Preventing the Fire Next Time: Too Big To Fail

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Introduction

The financial crisis of 2007–2009 threatened the very fabric of the financial system and ultimately the entire economy. At the nadir in the fall of 2008, there was global financial contagion. Multiple major financial institutions failed or virtually failed; even leading financial institutions would no longer extend credit to each other; the commercial paper and securitization markets shut down; and investors fled the money market funds.

The consequences of a total financial collapse may not have been limited to the financial system or even to the broader economy. There could have been profound social and political unrest of the type not seen since the 1930s. The dictatorships and demagogy of that time had many roots, but undoubtedly a principal one was economic desperation.

A total catastrophe was avoided only through massive government assistance—both to individual financial institutions and to entire classes of financial institutions—as well as a very large measure of luck. The government assistance to individual institutions took a wide variety of forms—including purchases of equity and warrants, secured lending, and issuance of guarantees—in a wide variety of transactions, including support for private acquirers (as in JPMorgan Chase's purchase of Bear Stearns);[1] investments and support in control transactions (AIG);[2] investments and support in non-control transactions (Citigroup);[3] and conservatorships

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1. Press Release, Fed. Reserve Bank of N.Y., Summary of Terms and Conditions Regarding the JPMorgan Chase Facility (Mar. 24, 2008), *available at* http://www.newyorkfed.org/newsevents/news/markets/2008/rp080324b.html.

2. Press Release, Bd. of Governors of the Fed. Reserve Sys., Federal Reserve Board, with full Support of the Treasury Department, authorizes the Federal Reserve Bank of New York to lend up to $85 billion to the American International Group (AIG) (Sept. 16, 2008) [hereinafter $85 Billion AIG Loan], *available at* http://www.federalreserve.gov/newsevents/press/other/20080916a.htm.

3. Press Release, Bd. of Governors of the Fed. Reserve Sys. et al., Joint Statement by Treasury, Federal Reserve, and the FDIC on Citigroup (Nov. 23, 2008), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20081123a.htm; Bd. of Governors of the Fed. Reserve Sys. et al., *Summary of Terms: Eligible Asset Guarantee*, FED. RESERVE (Nov. 23, 2008), http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20081123a1.pdf.

(Fannie Mae and Freddie Mac) (collectively, GSEs).[4] The assistance to classes of institutions included numerous programs[5] such as investments through the Troubled Asset Relief Program (TARP);[6] the Temporary Liquidity Guarantee Program (TLGP);[7] and support for the money market funds.[8]

I. Too Big to Fail

A. 2007–2009

The assistance provided under these massive government programs, particularly to major financial institutions, was widely regarded as formal

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4. Press Release, Statement of the FHFA Director James B. Lockhart (Sept. 7, 2008), *available at* http://www.treasury.gov/press-center/press-releases/Documents/fhfa_statement_090708.pdf; Press Release, Statement by Secretary Henry M. Paulson, Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers (Sept. 7, 2008), *available at* http://www.treasury.gov/press-center/press-releases/Pages/hp1128.aspx.

5. Temporary Liquidity Guarantee Program, Interim Rule, 73 Fed. Reg. 64,179-02, 64,180 (Oct. 29, 2008); Ben S. Bernanke, Chairman, Fed. Reserve, The Federal Reserve and the Financial Crisis: The Federal Reserve's Response to the Financial Crisis, George Washington University School of Business Lecture 3 (Mar. 27, 2012) [hereinafter Bernanke March 27 Lecture], *available at* http://www.federalreserve.gov/newsevents/files/chairman-bernanke-lecture3-20120327.pdf.

6. TARP ultimately comprised a number of initiatives, including investments through the Targeted Investment Program and the Capital Purchase Program (CPP). *See, e.g.*, Press Release, Dep't of Treasury, Treasury Announces TARP Capital Purchase Program Description (Oct. 14, 2008), *available at* http://www.treasury.gov/press-center/press-releases/Pages/hp1207.aspx; Press Release, Dep't of Treasury, Treasury Releases Guidelines for Targeted Investment Program (Jan. 2, 2009), *available at* http://www.treasury.gov/press-center/press-releases/Pages/hp1338.aspx.

7. Temporary Liquidity Guarantee Program, Final Rule, 73 Fed. Reg. 72,244–72,273 (Nov. 26, 2008) (codified at 12 C.F.R. pt. 370). The TGLP comprised the Debt Guarantee Program, through which the FDIC guaranteed certain newly-issued debt, and the Transaction Account Guarantee Program (TAGP), through which the FDIC provided an unlimited guarantee for certain accounts. 12 C.F.R. §§ 370.3–.4 (2009).

8. The U.S. Department of the Treasury established a temporary guarantee program for shareholders of qualifying money market funds. *See* Press Release, Dep't of Treasury, Treasury Announces Guaranty Program for Money Market Funds (Sept. 19, 2008), *available at* http://www.treasury.gov/press-center/press-releases/Pages/hp1147.aspx; *Treasury's Guarantee Program for Money Market Mutual Funds: What You Should Know*, FIN. INDUS. REGULATORY AUTH. (last updated July 9, 2010), http://www.finra.org/investors/protectyourself/investoralerts/mutualfunds/p117136. The Federal Reserve also instituted a program to provide loans to certain purchasers of money market funds' eligible asset-backed commercial paper. *See* Press Release, Bd. of Governors of the Fed. Reserve Sys., Federal Reserve Board announces two enhancements to its programs to provide liquidity to markets (Sept. 19, 2008), *available at* http://www.federalreserve.gov/newsevents/press/monetary/20080919a.htm; *Asset Backed Commercial Paper (ABCP) Money Market Mutual Fund (MMMF) Liquidity Facility: Terms and Conditions*, FED. RESERVE BANK OF BOS. (last updated Feb. 5, 2010), http://www.frbdiscountwindow.org/mmmftc.cfm?hdrID=14&dtlID=.

implementation of a "too big to fail" (TBTF) policy.[9] Although there is no single, clear definition of what "failure" means in this context, in only two cases involving very large financial institutions, Lehman Brothers and Washington Mutual, was there an actual insolvency process in which creditors experienced losses.[10] In other cases, there was presumably a determination by the government authorities that the potential systemic consequences of a failure in which creditors were placed at risk were so severe as to outweigh the negative consequences of a government-supported rescue.[11]

The Lehman experience was widely viewed as demonstrating that the concerns about severe systemic consequences were, if anything, understated.[12] A direct result was the collapse of the country's largest money market fund, the Reserve Primary Fund, as losses in its investments in Lehman commercial paper caused it to "break the buck."[13] It is less clear that the ensuing freezing of the financial markets was attributable to

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9. *See, e.g.*, Bernanke March 27 Lecture, *supra* note 5 (outlining U.S. government efforts including those with respect to GSEs, the money market funds, the Bear Stearns acquisitions, and the AIG transactions). *See also* DEAN BAKER & TRAVIS MCARTHUR, CTR. FOR ECON. POLICY & RESEARCH, THE VALUE OF THE "TOO BIG TO FAIL" BIG BANK SUBSIDY, 1 (2009), *available at* http://www.cepr.net/documents/publications/too-big-to-fail-2009-09.pdf ("After Lehman's failure, Congress passed [TARP] to . . . support banks in a period of extraordinary financial turbulence. In addition, the Federal Reserve Board lent hundreds of billions of dollars to the banks through a series of newly created special lending facilities. On top of these measures, the Fed and Treasury also took extraordinary actions to keep Citigroup and Bank of America solvent. . . . As a result of this recent history, TBTF is now virtually official policy.").

10. *See The Collapse of Lehman Brothers*, TELEGRAPH (London), http://www.telegraph.co.uk/finance/financialcrisis/6173145/The-collapse-of-Lehman-Brothers.html (tracing the timeline of the financial crisis, including the collapses of Lehman Brothers and Washington Mutual, and indicating that the federal government acted quickly to intervene and prevent additional financial institutions from collapsing).

11. *Id.*; *see also* Bernanke March 27 Lecture, *supra* note 5 ("All these firms [including Lehman Brothers, AIG, Washington Mutual, and Wachovia] were among the top 10 or 15 financial firms in the United States . . . . [H]ere we had the biggest, largest, most complex international financial institutions at the brink of failure . . . . [H]eeding those lessons [of the Great Depression], the Federal Reserve and the Federal Government did take vigorous actions to stop the financial panic, worked with other agencies and worked internationally with foreign central banks and governments . . . . [The G7] were going to work together to prevent the failure of anymore [sic] systemically important financial institutions.").

12. *See* James Quinn, *Lehman Brothers Files for Bankruptcy as Credit Crisis Bites*, TELEGRAPH (London) (Sept. 15, 2008, 6:40 AM), *available at* http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/4676621/Lehman-Brothers-files-for-bankruptcy-as-credit-crisis-bites.html (quoting former Federal Reserve chairman Alan Greenspan warning, "Let's recognize that this is a once in a half-century, probably once in a century type of event," and calling the Lehman Brothers collapse "by far" the worst of his career, and predicting that other major bank collapses were inevitable).

13. TOBIAS ADRIAN ET AL., FED. RESERVE BANK OF N.Y. STAFF REPORT NO. 423, THE FEDERAL RESERVE'S COMMERCIAL PAPER FUNDING FACILITY 10 (Jun. 2010), *available at* http://www.newyorkfed.org/research/staff_reports/sr423.pdf.

Lehman's failure alone. Within a period of only ten days in September 2008, there were multiple financial seismic shocks: the failures of the GSEs, with the wipeout of their preferred shareholders; Lehman; the Reserve Fund; and, perhaps of greatest impact, the collapse of American International Group (AIG), which only a few months earlier was regarded as an icon of the financial system.[14]

Whatever may have been the actual cause and effect, Lehman's failure had a traumatic impact on policymakers with respect to their ensuing decisions. There was now agreement as to the resolution of the Hobson's Choice between taxpayer-backed assistance to financial institutions and the potential of a catastrophic systemic failure in the absence of such assistance. The risk to the taxpayer and the other issues created by effective acknowledgment of TBTF were deemed to be outweighed by the risk to the financial system and the broader economy from a disorderly failure.[15]

The government's policy of TBTF can be viewed as having been confirmed by its response—more accurately, nonresponse—to the financial distress at hundreds of medium-sized and small depository institutions. The government provided only limited support for these institutions,[16] and 319

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14. *See* FED. RESERVE BANK OF ST. LOUIS, THE FINANCIAL CRISIS: A TIMELINE OF EVENTS AND POLICY ACTIONS, *available at* http://timeline.stlouisfed.org/pdf/CrisisTimeline.pdf (providing an overview of major events related to the financial crisis, including during the ten-day period from September 7 to September 16, 2008).

