, *see, e.g.,* Robert E. Litan, *What Should Banks Do?* 164–89 (1987). Kay, *supra* note 44, at 39–92; Ronnie J. Phillips & Alessandro Roselli, *How to Avoid the Next Taxpayer Bailout of the Financial System: The Narrow Banking Proposal* (Networks Fin. Instit. Pol'y Brief 2009-PB-05, 2009), available at http://ssrn.com/abstract_id=1459065.

4(c)(8) of the BHC Act.[186] For example, this first tier of traditional banks could take deposits, make loans, offer fiduciary services, and act as agents in selling securities, mutual funds and insurance products underwritten by non-affiliated firms. Additionally, they could underwrite and deal solely in "bank-eligible" securities that national banks are permitted to underwrite and deal in directly.[187] First-tier banking organizations could also purchase, as end-users, derivatives transactions that (i) hedge against their own firm-specific risks, and (ii) qualify for hedging treatment under Financial Accounting Standard ("FAS") Statement No. 133.[188]

Most first-tier banking firms would probably be small and midsized community-oriented banks. In the past, those banks typically have not engaged as principal in insurance underwriting, securities underwriting or dealing, derivatives dealing or trading, or other capital markets activities. Community banks should be encouraged to continue their primary business of attracting core deposits, providing "high touch," relationship-based loans to consumers and to small and medium-sized enterprises ("SMEs"), and offering wealth management and other fiduciary services to local customers. (In sharp contrast to traditional community banks, TBTF megabanks provide impersonal, highly automated lending and deposit programs to SMEs and consumers, and megabanks also focus on complex, higher-risk transactions in the capital markets.)[189] Traditional, first-tier banks and their holding companies should continue to operate

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[186] *See* 12 U.S.C. § 1843(c)(8) (2006); Carnell, Macey & Miller, *supra* note 14, at 442–44 (describing "closely related to banking" activities that are permissible for nonbank subsidiaries of BHCs under § 4(c)(8)).

[187] *See* Wilmarth, "Transformation," *supra* note 40, at 225, 225–26 n.30 (discussing "bank-eligible" securities that national banks are authorized to underwrite or purchase or sell for their own account); Carnell, Macey & Miller, *supra* note 14, at 132–34 (same).

[188] Wilmarth, "Dodd-Frank," *supra* note 5, at 1036.

[189] For discussions of the sharply different business models adopted by community banks and megabanks, see Wilmarth, "Dodd-Frank," *supra* note 5, at 1035-38; Wilmarth, "Transformation," *supra* note 40, at 261-70, 372-407.

under their current supervisory arrangements, and all deposits of first-tier banks (up to the current statutory maximum of $250,000) should be covered by deposit insurance.

In order to provide reasonable flexibility to first-tier banking organizations, Congress should amend § 4(c)(8) of the BHC Act by permitting the FRB to expand the list of "closely related" activities that are permissible for holding company affiliates of traditional banks.[190] However, Congress should prohibit first-tier BHCs from engaging as principal in underwriting or dealing in securities, underwriting any type of insurance (except for credit insurance), dealing or trading in derivatives, or making private equity investments.

b. The Second Tier of Nontraditional Banking Organizations

Unlike first-tier banking firms, the second tier of "nontraditional" banking organizations would be allowed to engage, through nonbank subsidiaries, in (i) underwriting and dealing (i.e., proprietary trading) in "bank-ineligible" securities,[191] (ii) underwriting all types of insurance, and (iii) dealing and trading in derivatives. Second-tier banking organizations would include: (A) FHCs registered under §§ 4(k) and 4(*l*) of the BHC Act,[192] (B) holding companies owning grandfathered "nonbank banks," and (C) grandfathered "unitary thrift" holding companies.[193] In

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[190] GLBA prohibits the FRB from approving any new "closely related" activities for bank holding companies under § 4(c)(8) of the BHC Act. *See* Carnell, Macey & Miller, *supra* note 14, at 444 (explaining that GLBA does not permit the FRB to expand the list of permissible activities under Section 4(c)(8) beyond the activities that were approved as of Nov. 11, 1999). Congress should revise § 4(c)(8) by authorizing the FRB to approve a limited range of new activities that are "closely related" to the traditional banking functions of accepting deposits, extending credit, discounting negotiable instruments and providing fiduciary services. *See* Wilmarth, "Dodd-Frank," *supra* note 5, at 1036-37 n.375.

[191] *See* Wilmarth, "Transformation," *supra* note 40, at 219-20, 225-26 n.30, 318-20 (discussing distinction between (i) "bank-eligible" securities, which banks may underwrite and deal in directly, and (ii) "bank-ineligible" securities, which affiliates of banks may underwrite and deal in under GLBA, but banks may not).

[192] 12 U.S.C. § 1843(k), (*l*) (2006). *See* Carnell, Macey & Miller, *supra* note 118, at 467-70 (describing "financial " activities, including securities underwriting and dealing and insurance underwriting, that are authorized for FHCs under the BHC Act, as amended by GLBA).

[193] *See* Arthur E. Wilmarth, Jr., "Wal-Mart and the Separation of Banking and Commerce," 39 *Connecticut Law Review* 1539, 1569-71, 1584-86 (2007) (explaining that (i) during the 1980's and 1990's, many securities firms, life insurers and industrial firms used the "nonbank bank" loophole or the

addition, firms controlling industrial banks should be required either to register as FHCs or to divest their ownership of such banks if they cannot comply with the BHC Act's prohibition against commercial activities.[194] Second-tier holding companies would thus encompass all of the largest banking organizations, most of which are heavily engaged in capital markets activities, as well as other financial conglomerates that control FDIC-insured depository institutions.

i. Congress Should Require a "Narrow Bank" Structure for Second-Tier Banks

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

Narrow banks could offer FDIC-insured deposit accounts, including checking and savings accounts and certificates of deposit. Narrow banks would hold all of their assets in the form of cash and marketable, short-term debt obligations, including qualifying government securities, highly-rated commercial paper and other liquid, short-term debt instruments that are eligible for investment by money market mutual funds ("MMMFs") under the SEC's rules.

"unitary thrift" loophole to acquire FDIC-insured institutions, and (ii) those loopholes were closed to new acquisitions by a 1987 statute and by GLBA, respectively), available at http://ssrn.com/abstract=984103 [hereinafter Wilmarth, "Wal-Mart"].

[194] Industrial banks are exempted from treatment as "banks" under the BHC Act. *See* 12 U.S.C. § 1841(c)(2)(H). As a result, the BHC Act allows commercial (i.e., nonfinancial) firms to retain their existing ownership of industrial banks. However, § 603 of Dodd-Frank imposes a three-year moratorium on the authority of federal regulators to approve any new acquisitions of industrial banks by commercial firms. In addition, § 603 requires the GAO to conduct a study and report to Congress on whether commercial firms should be permanently barred from owning industrial banks. *See* Senate Report No. 111-176, at 83 (2010). *See also* Wilmarth, "Wal-Mart," *supra* note 193, at 1543-44, 1554–1620 (arguing that Congress should prohibit commercial firms from owning industrial banks because such ownership (i) undermines the long-established U.S. policy of separating banking and commerce, (ii) threatens to spread federal safety net subsidies to the commercial sector of the U.S. economy, (iii) threatens the solvency of the DIF, (iv) creates competitive inequities between commercial firms that own industrial banks and other commercial firms, and (v) increases the likelihood of federal bailouts of commercial companies).

Narrow banks could not hold any other types of loans or investments, nor could they accept any uninsured deposits. Narrow banks would present a very small risk to the DIF, because (i) each narrow bank's non-cash assets would consist solely of short-term securities that could be "marked to market" on a daily basis, and the FDIC could therefore readily determine whether a narrow bank was threatened with insolvency, and (ii) the FDIC could promptly convert a narrow bank's assets into cash if the FDIC decided to liquidate the bank and pay off the claims of its insured depositors.[195]

Thus, narrow banks would effectively operate as FDIC-insured MMMFs. To prevent unfair competition with narrow banks, and to avoid future government bailouts of uninsured MMMFs, MMMFs should be prohibited from representing, either explicitly or implicitly, that they will redeem their shares based on a "constant net asset value" ("NAV") of $1 per share. Currently, the MMMF industry (which manages about $3 trillion of assets) leads investors to believe that their funds will be available for withdrawal (redemption) based on "a stable price of $1 per share."[196] Not surprisingly, "the $1 share price gives investors the false impression that money-market funds are like [FDIC-insured] banks accounts and can't lose money."[197] However, "[t]hat myth was shattered in 2008" when Lehman's default on its commercial paper caused Reserve Primary Fund (a large MMMF that invested heavily in Lehman's paper) to suffer large losses and to "break the buck."[198] Reserve Primary Fund's inability to redeem its shares based on a NAV of $1 per share caused an investor panic that precipitated runs on several MMMFs. The Treasury Department responded by establishing the Money Market Fund

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[195] *See* Wilmarth, "Dodd-Frank," *supra* note 5, at 1038; Kenneth E. Scott, "Deposit Insurance and Bank Regulation: The Policy Choices," 44 *Business Lawyer* 907, 921–22, 928–29 (1989).
[196] David Reilly, "Goldman Sachs Wimps Out in Buck-Breaking Brawl," *Bloomberg.com*, Feb. 3, 2010.
[197] *Id. See also* Kay, *supra* note 44, at 65 (arguing that an MMMF with a constant NAV of $1 per share "either confuses consumers or creates an expectation of government guarantee").
[198] Reilly, *supra* note 196 .

Guarantee Program ("MMFGP"), which protected investors in participating MMMFs between October 2008 and September 2009.[199]

Critics of MMMFs maintain that the Treasury's MMFGP has created an expectation of similar government bailouts if MMMFs "break the buck" in the future.[200] In addition, former FRB chairman Paul Volcker has argued that MMMFs weaken banks because of their ability to offer bank-like products without equivalent regulation. MMMFs typically offer accounts with check-writing features, and they provide returns to investors that are higher than bank checking accounts because MMMFs do not have to pay FDIC insurance premiums or to comply with other bank regulations.[201] A Group of Thirty report, which Mr. Volcker spearheaded, proposed that MMMFs that wish to offer bank-like services, such as checking accounts and withdrawals at a stable NAV of $1 per share, should reorganize as "special-purpose banks" with appropriate governmental supervision and insurance.[202] In contrast, MMMFs that do not wish to operate as banks should be required to base their redemption price on a floating NAV, so that investors are not misled into believing that they can always redeem their MMMFs shares at par.[203]

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[199] Wilmarth, "Dodd-Frank," *supra* note 5, at 1039.
[200] Jane Bryant Quinn, "Money Funds Are Ripe for 'Radical Surgery'," *Bloomberg.com*, July 29, 2009. *See also* Reilly, *supra* note 196 (arguing that the failure of federal authorities to reform the regulation of MMMFs "creates the possibility of future market runs and the need for more government bailouts").
[201] Wilmarth, "Dodd-Frank," *supra* note 5, at 1040.
[202] Group of Thirty, *Financial Reform: A Framework for Financial Stability* 29 (2009) (recommending that "[m]oney market mutual funds wishing to continue to offer bank-like services, such as transaction account services, withdrawals on demand at par, and assurances of maintaining a stable net asset value (NAV) at par, should be required to reorganize as special-purpose banks, with appropriate prudential regulation and supervision, government insurance, and access to central bank lender-of-last resort facilities") (Recommendation 3.a.), available at http://www.group30.org/pubs/reformreport.pdf .
[203] *Id.* at 29 (Recommendation 3.b., stating that MMMFs "should be clearly differentiated from federally insured instruments offered by banks" and should base their pricing on "a fluctuating NAV"). *See also* Reilly, *supra* note 196 (supporting the Group of Thirty's recommendation that MMMFs "either use floating values – and so prepare investors for the idea that these instruments can lose money – or be regulated as if they are bank products"); Kay, *supra* note 44, at 65 (similarly arguing that "[i]t is important to create very clear blue water between deposits, subject to government guarantee, and [uninsured MMMFs], which may be subject to market fluctuation").

