



FAILING TO END “TOO BIG TO FAIL”:
AN ASSESSMENT OF THE DODD-FRANK ACT FOUR YEARS LATER

REPORT PREPARED BY THE REPUBLICAN STAFF OF THE
COMMITTEE ON FINANCIAL SERVICES, U.S. HOUSE OF REPRESENTATIVES

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This report has not been officially adopted by the Committee on Financial Services and may not necessarily reflect the views of its Members.

“Because of this law, the American people will never again be asked to foot the bill for Wall Street’s mistakes.”

- President Barack Obama, July 21, 2010

“Does [too big to fail] still exist? Of course it does.”

- Former Treasury Secretary Timothy Geithner, quoted
in the *New York Times Magazine*, May 8, 2014

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Introduction

During the financial crisis of 2008 and 2009, the fear that several large, complex financial institutions might fail prompted the federal government to provide those institutions and their creditors with extraordinary taxpayer-funded assistance. The specter of financial firms that government officials had deemed “too big to fail” being rescued at taxpayer expense engendered profound public outrage. In the aftermath of the crisis, Congress passed and President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), which its supporters contended would end the “too big to fail” phenomenon. Since the enactment of the Dodd-Frank Act in 2010, the Committee on Financial Services has conducted rigorous oversight of its implementation, including examining whether “too big to fail” persists despite the Dodd-Frank Act reforms. This report summarizes the findings of those efforts and concludes that not only did the Dodd-Frank Act not end “too big to fail,” it had the opposite effect of further entrenching it as official government policy.

As detailed below, the Committee finds that the Dodd-Frank Act was based on a profound misunderstanding of the causes of the financial crisis and the consequences of the government’s bailout policy, which began in 1984 when the government rescued Continental Illinois and culminated in the bailouts of 2008 and 2009. Although former Treasury Secretary Tim Geithner and others have written that the government’s biggest mistake in containing the financial crisis was allowing Lehman Brothers to fail in the fall of 2008, it was actually the government’s ill-advised decision to rescue the creditors of Bear Stearns in the spring of 2008 that created the expectation that virtually every firm was “too big to fail” and set the stage for the financial crisis. Rather than break with this decades’ long history of bailing out the creditors of large financial institutions, the Dodd-Frank Act gives the regulators whose failures of

supervision led to the financial crisis even greater powers to control and manage these institutions and grants them a permanent authority that perpetuates the “too big to fail” doctrine.

The narrative of the financial crisis that animated the drafters of the Dodd-Frank Act holds that the crisis was the culmination of decades of misguided efforts to “de-regulate” the financial system, which left the economy vulnerable to excessive risk-taking on Wall Street. The federal financial regulators, who had a large hand in drafting the Dodd-Frank Act, have eagerly embraced this narrative. Yet this attempt to rewrite history ignores the inconvenient fact that even before the financial crisis, the financial services sector was one of the most highly regulated industries in the United States.¹ As the Mercatus Center at George Mason University puts it, “the financial sector was increasingly regulated over the decade leading up to the financial crisis”:

[W]e find that between 1997 and 2008 the number of financial regulatory restrictions in the Code of Federal Regulations (CFR) rose from approximately 40,286 restrictions to 47,494—an increase of 17.9 percent. Regulatory restrictions in Title 12 of the CFR—which regulates banking—increased 18.2 percent while the number of restrictions in Title 17—which regulates commodity futures and securities markets—increased 17.4 percent.²

Similarly, in their survey of financial regulation in the run-up to the crisis, regulation experts James Barth, Gerard Caprio, and Ross Levine point out that:

The U.S. banking system is heavily supervised and regulated. The Fed, with an operating budget of \$4 billion, employed about 22,000 people at the start of 2010. The FDIC has a budget of \$4 billion and employs 6,000 people for the purposes of ensuring the safety and soundness of the nation’s banks. The OCC contributes another \$1 billion and 4,000 employees toward overseeing nationally chartered

¹ See Gretchen Morgenson, *Wake Up the Banking Police*, N.Y. TIMES, Dec. 15, 2013, http://www.nytimes.com/2013/12/15/business/wake-up-the-banking-police.html?_r=0 (“There were plenty of regulations on the books that could have been enforced to rein in reckless lenders. But the police force was disengaged, or worse, protecting the institutions it was supposed to oversee.”).

² Patrick McLaughlin & Robert Greene, *Did Deregulation Cause the Financial Crisis? Examining a Common Justification for Dodd-Frank*, MERCATUS CENTER (July 19, 2013), <http://mercatus.org/publication/did-deregulation-cause-financial-crisis-examining-common-justification-dodd-frank>.

banks. And these are just the federal regulators; there are also state supervisors of state-chartered banks in all the states.³

From these statistics, Barth, Caprio, and Levine draw the inevitable conclusion:

While it is perfectly reasonable to argue that supervision and regulation failed to work for us, it is demonstrably wrong to contend that banks were unsupervised and unregulated. This is important because popular accounts of the crisis erroneously argue that the free-markets approach to regulation failed. This is not true because we did not have free markets; there are extensive regulations in commercial banking. It is more correct to argue that the particular mixture of extensive regulation and enforcement actions (or lack thereof) that existed in the United States and in a number of other countries from 1996 through 2006 failed—not that free markets or capitalism failed to work for us.⁴