15. *See* Bernanke March 27 Lecture, *supra* note 5 (discussing the October 10, 2008 G7 meeting following a number of major financial disruptions: "[The G7] were going to work together to prevent the failure of anymore [*sic*] systemically important financial institutions. This was after Lehman Brothers had failed. We were going to make sure that banks and other financial institutions had access to funding from central banks and capital governments. We were going to work to restore depositor confidence and investor confidence . . ."); $85 Billion AIG Loan, *supra* note 2 ("The [Federal Reserve] Board determined that, in current circumstances, a disorderly failure of AIG could add to already significant levels of financial market fragility and lead to substantially higher borrowing costs, reduced household wealth, and materially weaker economic performance."). *Cf.* Thomas M. Hoenig, President and Chief Executive Officer, Fed. Reserve Bank of Kansas City, Speech at the Money and Banking Conference at the Central Bank of Argentina, Central Banks: Changing Markets—Changing Mandates (Sept. 1, 2008), *available at* http://www.kc.frb.org/SpeechBio/HoenigPDF/Argentina09-01-08.pdf ("[F]or a market economy to work best, it must to the maximum extent possible find a balance between financial stability and a stable price environment and in doing so must be able to allow individual institutions to fail.").

16. Paul Krugman, Op-Ed., *Financial Reform 101*, N.Y. TIMES, Apr. 1, 2010, at A23, *available at* http://www.nytimes.com/2010/04/02/opinion/02krugman.html?ref=creditcrisis (noting that most of the government's rescue efforts during the financial crisis focused "on a handful of big players: A.I.G., Citigroup, Bank of America, and so on"). Smaller institutions, however, were eligible for and did receive investments from the U.S. Treasury under TARP and their transaction accounts were eligible for guarantee under the TAGP. *See* 12 C.F.R §§ 370.2, .4 (2008); DEP'T OF TREASURY, TRANSACTIONS REPORT—INVESTMENT PROGRAMS: CAPITAL PURCHASE PROGRAM FOR PERIOD ENDING APRIL 25 (2012), *available at* http://www.treasury.gov/initiatives/financial-stability/briefing-room/reports/tarp-transactions/DocumentsTARPTransactions/04-26-12%20Transactions%20Report%20as%20of%2004-25-12_INVESTMENT.pdf.

banks with assets of less than $25 billion failed in the three-year period from 2008–2010,[17] as compared to 43 total failures in the previous ten years.[18]

The government's support of large financial institutions was highly unpopular politically.[19] The ensuing recession stoked the opposition to government assistance. Media criticism was widespread, and the political challenge was one of the few recent examples of bipartisanship.[20]

Accordingly, it was both inevitable and necessary that a considerably more rigorous regulatory regime would emerge as a response to the financial crisis, the TBTF policy that it exposed, and the serious flaws in the regulatory system that were deemed responsible for the need to invoke that policy. These flaws included:

- A failure to intervene to prevent excessive risk taking by major financial institutions;
- Relatedly, a lack of information to identify excessive risk taking;
- A number of key regulatory standards that were too lax or administered too laxly;
- A major element of the financial system, the so-called "shadow banking system," that was virtually exempt from regulation; and

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17. *See HSOB Bank & Thrift Failures*, FED. DEPOSIT INS. CORP., http://www2.fdic.gov/hsob/SelectRpt.asp?EntryTyp=30 (demonstrating such failures in the 2008–2010 period). There were 322 failures during the three-year period, with Washington Mutual accounting for nearly 50% of the assets of those institutions.

18. *See id.* (demonstrating such failures in the 1998–2007 period). This result was calculated in the same manner as the data in note 17 *supra*, with changes only to the Effective Dates search parameter.

19. *See* John Cassidy, *No Credit: Timothy Geithner's Financial Plan Is Working—and Making Him Very Unpopular*, THE NEW YORKER (Mar. 15, 2010), http://www.newyorker.com/reporting/2010/03/15/100315fa_fact_cassidy?currentPage=1 (quoting the U.S. Treasury Secretary as saying, with respect to government responses to the financial crisis, "We saved the economy, but we kind of lost the public doing it"); Jonathan Yip, *The Bank Bailout in Perspective*, HARV. POL. REV. (Oct. 24, 2011, 5:14 PM), http://hpronline.org/arusa/the-bank-bailout-in-perspective/ (noting that "Americans across the political spectrum despised [TARP]").

20. *See, e.g.*, Michael R. Crittenden, *Panel Steps Up Criticism of Treasury Over TARP*, WALL ST. J., Jan. 9, 2009, at A3, *available at* http://online.wsj.com/article/SB123147360470067363.html (reporting the opinions of a congressional oversight committee criticizing the Treasury's administration of TARP); Merrill Goozner, *TARP's Lower Cost Doesn't Assuage Critics*, THE FISCAL TIMES (Mar. 4, 2011), http://www.thefiscaltimes.com/Articles/2011/03/04/Critics-Blast-Away-at-TARP.aspx#page1 (presenting a variety of criticisms of TARP).

- An absence of government planning for dealing with the failure of major financial institutions and of an effective resolution process.[21]

B. *The Regulatory Response to TBTF*

The resultant regulatory response to TBTF incorporates three distinct but related themes, each of which is designed either to prevent TBTF or to minimize its consequences. The first is a resolution system for large institutions that both precludes government support for large financial institutions in financial distress and makes their failure a viable option.[22] The second is a reduction of the risk of failure of large banks through a more vigorous and restrictive regulatory regime.[23] The third is a forced reduction in the size of the largest banks, so that no failure would have systemic consequences.[24] These three themes are hereafter referred to as resolution reform, risk reduction, and size reduction.

Before discussing each of the individual themes, it may be instructive to explain the linkage among them. If there were one issue on which virtually everyone agrees, it would be that TBTF is an unacceptable policy that must be ended by legislative reform. This policy creates moral hazard; it produces marketplace distortions; it is inequitable; and, of most importance, it represents a potential call option on the taxpayer.[25]

Although there may be some question whether a TBTF policy encourages excessive risk taking by management, TBTF undoubtedly

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21. Other regulatory flaws were also addressed, including insufficient regulation of the derivatives markets and a serious breakdown in consumer protection. For discussions of causes of the financial crisis, see, for example, Ben S. Bernanke, Chairman, Bd. of Governors of Fed. Reserve Sys., Address to Council on Foreign Relations: Financial Reform to Address Systemic Risk (Mar. 10, 2009), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm; James Bullard, et al., *Systemic Risk and the Financial Crisis: A Primer*, 91 FED. RESERVE BANK ST. LOUIS REV. 403 (2009); G20 WORKING GRP. 1, ENHANCING SOUND REGULATION AND STRENGTHENING TRANSPARENCY: FINAL REPORT (2009), *available at* http://thebankwatch.com/2009/04/02/g-20-working-group-1-enhancing-sound-regulation-and-strengthening-transparency/.

22. *See infra* Part II.

23. *See infra* Part III.

24. *See infra* Part IV.

25. *See* Daniel K. Tarullo, Member, Bd. of Governors of the Fed. Reserve Sys., Speech at the Exchequer Club (Oct. 21, 2009), *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20091021a.htm ("Creditors who believe that an institution will be regarded by the government as too big to fail may not price into their extensions of credit the full risk assumed by the institution. That, of course, is the very definition of moral hazard. Thus the institution has funds available to it at a price that does not fully internalize the social costs associated with its operations. The consequences are a diminution of market discipline, inefficient allocation of capital, the socialization of losses from supposedly market-based activities, and a competitive advantage for the large institution compared to smaller banks.").

facilitates such risk taking by providing virtually unlimited funding and liquidity. If a funder does not believe that its funding is at risk, then funding will not act as a check on the expansion or risk taking of the borrower. Prior to the financial crisis, the extraordinary level of leverage at a number of global financial institutions, as well as the low rates which they were charged, was less a question of the borrowers' opaqueness than the lenders' belief that due diligence was unnecessary.[26]

The issues of marketplace distortion and competitive inequity need little explanation. If funding is based on implicit government support rather than financial need and ability to repay, funding will not flow to where it is most needed or can be best utilized. Entities that lack this government support must pay higher rates than their competitors that enjoy such support, and, at the extreme, they may be deprived of the funding needed to compete.

The direct approach to ending TBTF is a credible and effective resolution regime for large institutions in which its creditors and other constituencies are at risk but the financial system is not. Having said this, the question remains whether such a resolution regime should be supplemented by risk reduction and size reduction. In considering this question, the answer should not be so simplistic as to conclude that any policy is acceptable if it facilitates the end of TBTF. The analysis should be more balanced, recognizing that excessive risk reduction or forced size reduction could have its own potential negative consequences. Ultimately, the answer should be a relative one, balancing the competing considerations. The more likely the success of a resolution regime, the less necessity for a highly restrictive regulatory regime or a forced reduction in size.

II. Resolution Reform

In attempting to answer the fundamental question of whether a resolution regime should be supplemented by risk reduction or size reduction, it is logical to begin with an analysis of the new resolution regime that has been put in place by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).[27]

As a statutory construct, Dodd-Frank would appear to have done virtually everything possible to eliminate TBTF for major U.S. financial

26. *See, e.g.*, U.K. FIN. SERVS. AUTH., A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS 59 (2009), *available at* http://www.fsa.gov.uk/pubs/discussion/dp09_02.pdf (discussing the case of the collapse of Lehman Brothers, stating, "Lehman Brothers had also expanded, with other investment banks, the scale of its leveraged loan business; as competition in this area grew, covenants across the market became weaker, leverage multiples higher, and the quality of due diligence poorer").

27. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (codified in scattered sections of 5, 12, 15, and 42 U.S.C.).

institutions. There are four basic components of the Dodd-Frank approach: elimination of the potential for favorable or special treatment for the resolved institution's investors, funders, and management;[28] a sufficiently effective and credible resolution structure so that an actual failure is feasible without significant systemic risk;[29] sufficient information so that the resolving authority can implement an effective resolution arrangement;[30] and elimination of regulatory and administrative authority to deploy targeted special assistance programs.[31]

First, it is difficult to understand what more Congress could have done than it did in Title II of Dodd-Frank to eliminate special treatment for the resolved institution's constituencies. In the event that a systemically important institution goes into the special resolution program, the institution's shareholders must be wiped out, its management replaced, and its creditors held responsible for any losses. Moreover, for such systemically important financial institutions, there is no alternative to government-controlled liquidation,[32] whereas nonfinancial U.S. companies (and certain nonbank U.S. financial companies for which there has not been a "systemic risk determination") can seek self-directed reorganization under Chapter 11 of the U.S. Bankruptcy Code.[33]

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28. Dodd-Frank Act § 204(a), which provides that:

> The authority provided in [Title II of Dodd-Frank] shall be exercised . . . so that—
> (1) creditors and shareholders will bear the losses of the financial company;
> (2) management responsible for the condition of the financial company will not be retained; and
> (3) the [FDIC] and other appropriate agencies will take all steps necessary and appropriate to assure that all parties, including management, directors, and third parties, having responsibility for the condition of the financial company bear losses consistent with their responsibility, including actions for damages, restitution, and recoupment of compensation and other gains not compatible with such responsibility.

Id.

29. *See id.* §§ 203–214.

30. *See id.* § 165(d)(1) (providing that systemically important financial companies be required "to report periodically to the Board of Governors, the [Financial Stability Oversight] Council, and the [FDIC] the plan of such company for rapid and orderly resolution in the event of material financial distress or failure . . .").

31. *See* Dodd-Frank Act § 1101 (amending section 13(3) of the Federal Reserve Act, and the preamble to Dodd-Frank and including, as part of Dodd-Frank's purpose, "to protect the American taxpayer by ending bailouts").

32. *See id.* §§ 202(a), 203(b), 204(a), 205 (providing for the liquidation by the FDIC as receiver of a financial company that meets specified criteria, including that the failure and resolution under otherwise applicable law of such financial company would have serious adverse effects on U.S. financial stability).

33. *See* 11 U.S.C. § 109(b) (setting forth the persons eligible to be debtors under Chapter 7 of the Bankruptcy Code); *id.* § 109(d) (providing that those eligible to be debtors under Chapter 7 of the Bankruptcy Code may be debtors under Chapter 11); Dodd-Frank Act § 203(b) (providing for systemic risk determinations).

Second, Title II creates a resolution regime that should sufficiently reduce the systemic consequences of the failure of a large financial institution so that resolution is a viable option:

- The FDIC can create a bridge company to stabilize the institution and enable it to be sold, recapitalized, or wound down in an orderly manner that maximizes value.[34]
- The FDIC can make prompt payments to creditors at estimated recovery rates.[35]
- Liquidity is available from the Treasury,[36] basically assuring debtor-in-possession financing.
- Creditors are assured of a recovery no less than they would have received in a Chapter 7 bankruptcy liquidation.[37]
- Numerous constructive provisions were incorporated from the Bankruptcy Code, including a preference clawback to avoid a rush to the exits,[38] an ex post facto provision voiding debt acceleration,[39] and special treatment for qualified financial contracts.[40]

The third component of an effective resolution scheme is sufficient information for the resolving authority to make informed decisions. A principal factor that promoted massive government rescues in 2008 was the absence of real knowledge as to the impact of any other option. There were no "break the glass in case of fire" plans for individual institutions. The living will requirement in Dodd-Frank is designed to deal with this issue. Title I of Dodd-Frank requires each systemic non-bank financial company

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34. Dodd-Frank Act §§ 210(h)(1)–(2).

35. This appears implicit in Title II and has been the FDIC's approach for resolving insured depository institutions.

36. Dodd-Frank Act § 210(n)(5).

37. *Id.* §§ 210(b)(4)(B), (d)(2) (providing that "all claimants that are similarly situated" under the priority order set forth in § 210(b)(1) must "receive not less than the amount" the claimants would have received had the FDIC not been appointed receiver and the company had instead been liquidated under Chapter 7 of the Bankruptcy Code).

38. *Id.* §§ 210(a)(11)(B), (s)(1).

39. *See id.* § 210(c)(13)(A) (providing for the authority of the FDIC as receiver to enforce nearly all contracts notwithstanding specified contractual rights of acceleration); *see also id.* § 210(c)(13)(C) (barring any person from exercising acceleration rights under any contract to which the covered financial company is a party without consent of the FDIC as receiver); *id.* § 210(c)(16)(A) (providing for limited authority of the FDIC as receiver to enforce contracts of subsidiaries and affiliates notwithstanding contractual rights to accelerate); *id.* § 210(c)(4)(B)(ii) (providing that lessors to covered financial companies will have no claim for damages under acceleration clauses for leases repudiated by the FDIC as receiver); *id.* § 210(c)(8)(A)(i) (providing for a qualified right of persons to exercise acceleration rights under financial contracts with covered financial companies arising on or after the date the receiver is appointed).

40. *Id.* §§ 205(b)(4), 210(c)(3)(C), 210(c)(8).

and large bank holding company (those with at least $50 billion in assets) to submit to the FDIC, the Federal Reserve, and the Financial Stability Oversight Council a plan, in minute detail, for its rapid and orderly resolution in the event of severe financial distress or failure.[41]

The fourth element of eliminating TBTF was to amend an obscure provision of the Federal Reserve Act that was used for a number of individual rescue programs. The Federal Reserve's special lending authority under § 13(3) of the Federal Reserve Act was amended by Dodd-Frank so that it can no longer be used to benefit a single institution.[42] Hopefully, it will never be necessary to ask the question whether the elimination of all discretion, as opposed to the imposition of stringent conditions, was the wisest policy choice.

The effectiveness of Dodd-Frank in dealing with TBTF has been recognized by the three major credit rating agencies. In downgrading ratings with respect to certain major U.S. banks, each agency has cited an increased possibility that the government might allow a large financial institution to fail.[43]

It is variously argued that the Dodd-Frank answer to TBTF has not worked or will not work.[44] Proponents of the former argument cite the continued lower funding cost of the largest banks in relation to smaller institutions.[45] This purportedly constitutes a TBTF government "subsidy."

41. *Id.* § 165(d)(1).

42. *Id.* § 1101; BD. OF GOVERNORS OF THE FED. RESERVE SYS., OFFICE OF INSPECTOR GEN., THE FEDERAL RESERVE'S SECTION 13(3) LENDING FACILITIES TO SUPPORT OVERALL MARKET LIQUIDITY: FUNCTION, STATUS, AND RISK MANAGEMENT 2 (2010).

43. *See, e.g.*, Andrew Dunn, *Fitch Ratings Agency Downgrades Bank of America, 7 Other Banks*, CHARLOTTE OBSERVER, Dec. 16, 2011, *available at* http://www.charlotteobserver.com/2011/12/16/2853203/fitch-ratings-agency-downgrades.html (reporting downgrades of Bank of America and other banks by Fitch, Moody's, and Standard & Poor's and stating that Moody's "cit[ed] Dodd-Frank financial reforms that make it less likely that big banks would again be rescued by the government" as a reason for its downgrade of Bank of America). WALL ST. J. PROF. (Nov. 30, 2011), http://professional.wsj.com/article/TPDJ0000020111130e7bu0001k.html ("Standard & Poor's Rating Services . . . downgraded dozens of large financial institutions . . . citing a new methodology that reflects weaker confidence in governments' willingness and ability to bail out banks in trouble.").

44. *See, e.g.*, Edward F. Greene, *Dodd-Frank and the Future of Financial Regulation*, 2 HARV. BUS. L. REV. ONLINE 79, 79 (2011) ("[Dodd-Frank] is seriously flawed. It does not deal with regulatory fragmentation, sidesteps international coordination, and is overly optimistic in dealing with [TBTF]. Going first doesn't mean you get it right."); Arthur E. Wilmarth, Jr., *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-to-Fail Problem*, 89 OR. L. REV. 951, 954 (2011) (arguing that Dodd-Frank has some useful reforms addressed at TBTF but does not go far enough to address the TBTF problem).

45. For example, Camden Fine, President and Chief Executive Officer of the Independent Community Bankers of America, argues for extension of the TAGP on the grounds that TBTF gives large banks a funding advantage. *See* Camden Fine, *So Long as Big Banks Can't Fail, Small Banks Need TAG*, AM. BANKER (Feb. 24, 2012, 1:29 PM), http://www.americanbanker.com/bankthink/so-

But, on closer examination, this argument is suspect. It appears that the largest companies in many industries have a lower cost of funds, as demonstrated by credit default swap spreads.[46] This suggests that the lower cost of funds for the largest banks reflects the market's view that size creates risk reduction through diversification and provides greater liquidity, rather than implicit government guarantees.

There are two principal arguments made as to why Dodd-Frank will not work. The first is that, at a time of crisis, a government will never run the risk of a large failure and will do whatever it takes to prevent such an occurrence.[47] It is undeniably conceivable that, at some future time, emergency legislation would be enacted to save a single institution from failure or that an administration would stretch its existing powers to accomplish that result. In view of the strong public condemnation of the government rescue programs in 2008, however, it is likely to be a very long time before an administration would ask Congress to enact legislation or take such action on its own initiative. It will perhaps be even longer before Congress would run the risk of committing political suicide by responding positively.

The second, and more plausible, argument is that the U.S. resolution regime cannot be effective because it is dealing with institutions of international scope—that is, whatever may be the intended extraterritorial reach of U.S. law, it will not trump the insolvency regimes of other countries. This argument is legitimate, but there are two feasible answers.