If Congress required nonbank MMMFs to base their redemption price on a floating NAV and also adopted my proposal for a two-tiered structure of bank regulation, many MMMFs would voluntarily reorganize as FDIC-insured narrow banks and would become subsidiaries of second-tier FHCs.[204] As explained above, rules restricting the assets of narrow banks to commercial paper, government securities and other types of marketable, highly-liquid investments would protect the DIF from any significant loss if a narrow bank failed.

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

Congress should adopt four supplemental rules to prevent second-tier holding companies from exploiting their narrow banks' safety net subsidies. First, narrow banks should be absolutely prohibited – without any possibility of a regulatory waiver – from making any extensions of credit or other transfers of funds to their affiliates, except for the payment of lawful dividends out of profits to their parent holding companies.[205] Currently, transactions between FDIC-insured banks and their affiliates are restricted by §§ 23A and 23B of the Federal Reserve Act.[206] However, the FRB has repeatedly waived those restrictions during recent financial crises. The FRB's waivers have allowed bank subsidiaries of FHCs to provide extensive support to affiliated securities broker-dealers and MMMFs. By granting those waivers, the FRB has enabled banks controlled by FHCs to transfer the safety net subsidy provided by low-cost, FDIC-insured deposits to their nonbank affiliates.[207]

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[204] *See* Quinn, *supra* note 200 (describing strong opposition by Paul Schott Stevens, chairman of the Investment Company Institute (the trade association representing the mutual fund industry), against any rule requiring uninsured MMMFs to quote floating NAVs, because "[i]nvestors seeking guaranteed safety and soundness would migrate back to banks" and "[t]he remaining funds would become less attractive because of their fluctuating price").

[205] Scott, *supra* note 195, at 929; Wilmarth, "Dodd-Frank," *supra* note 5, at 1041.

[206] 12 U.S.C. §§ 371c, 371c-1 (2006).

[207] Wilmarth, "Dodd-Frank," *supra* note 5, at 1042 n.395 (referring to (i) the FRB's waiver of § 23A restrictions so that major banks could make large loans to their securities affiliates following the terrorist

Dodd-Frank limits the authority of the FRB to grant future waivers or exemptions under §§ 23A and 23B, because it requires the FRB to obtain the concurrence of either the OCC (with respect to waivers granted by orders for national banks) or the FDIC (with respect to waivers granted by orders for state banks or exemptions granted by rulemaking).[208] Even so, it is unlikely that the OCC or the FDIC would refuse to concur with the FRB's proposal for a waiver under conditions of financial stress. Accordingly, Dodd-Frank does not ensure that the restrictions on affiliate transactions in §§ 23A and 23B will be adhered to in a crisis setting.

For example, the FRB recently permitted BofA to evade the restrictions of § 23A by transferring an undisclosed amount of derivatives contracts from its Merrill broker-dealer subsidiary to its subsidiary bank. The transfer materially increased the potential risk to the DIF and taxpayers from any losses that BofA might incur on those derivatives. However, the transfer reportedly enabled BofA – which has been struggling with a host of problems – to avoid a requirement to post $3.3 billion in additional collateral with counterparties, due to the fact that BofA's subsidiary bank enjoys a significantly higher credit rating than Merrill.[209] One commentator noted that "the Fed's priorities seem to lie with protecting [BofA] from losses at Merrill, even if that means greater risks for the FDIC's insurance fund."[210]

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attacks on September 11, 2001; (ii) the FRB's decisions, after the subprime financial crisis began in August 2007, to grant exemptions from § 23A restrictions so that six major U.S. and foreign banks – BofA, Citigroup, Chase, Barclays, Deutsche and RBS – could provide loans to support their securities affiliates; and (iii) the FRB's decisions to waive §§ 23A and 23B in 2008 and 2009 so that banks could purchase asset-backed commercial paper ("ABCP") from affiliated MMMFs in order to mitigate "ongoing dislocations in the financial markets, and the impact of such dislocations on the functioning of ABCP markets and on the operation of [MMMFs]").

[208] Dodd-Frank, § 608(a)(4) (amending 12 U.S.C. § 371c(f)).*id.* § 608(b)(6) (amending 12 U.S.C. § 371c-1(e)(2)).

[209] Kate Davidson, "Democrats Raise Red Flag on BofA Derivatives Transfer," *American Banker*, Oct. 28, 2011; Simon Johnson, "Bank of America Is Too Much of a Behemoth to Fail," *Bloomberg.com*, Oct. 23, 2011; Jonathan Weil, "Bank of America Bosses Find Friend in the Fed," *Bloomberg.com*, Oct. 19, 2011.

[210] Weil, *supra* note 209.

My proposal for second-tier narrow banks would replace §§ 23A and 23B with an absolute rule. That rule would completely prohibit any extensions of credit or other transfers of funds by second-tier banks to their nonbank affiliates (except for lawful dividends paid to parent holding companies). Under that rule, federal regulators would be barred from approving any transfers of safety net subsidies by narrow banks to their affiliates. An absolute bar on affiliate transactions is necessary to prevent FDIC-insured banks from being used as backdoor bailout devices for nonbank affiliates of LCFIs.

Second, as discussed above, Congress should repeal the "systemic risk exception" ("SRE") currently included in the FDI Act. By repealing the SRE, Congress would require the FDIC to follow the least costly resolution procedure for every failed bank, and the FDIC could no longer rely on the TBTF policy as a justification for protecting uninsured creditors of a failed bank or its nonbank affiliates. Repealing the SRE would ensure that the DIF could not be used to support a bailout of uninsured creditors of a failed or failing SIFI. Removing the SRE from the FDIA would make clear to the financial markets that the DIF could only be used to protect depositors of failed banks. Uninsured creditors of SIFIs and their nonbank subsidiaries would therefore have stronger incentives to monitor the financial operations and condition of such entities.[211]

Additionally, a repeal of the SRE would mean that smaller banks would no longer bear any part of the cost of protecting uninsured creditors of TBTF banks. Under current law, all FDIC-insured banks must pay a special assessment (allocated in proportion to their total assets) to reimburse the FDIC for the cost of protecting uninsured claimants of a TBTF bank under the SRE.[212] A 2000 FDIC report noted the unfairness of expecting smaller banks to help pay for

[211] Wilmarth, "Dodd-Frank," *supra* note 5, at 1042-43.
[212] 12 U.S.C. § 1823(c)(4)(G)(ii).

"systemic risk" bailouts when "it is virtually inconceivable that they would receive similar treatment if distressed."[213] The FDIC report suggested that the way to correct this inequity is "to remove the [SRE],"[214] as I have proposed here.

Third, second-tier narrow banks should be barred from purchasing derivatives except as end-users in transactions that qualify for hedging treatment under FAS 133. Thus, my proposal would require all derivatives dealing and trading activities of second-tier banking organizations to be conducted through separate nonbank affiliates, in the same manner that GLBA currently requires all underwriting and dealing in bank-ineligible securities to be conducted through nonbank affiliates of FHCs.[215] Prohibiting second-tier banks from dealing and trading in derivatives would accomplish an essential goal of the Volcker Rule and the Lincoln Amendment, because it would prevent FHCs from continuing to exploit federal safety net subsidies by conducting speculative trading activities within their FDIC-insured bank subsidiaries.

BofA's recent transfer of derivatives from Merrill to its bank subsidiary demonstrates that bank dealers in OTC derivatives enjoy significant competitive advantages over nonbank dealers, due to the banks' explicit and implicit safety net subsidies. Banks typically borrow funds at significantly lower interest rates than their holding company affiliates because (i) banks can obtain direct, low-cost funding through FDIC-insured deposits, and (ii) banks present lower risks to their creditors because of their direct access to other federal safety net resources, including (A) the FRB's discount window lending facility, (B) the FRB's guarantee of interbank payments

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[213] Federal Deposit Ins. Corp., Options Paper, Aug. 2000, at 33, *available at* http://www.fdic.gov/deposit/insurance/initiative/Options_080700m.pdf.
[214] *Id*.
[215] *See* Carnell, Macey & Miller, *supra* note 14, at 27, 130-34, 467-70, 490-91 (explaining that, under GLBA, all underwriting and dealing of bank-ineligible securities by FHCs must be conducted through nonbank holding company subsidiaries or through nonbank financial subsidiaries of banks); Wilmarth, "Transformation," *supra* note 40, at 219-20, 225-26 n.30, 318-20 (same).

made on Fedwire, and (C) the greater potential availability of TBTF bailouts for uninsured creditors of banks (as compared to creditors of BHCs).[216]

The OCC has confirmed that FHCs generate higher profits when they conduct derivatives activities directly within their banks, in part because the "favorable [funding] rate enjoyed by the banks" is lower than "the borrowing rate of their holding companies."[217] Such an outcome may be favorable to FHCs, but it is certainly not beneficial to the DIF and taxpayers. The DIF and taxpayers are exposed to a significantly higher risk of losses when derivatives dealing and trading activities are conducted directly within banks instead of within nonbank holding company affiliates. Congress must terminate this artificial, federally-subsidized advantage for bank derivatives dealers.[218]

Fourth, Congress should prohibit all private equity investments by second-tier banks and their holding company affiliates. To accomplish this reform – which would be consistent with the Volcker Rule as originally proposed – Congress should repeal Sections 4(k)(4)(H) and (I) of the BHC Act,[219] which allow FHCs to make merchant banking investments and insurance company portfolio investments.[220] Private equity investments involve a high degree of risk and have inflicted significant losses on FHCs in the past.[221] In addition, private equity investments threaten to "weaken the separation of banking and commerce" by allowing FHCs "to maintain

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[216] Carnell, Macey & Miller, *supra* note 14, at 492; Wilmarth, "Dodd-Frank," *supra* note 5 at 1044.
[217] Office of the Comptroller of the Currency, OCC Interpretive Letter No. 892, at 3 (2000) (from Comptroller of the Currency John D. Hawke, Jr., to Rep. James A. Leach, Chairman of House Committee on Banking & Financial Services), *available at* http://www.occ.treas.gov/interp/sep00/int892.pdf.
[218] Wilmarth, "Dodd-Frank," *supra* note 5, at 1044-45.
[219] 12 U.S.C. § 1843(k)(4)(H), (I) (2006).
[220] *See* Carnell, Macey & Miller, *supra* note 14, at 483–85 (explaining that "through the merchant banking and insurance company investment provisions, [GLBA] allows significant nonfinancial affiliations" with banks).
[221] Wilmarth, "Transformation," *supra* note 40, at 330-32, 375-78.

long-term control over entities that conduct commercial (i.e., nonfinancial) businesses."[222] Such affiliations between banks and commercial firms are undesirable because they are likely to create serious competitive and economic distortions, including the spread of federal safety net benefits to the commercial sector of our economy.[223]

In combination, the four supplemental rules described above would help to ensure that narrow banks cannot transfer their federal safety net subsidies to their nonbank affiliates. Restricting the scope of safety net subsidies is of utmost importance in order to restore a more level playing field between small and large banks, and between banking and nonbanking firms. Safety net subsidies have increasingly distorted our regulatory and economic policies over the past three decades. During that period, nonbanking firms have pursued every available avenue to acquire FDIC-insured depository institutions so that they can secure the funding advantages provided by low-cost, FDIC-insured deposits. At the same time, nonbank affiliates of banks have made every effort to exploit the funding advantages and other safety net benefits conferred by their affiliation with FDIC-insured institutions.[224]

The most practicable way to prevent the spread of federal safety net subsidies – as well as their distorting effects on regulation and economic activity – is to establish strong barriers that prohibit narrow banks from transferring their subsidies to their nonbanking affiliates, including those engaged in speculative capital markets activities. The narrow bank structure and the supplemental rules described above would force financial conglomerates to prove that they can produce superior risk-related returns to investors without relying on explicit and implicit