In fact, the two decades preceding the onset of the financial crisis in 2008 were a period of sustained legislative activity that gave federal regulators broad new powers over banks, mortgage lenders, and other financial services companies:

- The Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 (P.L. 102-242), the legislative response to the savings and loan crisis of the 1980s, was designed to strengthen bank supervision, enhance capital requirements, and promote safe and sound banking practices.⁵
- The Home Ownership and Equity Protection Act (HOEPA) of 1994 (P.L. 103-325) mandated detailed disclosures by lenders that make certain high-cost mortgage loans.
- The 2001 Bank Secrecy Act amendments made by the USA PATRIOT Act (P.L. 107-56) imposed extensive new reporting and due diligence requirements on banks.

³ JAMES R. BARTH, GERARD CAPRIO JR. & ROSS LEVINE, *GUARDIANS OF FINANCE: MAKING REGULATORS WORK FOR US* 88 (2012) [hereinafter *GUARDIANS OF FINANCE*].

⁴ *Id.*

⁵ FDICIA gave the FDIC the authority to take corrective action when it discovered problems at banks, but the FDIC failed to use this authority in the run-up to the crisis. FDICIA “was created to eliminate too much lenience being extended toward troubled, poorly capitalized institutions. . . . Yet the FDIC still failed to protect the nation’s banking system from systemic failure.” *Id.* at 112.

- The Sarbanes-Oxley Act of 2002 (P.L. 107-204), enacted in the wake of Enron and other corporate accounting scandals, sought to transform corporate governance practices and deter fraud by subjecting both corporate managers and boards of directors to a host of new duties and legal liabilities.
- The Fair and Accurate Credit Transactions Act of 2003 (P.L. 108-159) created new information-sharing, identity theft protection, and consumer disclosure mandates.

Moreover, beginning in 1988, U.S. banking regulators promulgated a series of regulations under the Basel Capital Accords that were intended to ensure that large, complex banking organizations operated with sufficient capital, but ended up having the exact opposite effect. Not only were those rules overly complex and costly, but their badly misguided “risk weights” encouraged banks to crowd into subprime mortgage-backed securities and other toxic assets that provided the dry tinder for the 2008 financial conflagration. Rather than making banks safer, the Basel rules made them more fragile.⁶

When viewed in this light, it becomes apparent that the financial crisis resulted not from a *lack* of regulation, but from bad or ineffective regulation, and the failures of regulators to use the tools they had. Among the regulatory failures that helped set the stage for the financial crisis and made it worse were the following:

- **The Government-Sponsored Enterprises.** Fannie Mae and Freddie Mac played an essential role in precipitating the financial crisis. Their hybrid public-private model wrapped a misguided public policy of promoting homeownership by aggressively securitizing and guaranteeing shoddily underwritten mortgages and selling them to investors in the secondary market with an implicit government guarantee to their

⁶ See generally JEFFREY FRIEDMAN & WLADIMIR KRAUS, ENGINEERING THE FINANCIAL CRISIS: SYSTEMIC RISK AND THE FAILURE OF REGULATION (2011).

bondholders that no matter what happened, the government stood behind them to ensure they would suffer no losses. This permitted the GSEs to borrow at artificially low rates and operate with minimal capital, while their politically connected executives collected hundreds of millions of dollars in salary and bonuses. When the bottom fell out of the subprime mortgage market, the government—as their creditors expected—stepped up with a rescue package in the hundreds of billions of dollars.⁷

- **The Securities and Exchange Commission’s Failed Oversight of Investment Banks.**

In 2004, the Securities and Exchange Commission (SEC) began overseeing investment banks and broker-dealers like Bear Stearns, Merrill Lynch, and Lehman Brothers under its “consolidated supervised entities” (CSE) program. Under the CSE program, the SEC allowed these investment banks to increase their leverage to dangerously high levels, yet devoted few resources to actually supervising them. While the investment banks benefited in the short term from the SEC’s lax oversight, the long-term costs to the taxpayer and the financial system became apparent in March 2008 when Bear Stearns collapsed and again in September 2008 when Merrill Lynch had to be rescued by Bank of America and Lehman Brothers failed.⁸

- **The Federal Reserve’s Failed Supervision of Bank Holding Companies.** Since 1956, the Federal Reserve has been responsible for supervising bank holding companies. In the case of the largest bank holding companies, including many of those that failed or came

⁷ See, e.g., GRETCHEN MORGENSON & JOSH ROSNER, RECKLESS ENDANGERMENT: HOW OUTSIZED AMBITION, GREED, AND CORRUPTION LED TO ECONOMIC ARMAGEDDON (2011); Edward J. Pinto, *How Fannie, Freddie and Politicians Caused the Crisis*, AMERICAN ENTERPRISE INST. (Jan. 12, 2012), <http://www.aei.org/article/economics/financial-services/housing-finance/how-fannie-freddie-and-politicians-caused-the-crisis/>.