The first answer is that the lack of international comparability and consensus may be susceptible to a relatively simple solution: international agreement on the governing legal regime. If such an agreement can be reached, then the FDIC will have clear guidelines as to how to administer the failed institution. As noted by Martin Gruenberg, the FDIC's Acting Chairman, "the FDIC has established a unit within its new Office of Complex Financial Institutions dedicated to developing relationships with the

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long-as-big-banks-can-not-fail-small-banks-need-tag-1046929-1.html. The FDIC publishes a Quarterly Banking Profile. *See* Fed. Deposit Ins. Corp., *Quarterly Banking Profile: Third Quarter 2011*, 5 FDIC QUARTERLY 4, 7 (2011), *available at* http://www2.fdic.gov/qbp/2011sep/qbp.pdf. The "cost of funding earning assets" gap between banks with assets over $10 billion compared to smaller banks has been previously cited as evidence that "too big to fail is still very much alive." *Id.*

46. This observation is based on a private study reviewed by the author.

47. Cyrus Sanati, *Don't Be Fooled, Too Big to Fail is Alive and Well*, CNN MONEY (Sept. 22, 2011, 11:24 AM), http://finance.fortune.cnn.com/2011/09/22/big-bank-bailouts/ ("[W]hile the government says it is no longer in the bailout business . . . it's hard to say how the government can better prevent a bank from failing or how they would be able to control the fallout from such a failure. All they say is that it is 'illegal' to bail them out. That may be true, but in times of crisis, rules tend to be broken.").

foreign supervisors of the foreign operations of systemically important U.S. financial institutions."[48] In addition, the FDIC can take action through the living will process to require restructuring when necessary to avoid a result that is inconsistent with the basic U.S. resolution regime.

The second is that the problem is more containable than it might initially appear because the vast majority of non-U.S. located assets of major U.S. banks are located in one country: the United Kingdom.[49] An FDIC "heat map exercise" reveals that, for each of the five top U.S. Systemically Important Financial Institutions (SIFIs), over 90% of its total foreign activity is located in no more than three jurisdictions, and on average approximately 88% of total reported foreign activity is in the United Kingdom.[50]

III. Risk Reduction

Turning to the second theme, risk reduction, it is impossible to argue with the general premise that risk reduction is a worthwhile goal. This premise should be tempered, however, with recognition that a regulatory regime will ultimately be counterproductive if it fails to recognize that financial institutions are in the risk-taking business, and that elimination of all risk taking would make it impossible for financial institutions to perform their role in the economy. The inherent function of banks is to take two basic types of risk: (i) credit risk in respect of borrowers and counterparties and (ii) interest rate risk because borrowers need longer-term credit than banks can match-fund.[51] The policy objective should be to control and manage risk, rather than eliminate it. To state the point somewhat differently, if every loan is repaid in full, a lot of good loans will not get made.

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48. Martin J. Gruenberg, Acting Chairman, Fed. Deposit Ins. Corp., Address to the Independent Community Bankers of America National Convention (Mar. 13, 2012), *available at* http://www.fdic.gov/news/news/speeches/chairman/spmar1312.html. He notes that these include bilateral and multinational relationships. *Id.* In the latter case, these involve the "crisis management groups of global [systemically important financial institutions (SIFIs)], the Crisis Management Steering Committee of the Financial Stability Board, and the Basel Committee's Cross Border Resolutions Working Group, which the FDIC co-chairs." *Id.*

49. FED. DEPOSIT INS. CORP., OFFICE OF COMPLEX FIN. INST. INT'L COORDINATION GROUP, INTERNATIONAL RESOLUTION COORDINATION OVERVIEW 4 (2012).

50. *Id.* at 4–5.

51. *See* COMPTROLLER OF THE CURRENCY, COMPTROLLER'S HANDBOOK: INTEREST RATE RISK 1 (1997), *available at* http://www.occ.treas.gov/publications/publications-by-type/comptrollers-handbook/irr.pdf ("The acceptance and management of financial risk is inherent to the business of banking . . . . [B]anks make loans, purchase securities, and take deposits with different maturities and interest rates."); COMPTROLLER OF THE CURRENCY, COMPTROLLER'S HANDBOOK: RISK MANAGEMENT OF FINANCIAL DERIVATIVES 44 (1997), *available at* http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/deriv.pdf ("Credit risk arises from all activities in which success depends on counterparty, issuer, or borrower performance. It arises any time bank funds are extended, committed, invested, or otherwise exposed . . . .").

Ultimately, the issue is balance. Hypothetically, there would presumably be a clear consensus that a one-tenth of 1% reduction in annual GDP growth would be acceptable if there were a 95% reduction in the probability of another 8.5 Richter Scale financial crisis. What is less clear is whether there should be acceptance of a 2% annual GDP reduction in exchange for a much smaller probability of a reduction in the risk of a financial crisis.

It is in this context that it is appropriate to describe and analyze the risk reduction efforts to date. The efforts to reduce the risk of failure have been comprehensive, involving legislation, formal regulation, supervision, and enforcement. It is perhaps most appropriate to start with supervision because its impact is already being directly and significantly reflected throughout the banking industry.

There has truly been a pendulum swing in the supervisory approach for financial institutions. That approach has become more proscriptive, prescriptive, and intrusive.[52] Moreover, the approach remains in a state of evolution.[53]

The principal manifestations of the new supervisory regime to date include:

- Higher capital requirements in terms of both quantity and quality, with a particular focus on a new Tier 1 common ratio.[54]
- Widespread examination rating downgrades. CAMELS ratings are based on a numeric scale of 1–5, with a rating of 3 being unsatisfactory and ratings of 4 and 5 being progressively worse. The "new normal" rating appears to have declined significantly and may be approaching a 3.[55]

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52. For an overview of U.S. responses to the financial crisis, see Ben S. Bernanke, Chairman, Fed. Reserve, The Federal Reserve and the Financial Crisis: The Aftermath of the Crisis, George Washington University School of Business Lecture 4 (Mar. 29, 2012) [hereinafter Bernanke March 29 Lecture], *available at* http://www.federalreserve.gov/mediacenter/files/chairman-bernanke-lecture4-20120329.pdf; K. Sabeel Rahman, Note, *Envisioning the Regulatory State: Technocracy, Democracy, and Institutional Experimentation in the 2010 Financial Reform and Oil Spill Statutes*, 48 HARV. J. ON LEGIS. 555, 562–64 (2011).

53. *See* John C. Coffee, *Systemic Risk After Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight*, 111 COLUM. L. REV. 795, 820–21 (2011) (suggesting that the power given by Dodd-Frank to administrative agencies to adopt detailed regulations over a few years will lead to ad hoc and discretionary enforcement).

54. Dodd-Frank Act § 171; Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594 (proposed Jan. 5, 2012) (to be codified at 12 C.F.R. pt. 252); BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE SUPERVISORY CAPITAL ASSESSMENT PROGRAM: DESIGN AND IMPLEMENTATION 1 (2009).

55. The composite CAMELS rating system, conducted by the federal banking regulators, rates bank soundness on a scale of 1 to 5. These ratings are not released publicly and reliable data is,

- Capital evaluations of specified financial institutions at least annually under a stress test scenario.[56] The 2012 stress test involved extremely stressful macroeconomic assumptions (13% unemployment, a further 20% decline in housing prices, and a 50% decline in the Dow Jones Total Stock Index) and appears to have been implemented under very conservative Federal Reserve loan loss models.[57]
- New and more stringent standards for capital actions such as dividends and buybacks.[58]
- New liquidity requirements.[59]
- New standards in such areas as loan grading and loan concentrations.[60]
- More generally, bank internal practices, policies, and procedures that previously went unmentioned by the

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therefore, difficult to obtain. However, the overall trends of the ratings can be discerned from the FDIC's quarterly reports and other sources. *See, e.g.*, Fed. Deposit Ins. Corp., *Quarterly Banking Profile: Fourth Quarter*, 6 FDIC QUARTERLY 1 (2011), at 5 tbl.1-A, 25 (2012) *available at* http://www2.fdic.gov/qbp/2011dec/qbp.pdf (showing that the number of "problem institutions," identified as institutions that have a composite CAMELS rating of a 4 or a 5, decreased from 884 in 2010 to 813 in 2011, but remained far above the numbers of problem institutions in previous years, e.g., 2009 (702 problem institutions), 2008 (252 problem institutions), 2007 (76 problem institutions). The Federal Reserve Bank of San Francisco reports that on March 31, 2011, 59.9% of the banks in the 12th District had CAMELS ratings of 3, 4, or 5, while the national figure at that date was 31.7%. In the period from 1990 until 2009, the previous high for the 12th District was less than 40%. FED. RESERVE BANK OF S.F., 12TH DISTRICT BANKING PROFILE 2 (2012), *available at* http://www.frbsf.org/publications/banking/profile/2012/12D_profile-4Q11.pdf.

56. Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. at 625.

57. BD. OF GOVERNORS OF THE FED. RESERVE SYS., COMPREHENSIVE CAPITAL ANALYSIS AND REVIEW 2012: METHODOLOGY FOR STRESS SCENARIO PROJECTIONS 7 (2012) [hereinafter 2012 CCAR METHODOLOGY], *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20120312a1.pdf; Bd. of Governors of the Fed. Reserve Sys., *Accessible Version of Figures* fig.3 (2012), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20120312a-accessible.htm.

58. BD. OF GOVERNORS OF THE FED. RESERVE SYS., COMPREHENSIVE CAPITAL ANALYSIS AND REVIEW: OBJECTIVES AND OVERVIEW (2011) [hereinafter 2011 CCAR OVERVIEW]; Bd. of Governors of the Fed. Reserve Sys., *supra* note 57, at fig.3, FED. RESERVE, http://www.federalreserve.gov/newsevents/press/bcreg/20120312a-accessible.htm.

59. Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. at 604–12.