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[222] Wilmarth, "Wal-Mart," *supra* note 193, at 1581-82.
[223] For further discussion of this argument, see *id*. at 1588-1613.
[224] *Id.* at 1569-70, 1584-93; *see also* Kay, *supra* note 44, at 43 (stating: "The opportunity to gain access to the retail deposit base has been and remains irresistible to ambitious deal makers. That deposit base carries an explicit or implicit government guarantee and can be used to leverage a range of other, more exciting, financial activities. [¶] The archetype of these deal-makers was Sandy Weill, the architect of Citigroup").

government subsidies. Economic studies have failed to confirm the existence of favorable economies of scale or scope in giant financial conglomerates, and those conglomerates have not been able to generate consistently positive returns, even under the current regulatory system that allows them to capture extensive federal subsidies.[225]

In late 2009, a prominent bank analyst suggested that if Congress prevented nonbank subsidiaries of FHCs from relying on low-cost deposit funding provided by their affiliated banks, large FHCs would not be economically viable and would be forced to break up voluntarily.[226] Many of the largest commercial and industrial conglomerates in the U.S. and Europe have been broken up through hostile takeovers and voluntary divestitures during the past three decades because they proved to be "less efficient and less profitable than companies pursuing more focused business strategies."[227] It is long past time for financial conglomerates to be stripped of their safety net subsidies and their presumptive access to TBTF bailouts so that they will be subject to the same type of scrutiny and discipline that the capital markets have applied to commercial and industrial conglomerates during the past thirty years. The narrow bank concept provides a workable plan to impose such scrutiny and discipline on FHCs.

c. Responses to Critiques of the Narrow Bank Proposal

Critics have raised three major objections to the narrow bank concept. First, critics point out that the asset restrictions imposed on narrow banks would prevent them from acting as

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[225] Wilmarth, "Reforming Financial Regulation," *supra* note 1, at 748-49; *see also* Johnson & Kwak, *supra* note 37, at 212-13.

[226] 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." 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. Stacy Kaper, "Big Banks Face Most Pain Under House Bill," *American Banker,* Dec. 2, 2009, at 1 (quoting Ms. Petrou).

[227] Wilmarth, "Dodd-Frank," *supra* note 5, at 1047.

intermediaries of funds between depositors and most borrowers. Many narrow bank proposals (including mine) would require narrow banks to invest their deposits in safe, highly marketable assets such as those permitted for MMMFs. Narrow banks would therefore be largely or entirely barred from making commercial loans. As a result, critics warn that a banking system composed exclusively of narrow banks could not provide credit to small and midsized business firms that lack access to the capital markets and depend on banks as their primary source of outside credit.[228]

However, my two-tiered proposal would greatly reduce any disruption of the traditional role of banks in acting as intermediaries between depositors and bank-dependent firms, because my proposal would allow first-tier "traditional" banks (primarily community-oriented banks) to continue making commercial loans that are funded by deposits. Community banks make most of their commercial loans in the form of longer-term "relationship" loans to SMEs. Under my proposal, community banks could continue to carry on their deposit-taking and lending activities as first-tier banking organizations without any change from current law, and their primary commercial lending customers would continue to be smaller, bank-dependent firms.[229]

In contrast to community banks, big banks do not make a substantial amount of relationship loans to small firms. Instead, big banks primarily make loans to large and well-established firms, and they provide credit to small businesses mainly through highly automated programs that use impersonal credit scoring techniques. Under my proposal, as indicated above, most large banks would operate as subsidiaries of second-tier "nontraditional" banking organizations. Second-tier holding companies would conduct their business lending programs through nonbank finance subsidiaries that are funded by commercial paper and other debt

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[228] *See, e.g.*, Neil Wallace, "Narrow Banking Meets the Diamond-Dybvig Model," 20 *Quarterly Review* (Fed. Res. Bank of Minneapolis, Winter 1996), at 3.
[229] Wilmarth, "Dodd-Frank," *supra* note 5, at 1048.

instruments sold to investors in the capital markets. This operational structure should not create a substantial disincentive for the highly automated small business lending programs offered by big banks, because most loans produced by those programs (e.g., business credit card loans) can be financed by the capital markets through securitization.[230]

Thus, my two-tier proposal should not cause a significant reduction in bank loans to bank-dependent firms, because big banks have already moved away from traditional relationship-based lending funded by deposits. If Congress wanted to give LCFIs a strong incentive to make relationship loans to small and midsized firms, Congress could authorize second-tier banks to devote a specified percentage (e.g., ten percent) of their assets to such loans, as long as the banks held the loans on their balance sheets and did not securitize them. By authorizing such a limited "basket" of relationship loans, Congress could allow second-tier banks to use deposits to fund those loans without exposing the banks to a significant risk of failure, since the remainder of their assets would be highly liquid and marketable.

The second major criticism of the narrow bank proposal is that it would lack credibility because regulators would retain the inherent authority (whether explicit or implicit) to organize bailouts of major financial firms during periods of severe economic distress. Accordingly, some critics maintain that the narrow bank concept would simply shift the TBTF problem from insured banks to their nonbank affiliates.[231] However, the force of this objection has been weakened by the systemic risk oversight and resolution regime established by Dodd-Frank. Under Dodd-Frank, LCFIs that might have been considered for TBTF bailouts in the past will be designated and regulated as SIFIs and will also be subject to resolution under Dodd-Frank's OLA. As

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[230] *Id.*.

[231] *See* Scott, *supra* note 195, at 929-30 (noting the claim of some critics that there would be "irresistible political pressure" for bailouts of uninsured "substitute-banks" that are created to provide the credit previously extended by FDIC-insured banks).

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

Thus, if my proposed reforms were fully implemented, (i) the narrow bank structure would prevent SIFI-owned banks from transferring their safety net subsidies to their nonbank affiliates, and (ii) the systemic risk oversight and resolution regime would require SIFIs to internalize the potential risks that their operations present to financial and economic stability. In combination, both sets of regulatory reforms would greatly reduce the TBTF subsidies that might otherwise be available to large financial conglomerates. Moreover, the narrow bank structure would advance the purpose of "living wills" (resolution plans) by making it much easier for regulators to separate banks owned by failed SIFIs from their nonbank affiliates. As discussed above, narrow banks would not be allowed to become entangled with their nonbank affiliates through extensions of credit and other transfers of funds.[232]

The third principal objection to the narrow bank proposal is that it would place U.S. FHCs at a significant disadvantage in competing with foreign universal banks that are not required to comply with similar constraints.[233] Again, there are persuasive rebuttals to this objection. For example, the U.K. Independent Commission on Banking recently issued a report (the "Vickers Report") that presents a reform program analogous to my proposal. The Vickers Report has proposed a regime that would force large financial conglomerates to adopt a "ring-fenced" structure that would separate their retail "utility" banking operations – including

[232] Wilmarth, "Dodd-Frank," *supra* note 5, at 1050-51..
[233] *See* Kay, *supra* note 44, at 71-74; Scott, *supra* note 195, at 931.

financial services provided to consumers and SMEs – from their wholesale "casino" activities in the financial markets.[234] U.K. analysts noted that the Vickers plan would require financial conglomerates to "build firewalls between their consumer units and investment banks" and likely cause "a jump in the cost of funding for their investment-banking divisions as the implicit [U.K.] government guarantee is removed."[235] The Cameron government has pledged to implement the recommendations of the Vickers Report by the end of the current Parliamentary session in 2015.[236]

If the U.S. and the U.K. both decide to implement a narrow banking structure (supplemented by strong systemic risk oversight and resolution regimes), their combined leadership in global financial markets would (i) eliminate claims by global SIFIs that they would face an unlevel playing field if they competing in both the New York and London financial markets, and (ii) place considerable pressure on other major global financial centers to adopt similar financial reforms.[237] The financial sector accounts for a large share of the domestic economies of the U.S. and U.K. Both economies were severely damaged by two financial crises during the past decade (the dotcom-telecom bust and the subprime lending crisis). Both crises were produced by the same set of LCFIs that continue to dominate the financial systems in both nations. Accordingly, regardless of what other nations may do, the U.S. and the U.K. have

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[234] Howard Mustoe & Gavin Finch, "Banks in U.K. Have to Insulate Consumer Units in $11 Billion Vickers Plan," *Bloomberg.com*, Sept. 12, 2011; *see also* Kay, *supra* note 44, at 51-69 (advocating adoption by the U.K. of a narrow banking plan that would accomplish "the separation of utility from casino banking").
[235] Liam Vaughan, Howard Mustoe & Gavin Finch, "U.K. Bank Investors Chided as Vickers Returns Firms to 1950s," *Bloomberg.com,* Sept. 13, 2011.
[236] Mustoe & Finch, *supra* note 234.
[237] Wilmarth, "Dodd-Frank," *supra* note 5, at 1051; Kay, *supra* note 44, at 74.

compelling national reasons to make sweeping changes to their financial systems in order to protect their domestic economies from the threat of a similar crisis in the future.[238]

The view that the U.S. and the U.K. must refrain from implementing fundamental financial reforms until all other major developed nations have agreed to do so rests upon two deeply flawed assumptions: (i) the U.S. and the U.K. should allow foreign nations with the weakest systems of financial regulation to dictate the level of supervisory constraints on LCFIs, and (ii) until a comprehensive international agreement on reform is achieved, the U.S. and the U.K. should continue to provide TBTF bailouts and other safety net subsidies that impose huge costs, create moral hazard and distort economic incentives simply because other nations provide similar benefits to their LCFIs.[239] Both assumptions are unacceptable and must be rejected.

d. The Relevance of the Schumer "Core Banking" Proposal of 1991

In 1991, Congress considered, but did not pass, legislation proposed by the Treasury Department to allow banks to affiliate with securities firms and insurance companies by organizing financial holding companies. During the House debates on the 1991 legislation, which was essentially a forerunner of GLBA,[240] then-Representative Charles Schumer offered an amendment that incorporated a narrow banking proposal similar to the one I have presented in this testimony.[241] Representative Schumer argued that Congress should not authorize financial holding companies unless it adopted his amendment, which he described as a "core bank proposal."[242] His proposal sought to guarantee that "insured deposits [are] used for low-risk, traditional banking activities, and then if our large financial institutions wish to invest in high-

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[238] *See e.g.*, *King 2009 Speech*, *supra* note 14; Kay, *supra* note 44, at 71-74; Wilmarth, "Dodd-Frank," *supra* note 5, at 1051-52.
[239] *See e.g.*, Kay, *supra* note 44, at 42-46, 57-59, 66-75; Wilmarth, "Dodd-Frank," *supra* note 5, at 1052..
[240] Wilmarth, "Reforming Financial Regulation," *supra* note 1, at 780.
[241] *See* 137 CONG. REC. 29359–29367 (1991).
[242] *Id*. at 29361 (remarks of Rep. Schumer).

risk activities, they do not use the depositors' money, they do not use insured dollars, but they go to the markets for money."[243]

Representative Schumer maintained that the FDIC and taxpayers should not be insuring such risky activities as "huge bridge loans to LBO's, . . . equity investments in real estate[,] . . . foreign currency trading and trading in . . . , derivatives, which is betting on futures."[244] He noted that "[m]ost of the large banks are opposed because they do not want to take the necessary medicine to make them better," but he argued that "[t]hey need strong medicine, and only core banking provides it."[245] Representative Marge Roukema supported the proposal because "the core bank concept is the only proposal before us to insulate the deposit insurance fund and protect the taxpayer from future bailouts."[246] She agreed that "insured deposits should only be used to finance [the] traditional business of banking" and should not be used to "finance highly speculative lending, equity investments or other activities which should be done outside the Federal safety net."[247]

Representative Schumer's core banking proposal was defeated.[248] However, he was undoubtedly correct in saying that his proposal was the "only amendment on the floor today that says we will not do what we did during the S&L crisis, and that is [to] use insured dollars for

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[243] *Id*. at 29360.
[244] *Id*.
[245] *Id*. at 29361 (remarks of Rep. Schumer).
[246] *Id*. at 29366 (remarks of Rep. Roukema).
[247] *Id*. at 29363 (remarks of Rep. Roukema). *See also id*. at 29365 (remarks of Rep. Slattery) (arguing that the "core-bank proposal offers real reform" because "it will say to the big banks in this country that . . . you can speculate in the monetary markets, you can speculate in real estate, you can speculate in high-yield junk bonds, but you cannot do it with the taxpayers' insured deposits"); *id*. at 29366–29367 (remarks of Rep. Weiss) (explaining that "the core bank proposal" would ensure that financial institutions interested in "underwriting, trading, and investment banking activities . . . would have to raise funds in the marketplace," and contending that "it would be unconscionable to expand bank powers without enacting major safeguards to the American taxpayer").
[248] *Id*. at 29367 (reporting that Rep. Schumer's amendment was defeated by a vote of 106-312).

risky activities."[249] He argued that Congress had grievously erred in 1982, when it allowed federal thrifts to "expand into new businesses with the taxpayers' dollars."[250] He further warned that Congress would be confronted with a future bailout of the banking system that could cost "$300 billion"

> unless we reform the system today. Do not put it off. Do not delay. The taxpayers cannot afford it. Only [the] core bank [proposal] will protect the insured deposit system once and for all.[251]

Unfortunately, Representative Schumer's warning not only proved to be prescient but also underestimated the potential cost of allowing banks to expand into capital markets activities while relying on federal safety net subsidies. As the current financial crisis has made clear, Congress must mandate narrow banking in order to prevent FDIC-insured banks from being used to subsidize similar high-risk underwriting, trading and investment activities in the future.

CONCLUSION

Dodd-Frank makes meaningful improvements in the regulation of large financial conglomerates. Dodd-Frank establishes a new umbrella oversight body – the FSOC – that will designate nonbank SIFIs and make recommendations for the supervision of those institutions and large BHCs. Dodd-Frank also empowers the FRB to adopt stronger capital requirements and other enhanced prudential standards for both types of SIFIs. Most importantly, Dodd-Frank

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[249] *Id*. at 29360 (remarks of Rep. Schumer). *See also id*. at 29366 (remarks of Rep. Schumer) (contending that his proposal was the "only . . . amendment on the floor today that learns from history").

[250] *Id*. at 29366. *See also id*. at 29360 (remarks of Rep. Schumer) (contending that congressional "deregulation" of thrift powers meant that "we . . . were insuring crazy, and risky and wild investments in the S&L industry to an enormous extent"); Wilmarth, "Wal-Mart," *supra* note 193, at 1574–79 (explaining that (i) Congress' expansion of the powers of federal thrifts in 1982 caused many states to "liberalize their own laws in order to keep state thrift charters attractive," and (ii) federal and state deregulation allowed many thrifts to expand aggressively into "nontraditional activities," including real estate development and investments in equity securities and junk bonds, which helped to cause "[s]ome of the largest and most costly thrift failures").

[251] 137 CONG. REC. 29366 (1991) (remarks of Rep. Schumer). *See also id*. at 29363 (remarks of Rep. Bacchus) (advocating the core banking proposal as the best way to "limit the risk [to] the taxpayers of a bank bailout that could cost hundreds of billions of dollars").

establishes a new systemic resolution regime – the OLA – that should provide a superior alternative to the "bailout or bankruptcy" choice that federal regulators confronted when they dealt with failing SIFIs during the financial crisis. However, the OLA's feasibility remains unproven with regard to global SIFIs that operate across multiple national borders, since most foreign countries do not have resolution procedures that are congruent with the OLA.[252]

In addition, as explained above, the OLA does not completely shut the door to future government rescues for creditors of SIFIs. The FRB can still provide emergency liquidity assistance to troubled LCFIs through the discount window and (perhaps) through "broad-based" liquidity facilities like the Primary Dealer Credit Facility, which are designed to help targeted groups of the largest financial institutions. FHLBs can still make advances to LCFIs. The FDIC can potentially use its Treasury borrowing authority and the SRE to protect uninsured creditors of failed SIFIs and their subsidiary banks. While Dodd-Frank has undoubtedly made TBTF bailouts more difficult, the continued existence of these avenues for financial assistance indicates that Dodd-Frank is not likely to prevent future TBTF rescues during future episodes of systemic financial distress. A recent report by Standard & Poor's ("S&P") concluded that Dodd-Frank does not eliminate the TBTF problem. S&P determined that "under certain circumstances and with selected systemically important financial institutions, future extraordinary government support is still possible."[253]

Dodd-Frank also relies heavily on the same supervisory tools – capital-based regulation and prudential supervision – that failed to prevent the banking and thrift crises of the 1980s as well as the current financial crisis. The reforms contained in Dodd-Frank depend for their

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[252] *See, e.g.,* Simon Johnson, "The Myth of the Resolution Authority," *Baseline Scenario* (blog), Mar. 31, 2011, available at http://baselinescenario.com/2011/03/31/the-myth-of-the-resolution-authority/.
[253] Standard & Poor's, "The U.S. Government Says Support for Banks Will Be Different 'Next Time' – But Will It? (July 12, 2011), at 2.

effectiveness on many of the same federal regulatory agencies that failed to stop excessive risk-taking by financial institutions during the credit booms that preceded both crises. As Simon Johnson and James Kwak observe:

> [S]olutions that depend on smarter, better regulatory supervision and corrective action ignore the political constraints on regulation and the political power of the large banks. The idea that we can simply regulate large banks more effectively assumes that regulators will have the incentive to do so, despite everything we know about regulatory capture and political constraints on regulation.[254]

The future effectiveness of the FSOC is also open to serious question in light of the agency turf battles and other bureaucratic failings that have plagued similar multi-agency oversight bodies in other fields of regulation (e.g., the Department of Homeland Security and the Office of the Director of National Intelligence).[255]

As an alternative to Dodd-Frank's regulatory reforms, Congress could have addressed the TBTF problem directly by mandating a breakup of large financial conglomerates. That is the approach advocated by Johnson and Kwak, who have proposed maximum size limits of four percent of GDP (about $570 billion in assets) for commercial banks and two percent of GDP (about $285 billion of assets) for securities firms. Those size caps would require a significant reduction in size for the six largest U.S. banking organizations (BofA, Chase, Citigroup, Wells Fargo, Goldman and Morgan Stanley).[256] Like Joseph Stiglitz, Johnson and Kwak maintain that

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[254] Johnson & Kwak, *supra* note 37, at 207

[255] *See, e.g.,* Dara Kay Cohen et al., "Crisis Bureaucracy: Homeland Security and the Political Design of Legal Mandates," 59 *Stanford Law Review* 673, 675-78, 718-20, 738-43 (2006) (analyzing organizational problems and operational failures within the Department of Homeland Security); Dana Priest & William M. Arkin, "A hidden world, growing beyond control," *Washington Post*, July 19, 2010, at A01 (discussing organizational problems and operational failures within the Office of the Director of National Intelligence); Paul R. Pillar, "Unintelligent Design," *The National Interest*, July-August 2010 (same) (available on Lexis).

[256] Johnson & Kwak, *supra* note 37, at 214-17.

"[t]he best defense against a massive financial crisis is a popular consensus that too big to fail is too big to exist."[257]

Congress did not follow the approach recommended by Johnson, Kwak and Stiglitz. In fact, the Senate rejected a similar proposal for maximum size limits by almost a two-to-one vote.[258] As noted above, Congress modestly strengthened Riegle-Neal's 10% nationwide deposit cap. However, that provision does not restrict "failing bank" mergers, intrastate mergers or acquisitions, or organic (internal) growth by LCFIs. In addition, Congress gave FSOC and the FRB broad discretion to decide whether to impose a 10% nationwide liabilities cap on mergers and acquisitions involving financial companies. LCFIs will undoubtedly seek to block the adoption of any such liabilities cap.

I am sympathetic to the maximum size limits proposed by Johnson and Kwak. However, it seems highly unlikely – especially in light of megabanks' enormous political clout – that Congress could be persuaded to adopt such draconian limits, absent a future disaster comparable to the present financial crisis.[259]

A third possible approach – and the one I advocate – would be to impose structural requirements and activity limitations that would (i) prevent LCFIs from using the federal safety

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[257] *Id.* at 221. *See also id.* at 217 ("Saying that we cannot break up our largest banks is saying that our economic futures depend on these six companies (some of which are in various states of ill health). That thought should frighten us into action"); Joseph E. Stiglitz, *Freefall: America, Free Markets, and the Sinking of the World Economy* 165-66 (2010) ("There is an obvious solution to the too-big-to-fail banks; break them up. If they are too big to fail, they are too big to exist").

[258] A proposed amendment by Senators Sherrod Brown and Ted Kaufman would have imposed the following maximum size limits on LCFIs: (i) a cap on deposit liabilities equal to 10 percent of nationwide deposits, and (ii) a cap on nondeposit liabilities equal to two percent of GDP for banking institutions and three percent of GDP for nonbanking institutions. The size caps proposed by Brown and Kaufman would have limited a single institution to about $750 billion of deposits and about $300 billion of nondeposit liabilities. The Senate rejected the Brown-Kaufman amendment by a vote of 61-33. Wilmarth, "Dodd-Frank," *supra* note 5, at 1055 n.454.

[259] *See* Johnson & Kwak, *supra* note 37, at 222 ("The Panic of 1907 only led to the reforms of the 1930s by way of the 1929 crash and the Great Depression. We hope that a similar [second] calamity will not be a prerequisite to action again").

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

My proposals for a pre-funded OLF, a repeal of the SRE, and a two-tiered system of bank regulation would provide a simple, straightforward strategy for accomplishing the goals of shrinking safety net subsidies and minimizing the need for taxpayer-financed bailouts of SIFIs. A pre-funded OLF would require all SIFIs to pay risk-based assessments to finance the future costs of resolving failed SIFIs. A repeal of the SRE would prevent the DIF from being used as a backdoor mechanism to protect uninsured creditors of megabanks. A two-tiered system of bank regulation would (i) restrict traditional banking organizations to deposit-taking, lending, fiduciary services and other activities that are "closely related" to banking, and (ii) mandate a "narrow bank" structure for banks owned by financial conglomerates. In turn, the narrow bank structure would (A) insulate narrow banks and the DIF from the risks of capital markets activities conducted by nonbank affiliates, and (B) prevent narrow banks from transferring their low-cost funding and other safety net subsidies to nonbank affiliates.

In combination, my proposed reforms would strip away many of the safety net subsidies that are currently exploited by LCFIs and would subject them to the same type of market discipline that investors have applied to commercial and industrial conglomerates over the past thirty years. Financial conglomerates have never demonstrated that they can provide beneficial services to their customers and attractive returns to their investors without relying on safety net subsidies during good times and massive taxpayer-funded bailouts during crises. It is long past time for LCFIs to prove – based on a true market test – that their claimed synergies and their supposedly superior business model are real and not mythical.[260] If, as I suspect, LCFIs cannot produce favorable returns when they are deprived of their current subsidies and TBTF status, market forces should compel them to break up voluntarily.

Thank you again for the opportunity to present this testimony.

Arthur E. Wilmarth, Jr. (12/5/11)

[260] *See* Johnson & Kwak, *supra* note 37, at 212-13 (contending that "[t]here is little evidence that large banks gain economies of scale above a very low size threshold," and also questioning the existence of favorable economies of scope for LCFIs); Stiglitz, *supra* note 257, at 166 (maintaining that "[t]he much-vaunted synergies of bringing together various parts of the financial industry have been a phantasm; more apparent are the managerial failures and conflicts of interest").