60. *See, e.g.*, *id.* 612–22; ROBERT E. LITAN & JOHN D. HAWKE, JR., AM. BANKERS ASS'N, VALUE-ADDED BANK SUPERVISION: A FRAMEWORK FOR SAFELY FOSTERING ECONOMIC GROWTH 12 (2012), *available at* http://www.aba.com/aba/documents/news/ValueAddedSupervisionWhitePaperApril2012.pdf; COLO. BANKERS ASS'N, REALITY IN BANK LENDING 4–5 (2009), *available at* http://coloradophotonics.org/Reality%20of%20Lending.pdf.

> supervisors in the examination process are now often the subject of sharp criticism.[61]

The consequences of this supervisory approach are manifest and pervasive. Capital ratios have been sharply heightened, with common-based ratios almost double precrisis levels. Asset quality has significantly improved.[62] Liquidity ratios are higher.[63] Dividend increases and stock buybacks have been constrained and often prohibited.[64] Expansion has been severely restricted by lower examination ratings.[65] There is substantially greater focus on risk management and compliance.[66]

With respect to formal regulations, there are two principal manifestations. The first is the new capital and liquidity requirements emanating from the Basel Committee on Supervision—what is known as Basel III.[67] On the surface, the new Basel III capital requirements are clear and, for most U.S. banks, not demanding in view of their substantial capital

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61. LITAN & HAWKE, *supra* note 60, at 10–12.

62. Press Release, Fed. Deposit Ins. Corp., FDIC-Insured Institutions Earned $35.3 Billion in the Third Quarter of 2011 (Nov. 22, 2011), *available at* http://www.fdic.gov/news/news/press/2011/pr11182.html.

63. JOHN S. SCOTT & CHRISTOPHER D. WOLFE, FITCHRATINGS, U.S. BANKS—LIQUIDITY RATIOS: MORE LIQUID THAN THEY MAY APPEAR UNDER BASEL III, 1, 5 (2011), *available at* http://www.fitchratings.cl/Upload/US%20Bank%20Liq%20Ratios.pdf.

64. 2011 CCAR OVERVIEW, *supra* note 58, at 6; BD. OF GOVERNORS OF THE FED. RESERVE SYS., REVISED TEMPORARY ADDENDUM TO SR LETTER 09-4: DIVIDEND INCREASES AND OTHER CAPITAL DISTRIBUTIONS FOR THE 19 SUPERVISORY ASSESSMENT PROGRAM BANK HOLDING COMPANIES 4 (2010) [hereinafter TEMPORARY ADDENDUM], *available at* http://www.federalreserve.gov/boarddocs/srletters/2009/SR0904_Addendum.pdf; Press Release, Citigroup, Inc., Citi Statement on Comprehensive Capital Analysis and Review Decision (Mar. 13, 2012), *available at* http://www.citigroup.com/citi/press/2012/120313c.htm; Ben Protess, *Fed Rejects Bank of America's Dividend Plan*, DEALBOOK (Mar. 23, 2011, 12:59 PM), http://dealbook.nytimes.com/2011/03/23/bofas-dividend-plan-rejected-by-fed/ (reporting that the Federal Reserve rejected Bank of America's plan to increase its dividend in the second half of 2011).

65. Among other things, in acting on bank acquisition applications the Federal Reserve is required by Section 3(c) of the Bank Holding Company Act of 1956, 12 U.S.C. § 1841 (2012), to take into consideration such factors as the financial and managerial resources (including consideration of the competence, experience, and integrity of the officers, directors, and principal shareholders) and future prospects of the company and banks concerned. Those institutions with CAMELS ratings of 3, 4, or 5 are unlikely to satisfy these tests. As a practical matter, these same considerations are applicable to transactions subject to the Bank Merger Act. 12 U.S.C. § 1828(c).

66. *See, e.g.*, Bernanke March 29 Lecture, *supra* note 52, at 21; OFFICE OF INSPECTOR GEN., FED. DEPOSIT INS. CORP., REPORT NO. MLR-11-010, FOLLOW-UP AUDIT OF FDIC SUPERVISION PROGRAM ENHANCEMENTS 12–13 (2010); G20 WORKING GROUP, *supra* note 21, at 35–38.

67. BASEL COMM. ON BANKING SUPERVISION, BASEL III: A GLOBAL REGULATORY FRAMEWORK FOR MORE RESILIENT BANKS AND BANKING SYSTEMS (2011) [hereinafter BASEL III CAPITAL STANDARDS FRAMEWORK], *available at* http://www.bis.org/publ/bcbs189.pdf.

ratio improvements in recent years. There is a focus on Tier 1 common capital, with a new Tier 1 common ratio requirement of 7%.[68]

But there are numerous unanswered questions. Will 7% be the actual number or, as appears more likely, just a floor? Will the Basel Committee's prolonged phase-in of the capital requirements, from 2013–2019,[69] be real or merely nominal? As a practical matter, these capital requirements have seemingly been applied immediately to major U.S. banks as a result of the Federal Reserve's "Temporary Addendum" on capital actions issued in 2010.[70] This Addendum appears to suggest that a bank cannot increase its dividend or repurchase its stock unless it meets Basel III on a fully phased-in basis.[71] A similar issue relates to regulatory applications for expansionary proposals; immediate Basel III compliance may be a prerequisite for regulatory approval.

These same limitations on capital-reduction actions appear to arise under the Federal Reserve's most recent stress test process, which, as discussed above, includes very stressful macroeconomic assumptions, such as a 13% unemployment rate.[72] The Federal Reserve imposes a virtual prohibition on a bank's dividend increases and stock repurchases unless the bank's Tier 1 common ratio exceeds 5% on a pro forma basis and the bank is well capitalized for the stress test results in each of the next nine quarters.[73]

The increase in capital imposed by Basel III is not limited to the new common capital ratio requirement, but is also a function of the revisions in the calculation methodology for computing that ratio. Perhaps the principal revision is the Basel III requirement that regulatory capital now include changes in Other Comprehensive Income, which is effectively a mark-to-market for much of a bank's securities portfolio.[74] This could create

68. *Id.*

69. *See id.* at annex 4 (listing the scheduled incremental increases in capital requirements and phase-in of the liquidity requirements).

70. *See* TEMPORARY ADDENDUM, *supra* note 64, at 4.

71. *See id.* at 1–4 ("The Federal Reserve will evaluate whether the proposed capital action(s) are appropriate in light of management's plans to address the proposed Basel III reform measures. . . . [T]he Federal Reserve expects that [bank holding companies] will demonstrate with great assurance that they could achieve the [capital] ratios required by the Basel III framework.").

72. *See* FED. RESERVE SYS., COMPREHENSIVE CAPITAL ANALYSIS AND REVIEW: SUMMARY INSTRUCTIONS AND GUIDANCE 32 (2011), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20111122d1.pdf (providing for a stress test unemployment rate of 13.05% in the second quarter of 2013).

73. *See id.* at 3, 19 (explaining that the Federal Reserve will assess the bank holding company's capital plan to determine the bank's "ability to maintain capital above each minimum regulatory capital ratio and above a tier 1 common ratio of 5 percent on a pro forma basis" and then will object to actions such as dividend increases).

74. *See* BASEL III CAPITAL STANDARDS FRAMEWORK, *supra* note 67, at 13 (including in Tier I common equity capital "[a]ccumulated other comprehensive income" (AOCI), defined as including

considerable volatility in capital ratios[75] and is likely to force banks to hold what might be called an "uncertainty buffer" to account for potential increases in interest rates.[76] In a period of rapidly rising interest rates, the adverse impact on regulatory capital ratios could be substantial.[77]

In addition, the Basel III requirement that certain assets, such as mortgage servicing rights and minority investments, be deducted from capital, subject to a so-called sin bucket, will increase the capital requirements for banks with those assets and could even change certain business models.[78]

The issues raised by the Basel III liquidity requirements may be even more consequential than those relating to capital. The original Basel III proposal for a liquidity coverage ratio, which evaluates liquidity at thirty days,[79] would leave U.S. banks with an estimated liquidity shortfall of as much as one and one-half trillion dollars;[80] the shortfall for the European

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"interim profit or loss"); SULLIVAN & CROMWELL LLP, BASEL III CAPITAL AND LIQUIDITY FRAMEWORK: BASEL COMMITTEE ISSUES FINAL REVISIONS TO INTERNATIONAL REGULATION OF BANK CAPITAL AND LIQUIDITY 5 (2010) [hereinafter SULLIVAN & CROMWELL, BASEL III], *available at* http://www.sullcrom.com/files/Publication/d6159da8-e931-4b08-bec2-5b3e23dbb035/Presentation/PublicationAttachment/3647a117-0730-4dfd-a8c3-00af96a9f684/SC_Publication_Basel_III_Capital_and_Liquidity_Framework.pdf ("For U.S. banks, this means that other comprehensive income/loss recorded to shareholders' equity under the Financial Accounting Standards Board's Financial Accounting Statement No. 115, which is currently "filtered" out of regulatory capital in reports filed with the U.S. bank regulatory agencies, will no longer be subject to that filter [and] mark-to-market amounts for securities held as available for sale [will be included within Tier 1 common equity].").

75. PAUL SALTZMAN, THE CLEARING HOUSE, PROPOSALS TO STRENGTHEN CAPITAL REGULATION 2 (2010), *available at* http://www.theclearinghouse.org/index.html?f=071027; SULLIVAN & CROMWELL, BASEL III, *supra* note 74 at 5. The Clearing House is a client of the author's law firm.

76. *Id.* at 4.

77. As is the case with such a calculation, a number of regulatory policies run the risk of being procyclical. They exacerbate the swings in each direction. DAVID WAGNER & HUGH C. CARNEY, THE CLEARING HOUSE, TREATMENT OF UNREALIZED GAINS AND LOSSES UNDER THE BASEL III CAPITAL FRAMEWORK 4 (2012), *available at* http://www.theclearinghouse.org/index.html?f=073582 ("Under the Basel III capital framework, an increase in market interest rates will put downward pressure on capital levels within the banking system, including in part as a result of unrealized losses recorded in AOCI [Accumulated Other Comprehensive Income].").