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Three Years Later

Unfinished Business in Financial Reform

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The William Taylor Memorial Lecture No. 13

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Group of Thirty, Washington, DC

About the Author

In the course of his career, Paul A. Volcker worked in the Federal Government for almost thirty years, culminating in two terms as Chairman of the Board of Governors of the Federal Reserve System from 1979 to 1987. Most recently, he was Chairman of President Barack Obama's Economic Recovery Advisory Board. Pursuing his many continuing interests in public policy, Mr. Volcker is associated with the Japan Society, the Institute of International Economics, the American Assembly, and the American Council on Germany. He is Honorary Chairman of the Trilateral Commission and the Group of Thirty. He is also Chairman of the Trustees of International House in New York City.

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The William Taylor Memorial Lecture Series No. 13

Three Years Later

Unfinished Business in Financial Reform

Paul A. Volcker

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The William Taylor Memorial Lecture

This lecture series is dedicated to the memory of William Taylor (1933 –1992). William Taylor's career in Washington, D.C. included 15 years at the Board of Governors of the Federal Reserve, where he rose to the position of Staff Director of Banking Supervision and Regulation, and culminated in his appointment as Chairman of the Federal Deposit Insurance Corporation in 1991. The lecture series is dedicated to honoring his long career of distinguished public service and to recognizing his dedication to ensuring the strength and stability of the financial system.

The lectures have traditionally been offered either at the biennial meeting of the International Conference of Banking Supervisors or, in intervening years, at the time of the annual meetings of the International Monetary Fund and the World Bank in Washington, D.C.

REMARKS OF

Paul A. Volcker

William Taylor Memorial Lecture
Washington, DC
September 23, 2011

Introduction

For the past eighteen years, lectures in honor of William Taylor have been presented around the time of the IMF/World Bank meetings. They collectively provide a record of expert commentary by those engaged in finance during a period of turbulent change, culminating in a destructive crisis.

This last of the Taylor Lectures is both symbolic and appropriate: Symbolic in the sense that the financial institutional markets in which Bill lived and worked have been transformed, and appropriate in that is time to think hard about new market structures and new approaches to regulation.

Bill's life was cut short well before securitization reached a full head of steam. Complex financial engineering and active derivative trading was in its infancy. Collateralized Debt Obligations, Credit Default Swaps, Structure Investment Vehicles and mysterious conduits simply didn't exist. Commercial banks hadn't yet become investment banks and investment banks hadn't yet acquired banking licenses. The innately conservative organizing principle for investment houses as partnerships has been dropped and increasingly aggressive and risky trading practices have come to take center stage.

In the process the major financial institutions have grown larger and larger, a lot more complicated, international in scope, interdependent,

impenetrable to outsiders and I fear to directors and many senior managers as well. I know all that because I've been re-reading past Taylor Lectures.

Those essays have been individually and collectively remarkable. Long before the financial crisis broke, several of the authors expressed strong concerns about the implications of the greater complexity, the need to develop more sophisticated and effective approaches toward risk management, and the difficult challenges for supervisors. [1] There were concerns about the incentives toward risk-taking embedded in new compensation practices (and especially stock options). Significantly, as early as the mid-1990's a senior European commercial banker raised questions about the seeming decline in ethical standards.[2] A decade later an experienced American central banker reiterated those concerns, suggesting that moral as well as practical issues were involved.[3]

More than a decade ago, a highly respected European official, Tommaso Padoa-Schioppa, raised questions about the implications for financial stability of the diminishing role for traditional (and highly regulated) commercial banking. The unspoken assumption of many was that the new investment bankers and both hedge and equity funds would in combination be capable of providing more competitive and stable markets and a more effective allocation of capital. But, the author asked, what about a stable core for the payments system, for the provision of liquidity, and for consumer services?[4]

One thing I found missing from the old lectures was a clear expression of an intellectual rationale for all the changes in the financial environment. Theorizing was lacking about market efficiency and rational expectations, which together would lead to stability and the optimal allocation of resources. The Taylor authors, after all, were not academics steeped in mathematical abstractions. They were central bankers, regulators, and market participants used to coping with the imperfections, excesses, and the frailties of human behavior. None were prepared to accept a "hands off" regulatory philosophy.

The "old world", the world in which Bill Taylor worked, surely had financial crises enough. The Latin American debt crisis of the 1980's, the savings and loan debacle, and the subsequent commercial bank

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1 See, e.g Cartellieri 1996; Crockett 1998; Fischer 2002.
2 Cartellieri 1996.
3 McDonough 2002.
4 Padoa-Schioppa 2000.

failures were no simple matters. Bill's leadership was critical through those years. A progressive breakdown in markets and lasting damage to the real economy was avoided.

That was not easy. The costs were significant. And those crises, in their severity, were a reminder of the simple fact that traditional banking, while providing essential public functions, necessarily entails risk. Those risks are inherent in intermediation between borrowers and lenders, between investors seeking longer-term funds and lenders placing priority on liquidity, and between obligations denominated in different currencies. It was the effort to deal with those risks that propelled much of the new financial architecture. But somehow in the effort to define, separate and diffuse those risks, with its familiar slogan of "slicing and dicing", sight was lost of the fact that this risk ultimately remained, however much it was relocated and re-priced. In fact, risk sometimes ended up in new concentrations, hidden from the view of supervisors, and too often from boards of directors and even top executives.

I well recall a conversation with Bill Taylor near the end of my Federal Reserve time. In stark terms he set out his concerns. As I recall the words, he put the point forcibly: "If you permit banks to securitize and sell their loans, they will lose interest in maintaining a strong credit culture and controls. And you are going to end up with even bigger crises."

Well, I shortly after left office. Bill, soon Chair of the FDIC, remained to cope with the increasingly complex world of finance. Of course, no single man, no single institution, could stand in the way of the powerful technical and political forces pushing for change—change that had the potent combination of strong intellectual support and prospects for high compensation. For all the cautions expressed, the succession of Taylor Lectures did not counsel resistance to the deep-seated structural changes taking place. Rather, they called for better, more disciplined management and supervision, most particularly a review of capital standards.[5]

Now, we know all the seeming mathematic precision brought to task, epitomized by calculations of Value at Risk, complicated new structured products, the explosion of derivatives, all intended to diffuse and minimize risk, did not bear out the hopes. Instead the vaunted efficiency helped justify exceedingly narrow credit spreads and exceedingly

5 Crockett 1998 and Fischer 2003.

large compensation. By now it is pretty clear that it was faith in the techniques of modern finance, stoked in part by the apparent huge financial rewards, that enabled the extremes of leverage, the economic imbalances, and the pretenses of the credit rating agencies to persist so long. A relaxed approach of regulators and important legislative liberalization reflected the new financial Zeitgeist.

If those remarks sound critical—and they are meant to inspire caution—let me emphasize that the breakdown in financial markets and the "Great Recession" are the culmination of years of growing, and ultimately unsustainable, imbalances between and within national economies. These are matters of national policy failures and the absence of a disciplined international monetary system.

Take the most familiar and egregious case. The huge external surpluses of China reflect its perceived desirability of rapidly growing export industries to support employment growth. Its willingness to build up trillions of short-term dollar assets at low interest rates to finance its surpluses kept the process going. Conversely, the United States happily utilized that inflow of low interest dollars to sustain heavy consumer spending, a growing budget deficit, and eventually an enormous housing bubble. Or, look to the current European crisis. At its roots are years of growing imbalances within the Euro Zone. As in other parts of the world, the ability to borrow at low rates bridged for a while the proclivities of some countries to spend and import beyond their means, while others saved and invested, tending to reinforce an underlying gap in productivity.

Those were fundamentally matters of public policy—taxing, spending, and exchange rate decisions, not a reflection of financial market characteristics. But neither can we ignore the fact that financial practices helped extend the imbalances. In the end, the build-up in leverage, the failure of credit discipline, and the opaqueness of securitization—all the complexity implicit in the growth of so-called "shadow banking"—helped facilitate accommodation to the underlying imbalances and to the eventual bubbles to a truly dangerous extent. In the end, the consequence was to intensify the financial crisis and to severely wound the real world economy. Even today, four years after the first intimations of the sub-prime mortgage debacle, high indebtedness and leverage, impaired banking capital, and a pervasive loss of confidence in a number of major financial institutions constrict

an easy flow of credit to smaller businesses, potential homebuyers and consumers alike.

By coincidence of timing, writing in the midst of the acute crisis in September and October of 2008, two Taylor lecturers set out perceptive analyses of the problems and anticipated the substance of much of the ensuing discussion of reform in the United States and other countries.[6] Just before the crisis, insightful questions were raised about what we really mean, or should mean, when we talk about financial stability—what's a reasonable objective, and how to reasonably align supervisory responsibilities.[7]

6 See Corrigan 2008; Ludwig 2008.
7 Davies 2005.

So, where do we stand?

The first international response has been to review collectively the capital standards of commercial banks. That's an old story. Shortly after I left office a generation ago, Basel I was completed, setting out so-called risk-based capital standards to be adopted by all financially important countries. That was, indeed, a success. Standards were raised and a degree of international consistency achieved. Those goals remain critically important, and by and large, capital standards can be agreed upon and enforced by regulators rather than be dependent on legislation in individual countries.

Review of those capital standards for banks—now with the further consideration of standards for liquidity—is widely perceived as a central element in the current reform effort—some would contend it is *the* central element. I do not want to discount the importance of the work. We do need, however, to be conscious of its practical difficulties and limitations. Those problems have long been evident in the effort to enforce the established standards. Not surprisingly, they reappear in the negotiations to strengthen the standards.

There are differences in national perceptions, reinforced by intense lobbying by affected institutions. The tendency may be to bend toward a least common denominator, weakening the standards, and to uneven application. Resistance to those pressures must be a priority for regulation.

There is the larger conceptual and unsettled question of the extent to which such standards should be applied to "shadow banks" and what do we precisely mean by "systemically important" shadow banks, worthy of regulation. Those *are* matters for legislation, complicated again by the need for enough international consistency to resist "forum shopping".

The need for regulators and supervisors to take account of new institutions and markets has spawned the new phrase "macro-prudential", to me among the most cumbersome words with obscure operational content spawned by the crisis. "Systemic surveillance" or "broad market oversight" seem to better convey what is necessary and desirable. Someone, some agency, some group should be charged with taking a holistic view toward assessing financial markets and institutions, particularly alert to the interconnections. Potentially dangerous inconsistencies and instabilities need to be recognized and assessed. Whether that function need carry with it specific regulatory responsibilities and enforcement authority (for instance, setting and enforcing capital standards for "non-banks") will likely vary country by country. But there can't be much doubt that success will require international consultation, exchanges of information, and in some areas coordinated action.

These days, finance flows far more freely across national borders than trade. Technology tightly links the operations of big banks and markets. Hedge funds and equity funds, securitized products—even equity markets—are more and more international by nature. Only the most draconian and destructive regulatory measures could stop it.

Today in Europe we see all those realities play out in real time in extreme form. Even among nations dedicated to a common market and a common currency, the tensions are great. The plain implication, to me, is not to retreat from an integrated Euro Zone, but to develop a new institutional structure to enforce greater consistency in banking and financial standards and more broadly to require a certain discipline in fiscal and economic policies.

There is no compulsion to carry that process of integration so far in the world more generally. The financial breakdown and the resulting severe impact on economic activity does, however, point to the need for coordination beyond the accepted need for common capital standards.

Among the more obvious areas is agreement on international accounting standards. The ground work has been well advanced over a decade. Full success, however, still awaits a definitive decision by

the SEC in the United States. I would add to that a more elusive but equally important consideration: true auditor independence. Required rotation and other means to that end are now under consideration by American authorities.