78. SULLIVAN & CROMWELL, BASEL III, *supra* note 74 at 4.

79. BASEL COMM. ON BANKING SUPERVISION, BASEL III: INTERNATIONAL FRAMEWORK FOR LIQUIDITY RISK MEASUREMENT, STANDARDS AND MONITORING 3 (2010), *available at* http://www.bis.org/publ/bcbs188.pdf ("The first objective is to promote the short-term resilience of the liquidity risk profile of banks by ensuring that they have sufficient high-quality liquid assets to survive a significant stress scenario lasting 30 calendar days. The Committee developed the Liquidity Coverage Ratio to achieve this objective.").

80. *See* THE CLEARING HOUSE, THE BASEL III LIQUIDITY FRAMEWORK: IMPACTS AND RECOMMENDATIONS 2 (2011), *available at* http://www.theclearinghouse.org/index.html?f=073043 [hereinafter CLEARING HOUSE LIQUIDITY PAPER], referencing its liquidity study: Assessing the Liquidity Coverage Ratio (LCR). ("The U.S. banking industry's estimated LCR shortfall has

banks could also be substantial.[81] The key factors responsible for this shortfall once again relate to the calculation methodology as opposed to the basic requirement. As one example, the Basel III proposal assumes deposit outflows that are twice what was experienced by the U.S. bank with the highest deposit outflows during the 2008 financial crisis.[82]

The second key formal regulation is the Federal Reserve's proposal for enhanced prudential standards for banking organizations with $50 billion or more in assets.[83] This regulation is required by Sections 165 and 166 of Dodd-Frank.[84] The Federal Reserve would generally incorporate the Basel III capital and liquidity requirements, but it would both adopt a more realistic calculation method for liquidity and layer on a comprehensive liquidity management requirement.[85] Other key areas of the proposal include single counterparty exposures, stress tests, risk management, and early remediation.[86]

The single counterparty credit limit is the most disruptive aspect of this proposal. A combination of a reduced 10% credit limit for "major" bank holding companies (those with $500 billion or more in assets) in respect of other major bank holding companies, as opposed to the statutory 25%, and certain calculation methodology exaggerations of risk (from what would otherwise be determined by internal models), could create a huge forced

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increased, from approximately $1.1 trillion at December 2009 (representing a 70% industry-wide LCR) to approximately $1.4 trillion at December 2010 (representing a 60% industry-wide LCR) . . . The $1.4 trillion estimated shortfall at December 2010 is a conservative, and likely understated, amount . . . .").

81. PHILIPP HÄRLE ET AL., MCKINSEY & COMPANY, BASEL III AND EUROPEAN BANKING: ITS IMPACT, HOW BANKS MIGHT RESPOND, AND THE CHALLENGES OF IMPLEMENTATION 2 (2010), *available at* http://www.mckinsey.com/~/media/McKinsey/dotcom/client_service/Risk/Working%20papers/26_Basel_III_and_European_banking.ashx (estimating "a short-term liquidity shortfall of €1.9 trillion (Europe: €1.3 trillion, United States: €0.6 trillion) (Exhibit 1)" and a "[l]ong-term . . . shortfall of about €2.3 trillion in Europe alone" and "€2.2 trillion" in the United States).

82. *See* CLEARING HOUSE LIQUIDITY PAPER, *supra* note 80 at 13 (reporting that the worst run-off rates experienced by banks were 38–41% whereas Basel III based its proposal on run-off rates of 75–100%).

83. *See generally* Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594 (proposed Jan. 5, 2012) (to be codified at 12 C.F.R. pt. 252).

84. *Id.*; Dodd-Frank Act §§ 165(a)(1), 166(a).

85. *See* Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. at 599–600, 604–12 (referencing Basel III and the Board's intention to propose additional rules to implement certain Basel III components, and describing the proposed liquidity requirements).

86. *Id.* at 612, 622, 625, 634.

reduction in interbank transactions, as well as disruptions in multiple markets.[87]

In terms of legislation, Dodd-Frank attempts to reduce risk both by requiring regulatory action and by outright prohibition. The principal example of prohibition is the Volcker Rule, which imposes broad restrictions on proprietary trading and on investments in and activities relating to hedge funds and private equity funds.[88] Reflecting the many issues raised by the Volcker Rule, more than 17,000 comments have been submitted to the five federal agencies with responsibility for implementing it.[89]

The fourth and last component of the risk reduction regulatory regime is a more aggressive enforcement and litigation environment. The recent $25 billion mortgage servicing settlement involving the five largest servicers[90] and huge individual settlements by JPMorgan Chase,[91] Citigroup,[92] Goldman Sachs,[93] Bank of America,[94] and Wells Fargo[95] have demonstrated—at a

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87. *Id.* at 613; Dodd-Frank Act § 165(e); Tom Braithwaite, *Banks Urge Fed Retreat on Credit Exposure*, FIN. TIMES, Apr. 15, 2012, *available at* http://www.ft.com/cms/s/0/6a789456-871d-11e1-865d-00144feab49a.html#axzz1v8yL7MAf (quoting Bob Chakravorti, the chief economist at The Clearing House: "The key issue is how to define and measure credit exposures . . . . [The proposed method is] a crude measure that overstates exposures under any reasonable calculation methodology by a significant multiple.").

88. Dodd-Frank Act § 619 (adding a new Section 13 to the Bank Holding Company Act).

89. *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68,846 (Nov. 7, 2011) (to be codified at 17 C.F.R. pt. 255 and scattered sections of 12 C.F.R.) (joint proposed rule to implement the Volcker Rule by the FRB, OCC, FDIC, and SEC). *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Covered Funds, 77 Fed. Reg. 8332 (Feb. 14, 2012) (to be codified at 17 C.F.R. pt. 75) (CFTC's separate notice of proposed rulemaking). The 17,000 comment letters have set a record for comments received on a proposed rule under Dodd-Frank. Victoria McGrane, *Comments Flood In on Volcker Rule*, WASH. WIRE (Feb. 15, 2012,4:01 PM), http://blogs.wsj.com/washwire/2012/02/15/comments-flood-in-on-volcker-rule/.

90. United States v. Bank of America Corp., No. 12-cv-00361 (D.D.C. Apr. 4, 2012); Press Release, Dep't of Justice, $25 Billion Mortgage Servicing Agreement Filed in Federal Court (Mar. 12, 2012), *available at* http://www.justice.gov/opa/pr/2012/March/12-asg-306.html.

91. *See* SEC v. J.P. Morgan Sec. LLC, No. 11-cv-04206 (S.D.N.Y. June 21, 2011) ($153.5 million settlement related to misleading investors in a CDO).

92. SEC v. Citigroup Global Mkts., Inc., No. 11-cv-7387 (S.D.N.Y. Oct. 19, 2011) ($285 million settlement related to misleading investors in a CDO).

93. SEC v. Goldman, Sachs & Co., No. 11-cv-3229 (S.D.N.Y. July 14, 2010) ($550 million settlement related to misleading investors in a CDO).

94. United States v. Countrywide Fin. Corp., No. 11-cv-10540 (C.D. Cal. Dec. 28, 2011) ($335 million settlement related to housing discrimination); Verified Petition at Ex. B, Bank of New York Mellon v. Walnut Place LLC (N.Y. Sup. Ct. 2011) (No. 651786/2011) (proposing an $8.5 billion settlement with private investors regarding mortgage-backed securities put-backs).

95. Wells Fargo & Co., Nos. 11-094-B-HC1, 11-094-I-HC1, 11-094-B-HC2, and 11-094-I-HC2 (Bd. of Governors of the Fed. Reserve Sys. July 20, 2011) (consent order), *available at*

minimum—an exponential increase in the size of government-imposed penalties.

It is not just that the penalties for violations have been raised, but the risk of a violation being determined has also sharply increased. This reflects more vigorous enforcement and a heightening of the standards for compliance. Although most of the headline focus has been on mortgages, the enforcement and litigation net is far wider, capturing a variety of financial, consumer, money laundering, economic sanctions, Foreign Corrupt Practices Act, and other compliance issues.[96]

Moreover, the out-of-pocket costs of enforcement penalties and fines represent only one element of the total cost of this more aggressive enforcement approach. In order to mitigate the impact, compliance costs are soaring.[97] Perhaps most damagingly, these enforcement actions can result in a prolonged hiatus in regulatory approvals for any expansion proposal that requires such an approval.[98]

Financial institutions are perhaps uniquely exposed to this more aggressive enforcement approach. There are literally thousands of rules and regulations governing a bank's operations, many of which involve subjective and discretionary judgments by governmental authorities. There will inevitably be violations. Moreover, in today's environment, with banks held in such widespread disrepute, it is difficult for a bank to defend itself no matter how strong its legal position may be.

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http://www.federalreserve.gov/newsevents/press/enforcement/enf20110720a1.pdf ($85 million civil monetary penalty related to housing discrimination).

96. U.S. SEC. & EXCH. COMM'N, SEC MONETARY RECOVERIES (2011), *available at* http://sec.gov/news/press/2011/2011-214-chart-recoveries.pdf; Louise Story & Meghan Louttit, *Tracking Financial Crisis Cases*, N.Y. TIMES (Feb. 2, 2012) http://www.nytimes.com/interactive/business/financial-crisis-cases.html?ref=litigation; *FCPA and Related Enforcement Actions*, JUSTICE.GOV (2012), http://www.justice.gov/criminal/fraud/fcpa/cases/2012.html; Office of Foreign Assets Control, *Civil Penalties and Enforcement Information*, TREASURY.GOV (2012), http://www.treasury.gov/resource-center/sanctions/CivPen/Pages/civpen-index2.aspx.

97. *See* NEIL KATKOV, DOW JONES RISK & COMPLIANCE, ACHIEVING GLOBAL SANCTIONS COMPLIANCE: CHALLENGES AND SOLUTIONS 11 (2011) (finding that watchlist compliance costs average $14.5 million for a large bank); Silla Brush, *Volcker Rule Will Cost Banks $1 Billion, U.S. Government Says*, BLOOMBERG (Oct. 28, 2011, 11:01 PM), http://www.bloomberg.com/news/2011-10-28/volcker-rule-to-cost-banks-1b-u-s-government.html (estimating compliance costs from the higher capital requirements of the Volcker Rule at $917 million); Letter from U.S. Chamber of Commerce et al. to Hon. Lanny A. Breuer, Assistant Attorney Gen., Criminal Div., U.S. Dep't of Justice and Robert Khuzami, Dir. of Enforcement, U.S. Sec. & Exch. Comm'n (Feb. 21, 2012), *available at* http://www.instituteforlegalreform.com/sites/default/files/FCPA%20Guidance%20Letter-2-21-12_4_.pdf (urging the DOJ to clarify various aspects of FCPA enforcement policies to facilitate compliance).

98. *See supra* note 65. In addition to the general management considerations, both the Bank Holding Company Act and the Bank Merger Act specifically require the regulators to take into consideration the effectiveness of the company in combatting money laundering. *See* 12 U.S.C. § 1842(c); 12 U.S.C. § 1828(c).

In attempting to analyze the overall impact of this risk-reduction regime, some have suggested that the regulatory model for banks should be along the same lines as utilities.[99] But the utility model for the banking industry is fundamentally inapt. It is one thing to accept regulation as a utility in return for a monopoly position and a reasonably assured return on equity. It is far different to impose utility-like regulation in a fiercely competitive environment, such as exists for banking organizations.

IV. Size Reduction

The third theme of the regulatory response to the financial crisis is size reduction. The simplistic analysis is that, if there are no big banks, there will be no bank failure that would have systemic consequences, and, therefore, no bank could be too big to fail. The most ardent advocates of this position urge a forced breakup of the largest financial institutions.[100] A less drastic approach is to impose regulatory restrictions that effectively force a reduction in size and prevent any increase in size beyond a defined level.[101]

In attempting to be informative without being pejorative, it is worthy of note that some of the strongest supporters of a "big is bad" regulatory approach in the financial crisis's aftermath had called for nationalization of banks during the crisis.[102] Ultimately, a "big is bad" policy is not about

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99. *See* Tim Morrison, *Nassim Nicholas Taleb*, TIME (Oct. 24, 2008), http://www.time.com/time/business/article/0,8599,1853531,00.html (answering questions as to the future of banking: "[W]e've got to progressively become a society where banks are deemed to be too precious for us, for our currency, to take too much risk . . . . Banks are going to become a utility."); Joe Rauch, *Big Banks Are Government-Backed: Fed's Hoenig*, REUTERS (Apr. 12, 2011), http://www.reuters.com/article/2011/04/12/us-fed-hoenig-idUSTRE73B3S820110412 (reporting on a speech made by then President of the Federal Reserve Bank of Kansas City, Thomas Hoenig to the National Association of Attorneys General 2011 conference, in favor of treating major U.S. banks like "government-guaranteed enterprises": "That's what they are . . . . You're a public utility, for crying out loud.").

100. *See* Richard W. Fisher & Harvey Rosenblum, *How Huge Banks Threaten the Economy*, WSJ.COM (Apr. 3, 2012, 12:23 PM), http://online.wsj.com/article/SB10001424052702303816504577312110821340648.html (calling for a reduction in the "size and complexity" of the largest banks).

101. *See, e.g.*, Dodd-Frank Act § 622 (prohibiting mergers and acquisitions or transactions if the resulting entity would have total consolidated liabilities that would exceed 10% of aggregate consolidated liabilities of all financial companies). Press Release, The White House, President Obama Calls for New Restrictions on Size and Scope of Financial Institutions to Rein in Excesses and Protect Taxpayers (Jan. 21, 2010), *available at* http://www.whitehouse.gov/the-press-office/president-obama-calls-new-restrictions-size-and-scope-financial-institutions-rein-e (describing the President's proposal of regulations that would prevent financial institutions from growing beyond certain predetermined limits).

102. Nouriel Roubini, *Nationalize Insolvent Banks*, FORBES (Feb. 12, 2009, 12:01 AM), http://www.forbes.com/2009/02/11/geithner-banks-nationalization-opinions-columnists_0212_nouriel_roubini.html; Joseph E. Stiglitz, Op-Ed, *Obama's Ersatz Capitalism*, N.Y. TIMES, Apr. 1, 2009, at A31.

effective regulation; it is an abdication of regulatory responsibility. The government is unable to regulate, so it should preclude.

Beyond the basic premise that, if there are no big banks, there cannot be any bank that is too big to fail, there have been two other premises for this "big is bad" position. The first additional premise is that the largest banks are likely to incur greater risk.[103] The second, which is only tangentially related to the financial crisis, is a political philosophy about the undue economic and political power of large banks—a political debate that has waxed and waned throughout much of U.S. history.[104]

The premise that larger banks are more risky is not consistent with the empirical record. An argument that size is correlated to risk is contradicted by the hundreds of smaller U.S. financial institutions that failed between 2007 and 2011.[105] It is also contradicted by the fact that three of the five largest U.S. banks came through the financial crisis largely unscathed.[106] It is also belied by the experience in Canada and Australia, where the banking system is highly concentrated, but the banks were able to withstand the international financial crisis better than their counterparts throughout the world.[107]

With respect to the second additional premise concerning undue political power, the rebuttal can be aptly and convincingly summarized by two words: Dodd-Frank. This statute is scarcely a testimony to the political influence, much less the undue influence, of large banks.

Moreover, the Jeffersonian agrarian society concept of promoting multiple small banks at the expense of large banks has not proven to be the pathway to safety and soundness.[108] There have been multiple periods where such a governmental approach has framed the U.S. banking industry: the 1830s, the 1880s, the early 1900s, the 1920s, and the early 1980s.[109] In each

103. Fisher & Rosenblum, *supra* note 100 ("Since the early 1970s, the share of assets controlled by the five largest banking institutions in the U.S. has tripled . . . . With size came complexity, magnifying the opportunities for . . . mismanaged risk.").

104. For a recent example, see Coffee, *supra* note 53, at 818–22.

105. Approximately 414 banks with assets of less than $25 billion failed in 2007–2011. *See supra* note 17 and accompanying text.

106. JPMorgan, Wells Fargo, and Goldman Sachs. Each of these institutions' earnings rose substantially between June 2007 and December 2011. *See* Peer Analytics, *Regulated Depositories*, SNL FINANCIAL, at Field 208795 (Retained Earnings), a*vailable at* http://www.snl.com (subscription required).

107. *See generally* ANDRE MURRAY ET AL., FITCH RATINGS, AUSTRALIAN AND CANADIAN MAJOR BANKS (2012); GERALD DWYER, FED. RESERVE BANK OF ATLANTA, INTERNATIONAL DIMENSIONS OF THE FINANCIAL CRISIS OF 2007 AND 2008 (2011).

108. *See generally* RAGHURAN RAJAN, FAULT LINES: HOW HIDDEN FRACTURES STILL THREATEN THE WORLD ECONOMY 172–73 (2010).

109. For a history of banking crises and responses, see generally CHARLES P. KINDLEBERGER ET AL., MANIAS, PANICS AND CRASHES: A HISTORY OF FINANCIAL CRISES (6th ed. 2011) and

case, this policy has been followed by a financial crisis in which scores of newly chartered banks have failed.[110]

Returning to the original premise, it is, of course, difficult to argue with the conclusion that if there are no big banks, there will be no banks that are TBTF. But few, if any, fundamental policy decisions are so simplistic. All the premises for a "big is bad" approach appear largely to ignore the advantages of size, not only for the institutions themselves, but also for their customers and the broader economy. Risk management 101 emphasizes the virtues of diversification.[111] Large financial institutions can create diversification in terms of geography, products, operations, and customer base.

In addition, size creates the opportunity for synergies. Although there are economists who claim that there are no synergies beyond a size that is at a level far below the size of the largest institutions, this view is vigorously contested.[112] Moreover, it is counterintuitive that a wide variety of per unit regulatory, staff, and other costs are identical regardless of size.

With respect to customers, many will benefit from the increased geographic and product scope, and the consistency of service, that can be provided by larger financial institutions.[113] Do global customers really want a different institution in each country in which they do business?

CARMEN M. REINHART & KENNETH ROGOFF, THIS TIME IS DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY (2009).

110. *Id.*

111. *See, e.g.*, JOËL BESSIS, RISK MANAGEMENT IN BANKING 46 (2011) (identifying "risk diversification" as one of the "basic principles" underlying credit limit systems); Gerhard Schöck & Manfred Steiner, *Risk Management and Value Creation in Banks*, *in* RISK MANAGEMENT: CHALLENGE AND OPPORTUNITY 57–58 (Frenkel et al. eds., 2005) (discussing the benefits of diversification in reducing the likelihood of "both worst-case and base-case outcomes," which "reduces the bank's probability of failure").

112. *See, e.g.*, Bob DeYoung, *How Big Should a Bank Be?*, AM. BANKER (Apr. 17, 2012, 8:50 AM), http://www.americanbanker.com/bankthink/how-big-should-a-bank-be-community-scale-1048454-1.html?zkPrintable=true; Joseph P. Hughes & Loretta J. Mester, *Who Said Large Banks Don't Experience Scale Economies? Evidence from a Risk-Return-Driven Cost Function* 23 (Fed. Reserve Bank of Phila. Working Paper No. 11-27, 2011), *available at* www.phil.frb.org/research-and-data/publications/ working-papers/2011/wp11-27.pdf ("Our results indicate that these measured scale economies do not result from cost advantages large banks may derive from too-big-to-fail considerations. Instead, they follow from technological advantages, such as diversification and the spreading of information costs and other costs that do not increase proportionately with size.").

113. *See* THE CLEARING HOUSE, UNDERSTANDING THE ECONOMICS OF LARGE BANKS (2011), *available at* http://www.theclearinghouse.org/index.html?f=073071. *See also* Rob Nichols, *Breaking Up Big Banks Would Weaken the U.S.*, AM. BANKER (Apr. 30, 2012, 4:35 PM), http://www.americanbanker.com/bankthink/Breaking-Up-Big-Banks-Weaken-America-1048896-1.html.