Given the weaknesses and conflicts exposed by the crisis, the role and structure of credit rating agencies needs further review. So far, no fully satisfactory approach has been set out, but surely this is a matter for international consideration. Current efforts toward reform within the major firms should help, but other approaches need emphasis. Reliance on the formal ratings by an oligopoly could be reduced both by greater, perhaps more focused, competition and by placing more emphasis on the need for "in house" credit competence, matters touched upon by the Dodd-Frank legislation.

More immediately important, and it seems to me more amenable to structural change, is the role of money market mutual funds in the United States. By grace of an accounting convention, shareholders in those funds are permitted to meet requests for withdrawals upon demand at a fixed dollar price so long as the market valuation of fund assets remains within a specified limit around the one dollar "par" (in the vernacular, "the buck"). Started decades ago essentially as regulatory arbitrage, money market funds today have trillions of dollars heavily invested in short-term commercial paper, bank deposits, and notably recently, European banks.

Free of capital constraints, official reserve requirements, and deposit insurance charges, these money market mutual funds are truly hidden in the shadows of banking markets. The result is to divert what amounts to demand deposits from the regulated banking system. While generally conservatively managed, the funds are demonstrably vulnerable in troubled times to disturbing runs, highlighted in the wake of the Lehman bankruptcy after one large fund had to suspend payments. The sudden impact on the availability of business credit in the midst of the broader financial crisis compelled the Treasury and Federal Reserve to provide hundreds of billions of dollars by resorting to highly unorthodox emergency funds to maintain the functioning of markets.

Recently, in an effort to maintain some earnings, many of those funds invested heavily in European banks. Now, without the backstop official liquidity, they are actively withdrawing those funds adding to the strains on European banking stability.

The time has clearly come to harness money market funds in a manner that recognizes both their structural importance in diverting funds from regulated banks and their destabilizing potential. If indeed they wish to continue to provide on so large a scale a service that mimics commercial bank demand deposits, then strong capital requirements, official insurance protection, and stronger official surveillance of investment practices is called for. Simpler and more appropriately, they should be treated as an ordinary mutual funds, with redemption value reflecting day by day market price fluctuations.

"Too Big To Fail"—the Key Issue in Structural Reform

The greatest structural challenge facing the financial system is how to deal with the wide-spread impression—many would say conviction—that important institutions are deemed "too large or too interconnected" to fail. During the crisis, creditors—and to some extent stockholders—were in fact saved by injection of official capital and liquidity in the aggregate of trillions of dollars, reinforcing the prevailing attitudes.

Few will argue that the support was unwarranted given the severity of the crisis, and the danger of financial collapse in response to contagious fears, with the implication of intolerable pressures on the real economy. But there are real consequences, behavioral consequences, of the rescue effort. The expectation that taxpayers will help absorb potential losses can only reassure creditors that risks will be minimized and help induce risk-taking on the assumption that losses will be socialized, with the potential gains all private. Understandably the body politic feels aggrieved and wants serious reforms.

The issue is not new. The circumstance in which occasional official rescues can be justified has long been debated.[8] What cannot be in question is that the prevailing attitudes and uncertainties demand an answer. And that answer must entail three elements:

8 Greenspan 1996.

First, the risk of failure of "large, interconnected firms" must be reduced, whether by reducing their size, curtailing their interconnections, or limiting their activities.

Second, ways and means must be found to manage a prompt and orderly financial resolution process for firms that fail (or are on the brink of failure), minimizing the potential impact on markets and the economy without massive official support.

Third, key elements in the approach toward failures need to be broadly consistent among major financial centers in which the failing institutions have critical operations.

Plainly, all that will require structural change embodied in legislation. Various approaches are possible. Each is difficult intellectually, operationally, and politically, but progress in these areas is the key to effective and lasting financial reform.

I think it is fair to say that in passing the Dodd-Frank legislation, the United States has taken an important step in the needed directions. Some elements of the new law remain controversial, and the effectiveness of some of the most important elements is still subject to administrative rule writing. Most importantly, a truly convincing approach to deal with the moral hazard posed by official rescue is critically dependent on complementary action by other countries.

In terms of the first element I listed to deal with "too big to fail"—minimizing the size and "interconnectedness" of financial institutions—the U.S. approach sets out limited but important steps. The size of the major financial institutions (except for "organic" growth) will be constrained by a cap on assets as a percent of the U.S. GDP. That cap is slightly higher than the existing size of the largest institutions, and is justified as much to limit further concentration as by its role as a prudential measure.

The newly enacted prohibitions on proprietary trading and strong limits on sponsorship of hedge and equity funds should be much more significant. The impact on the sheer size of the largest U.S. commercial banking organizations and the activities of foreign banks in the United States may be limited. They are, however, an important step to deal with risk, conflicts of interest and, potentially, compensation practices as well.

The recent trading losses in Europe illustrate the case for restrictions on proprietary trading and limiting participation in sponsoring private pools of capital beyond American institutions. At its root, it is a matter of the culture of the banking institution.

The justification for official support and protection of commercial banks is to assure maintenance of a flow of credit to businesses and individuals and to provide a stable, efficient payment system. Those are both matters entailed in continuing customer relations and necessarily imply an element of fiduciary responsibility. Imposing on those essential banking functions a system of highly rewarded—*very* highly rewarded—impersonal trading dismissive of client relationships presents cultural conflicts that are hard—I think really impossible—to successfully reconcile within a single institution. In any event, it is surely inappropriate that those activities be carried out by institutions benefiting from taxpayer support, current or potential.

Similar considerations bear upon the importance of requiring that trading in derivatives ordinarily be cleared and settled through strong clearing houses. The purpose is to encourage simplicity and standardization in an area that has been rapidly growing, fragmented, unnecessarily complex and opaque and, as events have shown, risk prone.

There is, of course, an important legitimate role for derivatives and for trading. The question is whether those activities have been extended well beyond their economic utility, driven by what one astute observer has expressed as "trying to extract pennies from a roller coaster".

There is one very large part of American capital markets calling for massive structural change that so far has not been touched by legislation. The mortgage market in the United States is dominated by a few government agencies or quasi-governmental organizations. The financial breakdown was in fact triggered by extremely lax, government-tolerated underwriting standards, an important ingredient in the housing bubble. The need for reform is self-evident and the direction of change is clear.

We simply should not countenance a residential mortgage market, the largest part of our capital market, dominated by so-called Government Sponsored Enterprises. Collectively, Fannie Mae, Freddie Mac and the Home Loan Banks had securities and guarantees outstanding that exceed the amount of marketable U.S. Treasury securities. The interest rates on GSE securities have been close to those on government obligations.

That was possible because it was broadly assumed, quite accurately as it has turned out, that in case of difficulty those agencies would be supported by the Treasury to whatever extent necessary to maintain their operations. That support was triggered in 2008, confirming the

moral hazard implicit in the high degree of confidence that government-sponsored enterprises would not be allowed to fail.

The residential mortgage market today remains almost completely dependent on government support. It will be a matter of years before a healthy, privately supported market can be developed. But it is important that planning proceed now on the assumption that Government Sponsored Enterprises will no longer be a part of the structure of the market.

We cannot, and should not, contemplate a financial world so constrained by capital requirements and regulation that all failures are avoided and innovation and risk-taking is lost. As I noted earlier, we need to develop arrangements to deal with such failures that do occur in a manner that will minimize market continuity and contagion.

Success will be dependent on complementary approaches in major markets—New York, London, Continental European centers and Tokyo, Hong Kong and before long other growing Asian markets. In essence, the authorities need to be able to cut through existing and typically laborious national bankruptcy procedures. The need is for new "resolution authorities" that can maintain necessary services and the immediate need for day-to-day financing while failing organizations are liquidated, merged or sold, whether in their entirety or piece by piece. Shareholders and management will be gone. Creditors will be placed at risk.

Such arrangements are incorporated in Dodd-Frank. I think it fair to say that there is a great deal of skepticism as to whether such arrangements will be effective in the midst of crises, and whether market participants will continue to presume that governments will again "ride to the rescue". Surely, that skepticism is likely to remain until the most important of jurisdictions can be brought into reasonable alignment.

My sense is that efforts are, in fact, well underway to clear away some of the technical underbrush and to agree on procedures for intervention and exchanging information. An important element in that effort is the concept of requiring institutions to develop "living wills". The idea is to have clarity as to the parts of their operations that could stand alone or be sold or merged as part of an orderly and rapid resolution process.

It is evident that there is not yet full agreement on elements of the basic structural framework for banking and other financial operations. Some jurisdictions seem content with what is termed "universal banks", whatever the conflicting risks and cultural issues involved. In the

United States, there are restrictions on the activities of commercial banking organizations, particularly with respect to trading and links with commercial firms.

Financial institutions not undertaking commercial banking activities will be able to continue a full range of trading and investment banking activities, even when affiliated with commercial firms. When deemed "systemically significant", they will be subject to capital requirements and greater surveillance than in the past. However, there should be no presumption of official support—access to the Federal Reserve, to deposit insurance, or otherwise. Presumably, failure will be more likely than in the case of regulated commercial banking organizations protected by the official safety net. Therefore, it is important that the new resolution process be available and promptly brought into play.

The Independent Commission on Banking in the United Kingdom—the so-called Vickers Committee—two weeks ago proposed a more sweeping structural change for organizations engaged in commercial banking. In essence, within a single organization the range of ordinary banking operations—deposit taking, lending, and payments—would be segregated in a "retail bank". That bank will be overseen by its own independent board of directors and "ring fenced" in a manner designed to greatly reduce relations with the rest of the organization.

Apparently, customers could deal with both parts of the organization, and some limited transactions would be permitted between them. But as I understand it, the "retail bank" would be much more closely regulated, with relatively high capital and other stringent requirements. The emphasis is to insulate the bank from failures of the holding company and other affiliates. There seems to be at least a hint that public support may be available in time of crisis. That presumably would be ruled out for other affiliates of the institution.

I frankly have not absorbed all the practical and legal implications of the U.K. proposal. Surely problems abound in trying to separate the fortunes of different parts of a single organization, reflected in the length and detail of the Commission's Report (which may come to rival Dodd-Frank!). Perhaps most fundamentally, directors and managements of a holding company are ordinarily assumed to have responsibility to the stockholders for the capital, profits and stability of the whole organization, which doesn't fit easily with the concept that one subsidiary, the "retail bank", must have a truly independent board of its own.

As an operational matter, some interaction between the retail and investment banks is contemplated in the interest of minimizing costs and facilitating full customer service. American experiences with "fire walls" and prohibitions on transactions between a bank and its affiliates have not been entirely reassuring in practice. Ironically, the philosophy of U.S. regulators has been to satisfy itself that a financial holding company and its non-bank affiliates should be a "source of strength" to the commercial bank. That principle has not been highly effective in practice.

Conclusion

In any event, while there are differences in the structural approaches in the U.S. and U.K., they are in fundamental agreement on the key importance of protecting traditional commercial banking from the risks and conflicts of proprietary activity. Both are consistent with developing a practical resolution authority. Widely agreed upon internationally, that will be the keystone in a stronger international financial system.

One thing is for sure, we have passed beyond the stage in which we can expect a new 'Bill Taylor'—and his successors in central banks, regulatory authorities and Treasuries—to rely on *ad hoc* responses in dealing with what have become increasingly frequent, complex and dangerous financial breakdowns. Structural change is necessary.

As it stands, the reform effort is incomplete.

It needs fresh impetus. I challenge governments and central banks to take up the unfinished agenda. Only then can our recollections of Bill Taylor be appropriately rewarded.

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Taming the Too-Big-to-Fails: Will Dodd–Frank Be the Ticket or Is Lap-Band Surgery Required?

(With Reference to Vinny Guadagnino, Andrew Haldane, Paul Volcker, John Milton, Tom Hoenig and Churchill's 'Terminological Inexactitude')

Remarks before Columbia University's Politics and Business Club

Richard W. Fisher
President and CEO
Federal Reserve Bank of Dallas

New York City
November 15, 2011

The views expressed are my own and do not necessarily reflect official positions of the Federal Reserve System.

Taming the Too-Big-to-Fails: Will Dodd–Frank Be the Ticket or Is Lap-Band Surgery Required?

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Richard W. Fisher

It is bracing to be with bright, young students here at the Politics and Business Club of Columbia University. I understand I have a high bar today: I need to surmount the heights reached in the insightful lecture recently given your undergraduate students by Vinny Guadagnino from the show *Jersey Shore*. I'll do my best.

Executive Summary

Today, I will speak to the issue of depository institutions considered "too big to fail" and "systemically important." I will argue that, just as health authorities in the United States are waging a campaign against the plague of obesity, banking regulators must do the same with regard to oversized banks that undermine the nation's financial health and are a potential threat to economic stability. I shall speak of the difficulty of treating this pernicious problem in a culture held hostage by concerns for "contagion," "systemic risk" and "unique solutions." I will posit that preoccupation with these concerns leads to an ethic that coddles survival of the fattest rather than promoting survival of the fittest, to the detriment of social welfare and economic efficiency.[1] I will express my hope that, properly implemented, the capstone of financial oversight, the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank), might assist in reining in the pernicious threat to financial stability that megabanks or "systemically important financial institutions"—the SIFIs—have become. But I will also express concern about the difficulty of doing so, concluding with a suggestion that perhaps the financial equivalent of irreversible lap-band or gastric bypass surgery is the only way to treat the pathology of financial obesity, contain the relentless expansion of these banks and downsize them to manageable proportions.

The Problem with SIFIs

Aspiring politicians in this audience do not have to be part of the Occupy Wall Street movement, or be advocates for the Tea Party, to recognize that government-assisted bailouts of reckless financial institutions are sociologically and politically offensive; they stand the concept of American social justice on its head. Business school students here will understand that bailouts of errant banks are questionable from the standpoint of the efficient workings of capitalism, for they run the risk of institutionalizing a practice that distorts the discipline of the marketplace and interferes with the transmission of monetary policy.

To this last point, my colleague and director of research at the Dallas Fed, Harvey Rosenblum, and I have written about how too-big-to-fail banks disrupt the transmission of policy initiatives. I refer you to the article we jointly authored for the *Wall Street Journal* in September 2009, titled "The Blob That Ate Monetary Policy." Our thesis was that as their losses mounted, the too-big-to-fails, or SIFIs, were forced to cut back their lending and gummed up the nation's capital

markets in general. Thus, before the Dodd–Frank Act was even proposed, we wrote that "guarding against a resurgence of the omnivorous TBTF Blob [must] be among the goals of financial reform."[2]

In previous speeches I have taken note of another dimension to the problem of sustaining behemoth financial institutions, and that is the cost of doing so. Andrew Haldane, executive director for financial stability and a member of the Financial Policy Committee at the Bank of England, provides some rough estimates of the subsidy that flows to banks from governments following a too-big-to-fail policy. With markets working under the assumption that they will invariably be protected by government, the cost of funds is measurably less, according to Haldane's work, giving them preferential access to investment capital. He estimates the global subsidies enjoyed by the too-big-to-fails in 2009 ranged up to a staggering $2.3 trillion.[3]

Thus, I argue that sustaining too-big-to-fail-ism and maintaining the cocoon of protection of SIFIs is counterproductive, expensive and socially questionable.

As students, you should know that financial booms and busts are a recurring theme throughout history and that bankers and their regulators suffer from recurring amnesia. They periodically forget the past and all the lessons of history, tuck into some new financial, quick-profit fantasy—like the slicing and dicing and packaging of mortgage financing—and underestimate the risk of growing into unmanageable and unsustainable size, scale and complexity as they overindulge in that new financial fantasy. Invariably, these behemoth institutions use their size, scale and complexity to cow politicians and regulators into believing the world will be placed in peril should they attempt to discipline them. They argue that disciplining them will be a trip wire for financial contagion, market disruption and economic disorder. Yet failing to discipline them only delays the inevitable—a bursting of a bubble and a financial panic that places the economy in peril. This phenomenon most recently manifested itself in the Panic of 2008 and 2009.

Paul Volcker states the problem thus: "The greatest structural challenge facing the financial system is how to deal with the widespread impression—many would say conviction—that important institutions are deemed 'too large or too interconnected' to fail."[4]

Paul 'Moses' and John Milton

On previous occasions, I have referred to Paul Volcker as the Moses of central bankers. He is an iconic figure who led us out of the desert of inflation and economic stagnation in the 1980s. Mr. Volcker is a man of principle and probity; is selfless and indifferent to financial gain; and is wise to the political shenanigans of powerful lobbies that perpetuate structural distortions that interfere with the public good. (In short, he is the perfect stuff of a central banker.) Most importantly, he understands the necessity of allowing for failure as a part of the process of creative destruction, especially so in the world of finance.

Having referred to Moses, I trust that in this academic setting, I might be forgiven if I draw upon one of my favorite literary references to failure, albeit one that is other-worldly. In *Paradise Lost*, John Milton has God telling us why he created men and angels, both of whom could betray Him:

"…I made [mankind] just and right,

Sufficient to have stood, though free to fall.
Such I created all th' ethereal Powers
And Spirits, both them who stood and them who failed;
Freely they stood who stood, and fell who fell…"[5]

Milton considered the issue of failure on a much higher plane than the realm of bank regulatory policy. But the principle, expressed in that stanza of his paean to God's creation of the "ethereal Powers," applies equally to banking. Banks are created and given powers as mechanisms of credit intermediation, in order to allow an economy to grow and become prosperous. Yet, if regulators—who oversee the creation of banks and monitor their business—can't secure capital structures at our largest financial institutions that are "just and right," and do not allow for institutions that "betray" their creators to be "free to fall," it is unlikely those financial institutions will fulfill their proper intermediary role and be agents of economic prosperity.

Thus far, regulators have failed in their mission of warding off betrayal.

Perpetuating Obesity

With each passing year, the banking industry has become more concentrated. Half of the entire banking industry's assets are now on the books of five institutions. Their combined assets presently equate to roughly 58 percent of the nation's gross domestic product (GDP). The combined assets of the 10 largest depository institutions equate to 65 percent of the banking industry's assets and 75 percent of our GDP.

Some of this ongoing consolidation is the result of a dynamic set in place by Congress' passage of interstate branching legislation in 1994 and repeal of Glass–Steagall provisions in 1999. But some of it also reflects the result of the recent financial crisis. When difficulties began to appear at large financial institutions, resolution policies often entailed their merger or acquisition with other large institutions. Add to this the regulatory forbearance and financial backstops that tend to be granted to the largest banks in exigent circumstances, and the end result is a few financial behemoths, each with well over a trillion dollars in assets and a heavy concentration of power. In fact, the top three U.S. bank holding companies each presently have assets of roughly $2 trillion or more.

Of course, problems in the banking sector have not been exclusively confined to large financial institutions. Regional and community banks have faced their own problems, especially connected to construction lending. But here is the rub: When smaller banks get in trouble, regulators step in and resolve them. The term "resolve" in the context of smaller banks is a fancy way of saying their demise was quickly and nondisruptively arranged—they were disposed of. We might have expected equal treatment of big banks, but, of course, that did not happen.[6] To be sure, some very large financial firms have ceased to exist or have been through a corporate reorganization with some of the characteristics of a Chapter 11 bankruptcy. But these institutions deemed "too big to fail," and deemed to be "systemically" important due to their size and complexity, were given preferential treatment. Many were absorbed by still larger financial institutions, thus perpetuating and exacerbating the phenomenon of too big to fail.

This problem of supersized and hypercomplex banks is not unique to the United States. Europe is struggling today with how to cushion its megabanks from excessive exposure to intra-European

sovereign debt. And Japan is still feeling the negative impacts of not successfully resolving the financial difficulties at its megabanks two decades ago.

A Perverse Lake Wobegon

Why are too-big-to-fail institutions treated differently than smaller banks? Even Vinny Guadagnino knows the obvious answer to that question: In a system of large and/or interconnected banks, difficulties at one institution can easily spill over and take down other banks or even the entire industry. Fear of "systemic risk" conditions the treatment of financial behemoths.

In today's interconnected, globalized financial system, systemic risk is more pronounced than ever. And we know that when a systemic crisis occurs—as it did in the Panic of 2008–09—the results can be catastrophic to the economy. Small wonder that in commenting on the problems currently besetting Europe, the U.S. Treasury secretary recently stated, "The threat of cascading default, bank runs and catastrophic risk must be taken off the table."[7] This has become dogma among banking regulators and their minders. Thus, in the recently announced Greek bond deal, the Euro Summit Statement tells us that "Greece requires an exceptional and unique solution."[8]

Such a solution is certainly in the interest of American bankers. In Saturday's *New York Times,* it was reported that the Congressional Research Service has estimated that the exposure of U.S. banks to Portugal, Italy, Ireland, Greece and Spain amounted to $641 billion; American banks' exposure to German and French banks was in excess of an additional $1.2 trillion. According to the Bank for International Settlements, U.S. banks have $757 billion in derivative contracts and $650 billion in credit commitments from European banks. Thus, the Congressional Research Service concluded that "a collapse of a major European bank could produce similar problems in U.S. institutions."[9]

In the land of the too-big-to-fails, we find ourselves in something akin to a perverse financial Lake Wobegon: All crises are "exceptional," and all require "unique solution(s)."

Yet, it seems to me that in our desire to avoid "cascading default" and "catastrophic risk," and in our search for "exceptional and unique solution(s)," we may well be compounding systemic risk rather than solving it. By seeking to postpone the comeuppance of investors, lenders and bank managers who made imprudent decisions, we incur the wrath of ordinary citizens and smaller entities that resent this favorable treatment, and we plant the seeds of social unrest. We also impede the ability of the market to clear or, to paraphrase Milton, allow the marketplace to distinguish "freely" those who should stand and those who should fall.

Enter Dodd–Frank

I said earlier that financial crises are nothing new. Nor is the response to them: a flurry of legislation that ends up giving more power to regulators in the hope of preventing the next crisis. The Glass–Steagall Act was enacted during the Great Depression, the FDIC Improvement Act after the banking and savings-and-loan troubles in the late 1980s. And now, in response to the Panic of 2008–09, we are implementing the Dodd–Frank Act.

Dodd–Frank—which is over 2,000 pages long, contains 16 titles, 38 subtitles and a total of 541 sections—is the most complex document ever written in the history of efforts to change the financial regulatory landscape. A cheeky historian might recall French Prime Minister Georges Clemenceau's reaction to Woodrow Wilson's 14 points, proposed as a safeguard for world peace after World War I: Clemenceau is reported to have thought that God did a pretty good job with only 10.

Whether it is through 10 commandments or 14 points, or over 2,000 pages, the question is: Does Dodd–Frank appropriately confront systemic risk and the associated problem of too big to fail? Its preamble certainly states a desire to do so, declaring boldly that its purpose is to "end 'too big to fail'" and "protect the American taxpayer by ending bailouts."[10]

Dodd–Frank does, in fact, contain a number of measures that attempt to address too-big-to-fail-ism. It creates a Financial Stability Oversight Council—or FSOC—composed of the major financial-sector regulators charged with overseeing the entire financial system. The FSOC can recommend that important nonbank firms be brought under the regulatory umbrella. Those who will be brought under that umbrella will be subjected to periodic stress tests to make sure they can withstand reversals in the economy and other adverse developments. Dodd–Frank calls for enhanced capital requirements for SIFIs. And it provides for a new authority for resolving bank holding companies and other financial institutions that wasn't available to authorities during the recent crisis.

Implementing Dodd–Frank

Will it work? Will Dodd–Frank achieve the desired goals declared in its preamble? The devil, as always, is in the details of how the legislation is implemented.