What happens when financial institutions fail, as they inevitably will? Should not an acquisition by a large financial institution, even if it is a last resort solution, still be a viable option in terms of societal benefit?

With respect to the broader economy, if our largest financial institutions are compelled to reduce their size, who will make the loans that they previously made and that are necessary to fuel economic growth? Some purport to speak with certainty that smaller banks, and even the shadow banking system, will pick up the slack.[114] But do we want to see rapid loan growth at smaller banks or any loan growth in the shadow banking system? Of more importance, how confident can one be that other financial institutions will make these loans? Are we willing to bet the economy?[115]

The financial crisis started in the shadow banking system, in large part because of the absence of regulation and transparency.[116] Regulatory actions that drive financial activities into the shadow banking system are therefore likely to create risk for the financial system as a whole. Precedent suggests that not only will the activity migrate, but that the risk will re-migrate.[117] A regulatory corollary to Gresham's Law[118] could be: "Bad regulation drives out good."

Notwithstanding these concerns, there have already been a number of regulatory manifestations of the size-reduction approach. At the top of the list are the Basel III rules implementing a substantial capital surcharge on

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114. For discussion of the shadow banking system's role, see Patrick Jenkins et al., *New Force Emerges from the Shadows*, FIN. TIMES, April 10, 2012, at 18, *available at* http://www.ft.com/cms/s/0/32033fc2-7f39-11e1-b3d4-00144feab49a.html#axzz1wI96rsLo. On the role of small banks, see, for example, Robert Teitelman, *Christopher Whalen and the Bet on Small Banks*, THE DEAL ECONOMY (Jan. 31, 2012, 1:02 PM), http://www.thedeal.com/thedealeconomy/christopher-whalen-and-the-bet-on-small-banks.php (discussing Whalen's view that small banks could pick up the slack if big banks failed).

115. *See* THE CLEARING HOUSE, *supra* note 111, at 40–42; Robert Teitelman, *Christopher Whalen and the Bet on Small Banks*, THE DEAL ECONOMY (Jan. 31, 2012, 1:02 PM), http://www.thedeal.com/thedealeconomy/christopher-whalen-and-the-bet-on-small-banks.php (considering whether small banks will be in a position to pick up the slack if large banks are broken up).

116. RAJ DATE, CAMBRIDGE WINTER CTR., THROUGH THE LOOKING GLASS (STEAGALL): BANKS, BROKER DEALERS, AND THE VOLCKER RULE 4–5 (2010); Nouriel Roubini, Op-Ed, *The Shadow Banking System Is Unraveling*, FIN. TIMES, Sept. 21, 2008, *available at* http://www.ft.com/intl/cms/s/0/622acc9e-87f1-11dd-b114-0000779fd18c.html.

117. FIN. STABILITY BD., SHADOW BANKING: STRENGTHENING OVERSIGHT AND REGULATION, 1 (2011), *available at* http://www.financialstabilityboard.org/publications/r_111027a.pdf (describing the pre-crisis growth of the shadow banking system and noting "as the financial crisis has shown, the shadow banking system can also become a source of systemic risk, both directly and through its interconnectedness with the regular banking system").

118. Gresham's Law is "any process by which inferior products or practices drive out superior ones." MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 549 (11th ed. 2003).

banks deemed globally significant, the so-called G-SIBs.[119] At present, there are twenty-nine of these worldwide, including eight in the United States.[120] The surcharges range from 100 to 250 basis points, or even 350 basis points if a G-SIB has the temerity to grow.[121] To place the surcharge in perspective, the difference between a 7% and a 9.5% Tier 1 common equity capital requirement is to reduce a 9.2% ROE to 7.2%.[122]

One consequence of this surcharge arrangement is to freeze almost all acquisitions by G-SIBs. It is difficult to imagine that any G-SIB would be prepared to entertain an acquisition that moved the bank into a higher capital surcharge bucket. The returns generated by the acquired institution would need to be extraordinary to compensate for the overall sharp reduction in return on equity. Yet, the Basel release suggests that any growth by acquisition by the largest banks could place them in a higher bucket.[123]

Another manifestation is found in two recent Federal Reserve decisions that approved, respectively, PNC Financial Services Group's acquisition of RBC's U.S. subsidiary bank[124] and Capital One's acquisition of ING

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119. BASEL COMM. ON BANKING SUPERVISION, GLOBAL SYSTEMATICALLY IMPORTANT BANKS: ASSESSMENT METHODOLOGY AND THE ADDITIONAL LOSS ABSORBENCY REQUIREMENT (2011) [hereinafter BASEL III G-SIB SURCHARGE METHODOLOGY], *available at* http://www.bis.org/publ/bcbs207.pdf; SULLIVAN & CROMWELL LLP, BANK CAPITAL REQUIREMENTS: BASEL COMMITTEE ISSUES FINAL RULE REGARDING COMMON EQUITY SURCHARGE FOR GLOBAL SYSTEMICALLY IMPORTANT BANKS (2011) [hereinafter SULLIVAN & CROMWELL, G-SIB SURCHARGE], *available at* http://www.bis.org/press/p110625.htm.

120. *See* FIN. STABILITY BD., POLICY MEASURES TO ADDRESS SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS 4 (2011), *available at* http://www.financialstabilityboard.org/publications/r_111104bb.pdf (providing a comprehensive list of institutions that have initially been identified as G-SIBs).

121. *See generally* BASEL III G-SIB SURCHARGE METHODOLOGY; SULLIVAN & CROMWELL, G-SIB SURCHARGE. The Basel III G-SIB Surcharge Methodology is based on assigning each G-SIB to a so-called "bucket" based on such G-SIB's systemic importance score. The systemic importance score is determined based on five indicators, which include size. Each bucket is assigned a certain surcharge level. No G-SIB would be subject to the 350 basis point surcharge at present, but to the extent that a G-SIB that is subject to the 250 basis point surcharge becomes more systemically important, which may occur through growth, it would move to the higher, 350 basis point, bucket.

122. *See* THE CLEARING HOUSE, HOW MUCH CAPITAL IS ENOUGH? CAPITAL LEVELS AND G-SIB CAPITAL SURCHARGES 24 (2011), *available at* www.theclearinghouse.org/index.html?f=072896 (providing a chart explaining the impact on ROE of the Basel III capital requirements and a 2.5% surcharge on G-SIBs). Specifically, a 250-basis-point surcharge would decrease ROE by approximately 200 basis points. *Id.* If so, ROE would decrease from 9.2% to 7.2%. *Id.*

123. *See supra* note 121.

124. BD. OF GOVERNORS OF THE FED. RESERVE SYS., ORDER APPROVING ACQUISITION OF A STATE MEMBER BANK (2011), *available at* http://www.federalreserve.gov/newsevents/press/orders/order20111223.pdf.

Direct.[125] Both decisions included a lengthy discussion of the new financial stability factor added by Dodd-Frank to Section 3 of the Bank Holding Company Act.[126] Although it is difficult to understand how either transaction would have involved a material financial stability issue, the Federal Reserve took advantage of the opportunity to suggest that it would hereafter look with considerable skepticism at any acquisition application by the country's largest banks.[127] In effect, the Federal Reserve has interpreted this factor as imposing a third, and considerably more stringent, size limitation on acquisitions. There are already specific 10% nationwide limits on deposits and liabilities.[128]

Still a third manifestation is the aforementioned Federal Reserve's recent proposal under Section 165 of Dodd-Frank for single counterparty credit exposures. The limit is 25% for covered banks with assets of less than $500 billion, but only 10% for banks with assets of $500 billion or more.[129] More generally, the preamble to the proposal describes its objective as a "reduction of systemic footprint."[130] Other manifestations include the Tester Amendment to Dodd-Frank, which shifted the FDIC insurance assessment calculation basis from risk to size,[131] and the Volcker Rule,[132] which will likely require material divestitures of nonconforming operations.

Conclusion

In conclusion, the magnitude of the financial crisis and the regulatory failures that contributed to it legitimately demand an aggressive regulatory response. The development of that response, however, requires thoughtful

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125. BD. OF GOVERNORS OF THE FED. RESERVE SYS., ORDER APPROVING ACQUISITION OF A SAVINGS ASSOCIATION AND NONBANKING SUBSIDIARIES (2012), *available at* http://www.federalreserve.gov/newsevents/press/orders/order20120214.pdf.

126. *Id.* at 28–36; BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 124, at 10–18.

127. *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 124, at 12; BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 125, at 31 (Federal Reserve considers size as a factor when determining whether a transaction threatens financial stability). *See also* SULLIVAN & CROMWELL LLP, BANK MERGERS & ACQUISITIONS: FEDERAL RESERVE BOARD'S APPROVAL OF CAPITAL ONE'S ACQUISITION OF ING DIRECT DISCUSSES FINANCIAL STABILITY FACTOR 2 (2012), *available at* http://www.sullcrom.com/Bank-Mergers-Acquisitions-02-15-2012/ (detailing the Federal Reserve's analysis in approving the Capital One transaction indicates that larger organizations may experience more difficulty persuading the Federal Reserve that major acquisitions do not present significant financial stability concerns).

128. 12 U.S.C. § 1842(d)(A) (2010); 12 U.S.C. § 1852(b) (2010); 12 U.S.C. § 1828(c)(13) (2010).

129. Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594, 652 (proposed Jan. 5, 2012) (to be codified at 12 C.F.R. § 252.93).

130. *Id.* at 596.

131. Dodd-Frank Act § 331. Total assets have replaced deposits as the basis for calculation.

132. Dodd-Frank Act § 619.

and comprehensive analysis as opposed to simplistic answers. It also demands the right note of realism and even humility. If it were truly possible to identify the causes of a financial crisis in advance, there would not be financial crises.

It is also necessary to recognize that the regulatory response will determine not only the future of our banking industry, but in large measure the overall economy. It was not merely an exaggeration, but a fundamental error, to have regarded the banking system as the engine of the economy. But it would be at least an equally serious mistake to ignore the vital role that banking plays as the fuel of the economy.