At the most basic level, the legislation leaves many of the details to rulemakings by various regulatory agencies; more than one year after enactment, there is still much work to be done in actually implementing the act. On Nov. 1, the law firm of Davis Polk & Wardwell released its monthly progress report on Dodd–Frank implementation. According to that report, of the 400 rulings required by the legislation, 173, or roughly 43 percent, have not yet been proposed by regulators. Of the 141 rulemakings required of bank regulators—the Federal Reserve, Federal Deposit Insurance Corp. and Office of the Comptroller of the Currencey—58, or about 41 percent, have not yet been proposed.[11]

Capital Requirements and an Atomic Reaction

While acknowledging that the specific regulations spawned by Dodd–Frank have yet to be perfected, one of the harshest criticisms of its treatment of SIFIs has come from my former colleague and president of the Kansas City Fed, Tom Hoenig, who is now the nominee to be vice chair of the FDIC. He has argued that the very existence of SIFIs is "fundamentally inconsistent with capitalism" and "inherently destabilizing to global markets and detrimental to world growth."[12] Moreover, according to Mr. Hoenig—who had unquestionably the greatest depth of regulatory experience of all the Federal Reserve presidents and governors—even with the completion of Dodd–Frank, the existence of too-big-to-fail institutions will likely remain and "poses the greatest risk to the U.S. economy."[13]

One might counter that the enhanced capital requirements envisioned by Dodd–Frank—being negotiated presently by the Fed and other regulators nationally and internationally—will be a fitting treatment for too-big-to-fail-ism. In theory, it certainly sounds good. But as Paul Volcker has pointed out, "That's an old story."[14] We've had a system of international risk-based capital requirements in place for some time under the auspices of the Bank for International Settlements, beginning with Basel I in the early 1990s. That morphed into Basel II in the early 2000s, and now we are introducing Basel III. In fact, in the U.S., we can go all the way back to the National Bank Act of 1864 to find a system of capital requirements on banks.

Capital requirements are indeed important. A strong capital base protects a business when times get tough, giving it reserves to draw upon so that it can wait out a storm. Applied to banks, it also should mitigate risk-taking incentives that are an inevitable by-product of our too-big-to-fail system: If you put meaningful shareholder money directly at risk, managers of banks beholden to those shareholders will be less tempted to take pie-eyed risks.[15]

The operative word in the previous sentence is "meaningful." The existing regulatory measures were found wanting on measures of meaningful capital. For example, at the height of the crisis in mid-2008, two of the largest, most troubled institutions—Citigroup and Bank of America—were considered "adequately capitalized" (or even higher), according to the then-prevailing regulatory criteria. The Belgian bank Dexia is another case in point. In a press release issued just last May, it highlighted its regulatory capital ratio of 13.4 percent as "confirming our Group's high level of solvency."[16]

Winston Churchill used the phrase "terminological inexactitude" to suggest a certain lack of directness; one might easily conclude that there was some "inexactitude" surrounding the capital structures of Citi, Bank of America and Dexia.

I return to Andrew Haldane of the Bank of England. Haldane makes an intriguing parallel between the financial system and epidemiological networks. Conventional capital requirements seek to equalize failure probabilities across institutions to a certain threshold, say 0.1 percent. But using a systemwide approach would result in a different calibration, if the objective were to set a firm's capital requirements equal to the marginal cost of its failure to the system as a whole. Regulatory capital requirements would then be higher for banks posing the greatest risk to the system, which is what Dodd–Frank proposes, and what the current Basel III requirements are also considering.

To Haldane, this is a new approach in banking, but not in epidemiology where "focusing preventive action on 'super-spreaders' within the network to limit the potential for systemwide spread" is the norm. As Haldane emphasizes, "If anything, this same logic applies with even greater force in banking."[17] To me, treating too-big-to-fail institutions as potential "super-spreaders" of financial germs has a great deal of appeal.

The latest round of international capital standards is seeking to correct for "terminological inexactitude" and tighten up the definition of what banks can count as capital, so as to prevent "super-spreading." That's good news. Yet, this effort is being met with fierce resistance from the SIFIs. Tom Hoenig once suggested that when regulators begin the process of tightening up the latitude granted the megabanks, they will find themselves "facing an atomic force of resistance."[18] He appears to have been spot on. The head of one of the major U.S. financial

institutions has called these new proposals "anti-American."[19] Last Thursday, the *Wall Street Journal* wrote of "bankers seething over rising … capital requirements."[20] Such is the intensity of emotion to resist the work of the Fed and other regulators as they seek to protect the system from the pernicious risk inherent in the existence of megabanks.

We cannot let that resistance prevail.

And we must insist, as Dodd–Frank does, that SIFIs be required to submit a "living will" that describes their orderly demise. Credit exposure reports must also be submitted periodically to estimate the extent of SIFI interconnectedness. We must see to it that the FDIC "ensure(s) that the shareholders of a covered financial company … not receive payment until after all other claims … are fully paid."[21] This is essential to restoring the discipline of the marketplace and is what the Fed expects to achieve when it finalizes its work on Section 165 and other aspects of the legislation, as discussed last week by Vice Chair Janet Yellen in a speech in Chicago.[22]

An Achilles' Heel

For all that it specifies to treat the unhealthy obesity and complexity of too-big-to-fails, Dodd–Frank has an Achilles' heel. It states that in the disposition of assets, the FDIC shall "to the greatest extent practicable, conduct its operations in a manner that … mitigates the potential for serious adverse effects to the financial system."[23] This is entirely desirable; nobody wants to initiate serious financial disruption. But directing the FDIC to mitigate the potential for serious adverse effects leaves plenty of wiggle room for fears of "cascading defaults" and "catastrophic risk" to perpetuate "exceptional and unique" treatments, should push again come to shove.

I may be excessively skeptical on this front. Vigilantes of the bond and stock market, of which I was once a part, have been demanding greater transparency in reporting the exposures of the megabanks, including a more fulsome account of both gross and net exposures of credit default swaps. And Moody's has recently downgraded the long-term debt of major U.S. and U.K. banks. This is oddly reassuring. Moody's said that "actions already taken by U.K. authorities have significantly reduced the predictability of support over the medium to long term,"[24] whereas in the U.S., it found "a decrease in the probability that the U.S. government would support [major banks]."[25]

Of course, the ratings agencies did not exactly cover themselves in glory during the crisis. Let's hope their assessment of at least somewhat more limited government support for the megabanks proves more accurate than the triple-A ratings they gave to so many mortgage-backed securities.

The Alternative: Radical Surgery

In short, progress is being made in the direction of treating the pathology of SIFIs and the detailing of enhanced prudential standards governing their behavior. Yet, in my view, there is only one fail-safe way to deal with too big to fail. I believe that too-big-to-fail banks are too-dangerous-to-permit.[26] As Mervyn King, head of the Bank of England, once said, "If some banks are thought to be too big to fail, then … they are too big." I favor an international accord that would break up these institutions into more manageable size. More manageable not only for regulators, but also for the executives of these institutions. For there is scant chance that managers of $1 trillion or $2 trillion banking enterprises can possibly "know their customer,"

follow time-honored principles of banking and fashion reliable risk management models for organizations as complex as these megabanks have become.

Am I too radical? I think not. I find myself in good company—Paul Volcker, for example, advocates "reducing their size, curtailing their interconnectedness, or limiting their activities."[27]

In my view, downsizing the behemoths over time into institutions that can be prudently managed and regulated across borders is the appropriate policy response. Then, creative destruction can work its wonders in the financial sector, just as it does elsewhere in our economy.

We shouldn't just pay lip service to letting the discipline of the market work. Ideally, we should rely on market forces to work not only in good times, but also in times of difficulties. Ultimately, we should move to end too big to fail and the apparatus of bailouts and do so well before bankers lose their memory of the recent crisis and embark on another round of excessive risk taking. Only then will we have a financial system fit and proper for servicing an economy as dynamic as that of the United States.

Thank you.

Notes

[1] I am thankful to Andrew Haldane of the Bank of England for coining this phrase. "Systemic Risk in Banking Ecosystems," by Andrew G. Haldane and Robert M. May, *Nature*, Jan. 20, 2011, pp. 351–55.

[2] "The Blob That Ate Monetary Policy," by Richard W. Fisher and Harvey Rosenblum, *Wall Street Journal*, Sept. 28, 2009.

[3] "Control Rights (and Wrongs)," speech by Andrew G. Haldane, executive director for financial stability and member of the Financial Policy Committee, Bank of England, Oct. 24, 2011, Table 1.

[4] "Three Years Later: Unfinished Business in Financial Reform," by Paul Volcker, the William Taylor Memorial Lecture, Sept. 23, 2011, Washington, D.C., p. 8.

[5] *Paradise Lost*, Book III, by John Milton, New York: W.W. Norton and Co., 1993, lines 98–102.

[6] "Financial Reform or Financial Dementia?," speech by Richard W. Fisher, June 3, 2010.

[7] Statement by Treasury Secretary Timothy F. Geithner, 24th Meeting of the International Monetary and Financial Committee, Sept. 24, 2011, U.S. Department of the Treasury, Press Center.

[8] See "Euro Summit Statement," Brussels, Oct. 26, 2011, p. 5.

[9] "European Turmoil Could Slow U.S. Recovery," by Annie Lowrey, *New York Times*, Nov. 12, 2011.

[10] See the Dodd–Frank Wall Street Reform and Consumer Protection Act, http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173enr.txt.pdf.

[11] See "Dodd–Frank Progress Report," Davis Polk & Wardwell, November 2011, www.davispolk.com/files/Publication/e3379fb6-ab9d-4ed8-b873-0877696a8005/Presentation/PublicationAttachment/690130be-02e6-4037-88e8-01648c94664f/November2011_Dodd.Frank.Progress.Report.pdf.

[12] "Do SIFIs Have a Future?," speech by Thomas M. Hoenig, president and chief executive officer, Federal Reserve Bank of Kansas City, July 27, 2011.

[13] "Financial Reform: Post Crisis?," speech by Thomas M. Hoenig, president and chief executive officer, Federal Reserve Bank of Kansas City, Feb. 23, 2011.
[14] See note 4, p. 5.
[15] Given the opacity of bank balance sheets and the arcane accounting practices whereby very similar assets can be valued differently in many circumstances, the discipline imposed on bank managers by shareholders has been limited, in both megabanks and smaller banks.
[16] "Net Profit of EUR 69 Million in 1Q2011. Strong Operational Performance by the Commercial Business Lines. Transformation Plan Ahead of Schedule," Dexia press release, May 11, 2011.
[17] See note 1.
[18] "It's not Over 'Til It's Over: Leadership and Financial Regulation," speech by Thomas M. Hoenig, president and chief executive officer, Federal Reserve Bank of Kansas City, Oct. 10, 2010.
[19] "JPMorgan Chief Says Bank Rules 'Anti-US,'" by Tom Braithwaite and Patrick Jenkins, *Financial Times*, Sept. 11, 2011.
[20] "Fed Governor Allays Banks," by Victoria McGrane, *Wall Street Journal*, Nov. 10, 2011.
[21] Dodd–Frank Act, Section 206.
[22] "Pursuing Financial Stability at the Federal Reserve," speech by Janet Yellen, vice chair of the Federal Reserve Board of Governors, Nov. 11, 2011, www.federalreserve.gov/newsevents/speech/yellen20111111a.htm.
[23] Dodd–Frank Act, Section 210.
[24] "Rating Action: Moody's Downgrades 12 UK Financial Institutions, Concluding Review of Systemic Support," Moody's Investors Service, Oct. 7, 2011.
[25] "Rating Action: Moody's Downgrades Wells Fargo & Company Rating," Moody's Investors Service, Sept. 21, 2011 (similar releases appeared on the same date for Citigroup and Bank of America).
[26] See "Lessons Learned, Convictions Confirmed," speech by Richard W. Fisher, March 3, 2010, and "Minsky Moments and Financial Regulatory Reform," speech by Richard W. Fisher, April 14, 2010.
[27] See note 4, p. 9.