⁸ See, e.g., Ben Protess, ‘Flawed’ SEC Program Failed to Rein in Investment Banks, PROPUBLICA (Oct. 1, 2008), <http://www.propublica.org/article/flawed-sec-program-failed-to-rein-in-investment-banks-101>; Stephen Labaton, *SEC Concedes Oversight Flaws Fueled Collapse*, N.Y. TIMES, Sept. 26, 2008, <http://www.nytimes.com/2008/09/27/business/27sec.html>.

close to failing during the crisis, the Federal Reserve had resident examiners embedded in the institutions. Yet the Federal Reserve failed to identify material weaknesses in these firms' operations and the risks lurking in their portfolios until it was far too late.⁹ As Columbia University Professor Charles Calomiris has observed, "The failure of supervisors and regulators to measure risk has been the rule rather than the exception in banking for the past three decades, in the United States and abroad."¹⁰

- **The Federal Reserve's Failure to Anticipate the Collapse of the Housing Market and Understand Its Consequences.** In March 2007, Federal Reserve Chairman Bernanke testified to Congress that "the impact on the broader economy and financial markets of the problems in the subprime markets seems likely to be contained."¹¹ As a result of the Federal Reserve's misplaced optimism in 2007, it failed to make plans for avoiding or minimizing the effect that the collapse of the subprime housing market would have on the financial system in 2008. Moreover, minutes of meetings of the Federal Open Market

⁹ One of the central risks to financial stability that the Federal Reserve misjudged involved assets held off-balance sheet, through so-called "structured investment vehicles" and other conduits, that were intended to circumvent accounting rules and regulatory capital standards and allow large, complex financial institutions to operate with greater leverage. By holding assets off-balance sheet, investment and commercial banks could avoid capital charges that would have applied had they held these assets on their balance sheets. When credit markets seized up in the summer of 2007, these off-balance sheet vehicles, many of them stuffed with subprime mortgage-backed securities, could not roll over their short-term funding, which left financial market participants unsure about the risk exposures of the financial institutions that sponsored these vehicles. As Howard Davies, the former director of the London School of Economics and Political Science explains, "The market was aware that some [of these off-balance sheet vehicles] had significant exposure to the subprime market, but the opacity of the structures meant there was considerable uncertainty about who was most exposed, which created a liquidity crisis in the market as a whole." HOWARD DAVIES, *The Financial Crisis: Who is to Blame?* 47 (2010). When short-term credit for these vehicles dried up, the large financial institutions that sponsored them were forced to bring the assets back onto their balance sheets and recognize the losses, fueling the crisis of confidence plaguing financial markets. Tim Geithner, who served during this period as the President of the New York Federal Reserve Bank, the primary federal regulator of many of the largest sponsors of off-balance sheet vehicles, acknowledged in his 2014 memoir that neither the institutions themselves nor the New York Fed understood how quickly losses from these investments could "boomerang" back onto their balance sheets. TIMOTHY F. GEITHNER, *STRESS TEST: REFLECTIONS ON FINANCIAL CRISES* 136 (2014).

¹⁰ Charles W. Calomiris, *An Incentive-Robust Program for Financial Reform*, 31 CATO J. 561, 570 (2011), available at <http://object.cato.org/sites/cato.org/files/serials/files/cato-journal/2011/9/cj31n3-10.pdf>.

¹¹ Colin Barr, *Bernanke's Biggest Blunders*, CNNMONEY, Feb. 1, 2011, <http://finance.fortune.cnn.com/2011/02/01/bernankes-biggest-blunders/>.

Committee during 2008, released in February 2014, demonstrate that the Federal Reserve failed to appreciate the magnitude of the financial crisis as it was unfolding.¹²

- **The Federal Reserve and the SEC’s Failure to Plan for Lehman’s Bankruptcy.** In March 2008, the investment bank Bear Stearns failed, and the Federal Reserve stepped in to bail out its creditors. Bear Stearns’s failure should have sent a signal to regulators that other investment banks whose business model was similar to Bear Stearns’s would also find themselves in danger of collapsing if financial conditions did not improve. After Bear Stearns’s failure, the Federal Reserve and the SEC installed personnel at Lehman Brothers to monitor its condition. In fact, in June 2008, Federal Reserve Vice-Chairman Donald Kohn e-mailed Federal Reserve Chairman Ben Bernanke that “One of the hedge fund types on Cape Cod told me that his colleagues think Lehman can’t survive—the question is when and how they go out of business not whether. He claimed this was a widely shared view on the Street.”¹³ Yet not only did the Federal Reserve and the SEC fail to plan for Lehman’s bankruptcy in September 2008, they also missed an accounting fraud that was going on even as they were embedded in Lehman’s headquarters.¹⁴
- **The Credit Rating Agencies.** Virtually every post mortem ever written about the causes of the financial crisis assigns a central role to the credit rating agencies. With the benefit of competitive advantages conferred upon them by the federal government, the rating

¹² See Binyamin Appelbaum, *Fed Misread Crisis in 2008, Records Show*, N.Y. TIMES, Feb. 21, 2014, <http://www.nytimes.com/2014/02/22/business/federal-reserve-2008-transcripts.html> (“The hundreds of pages of transcripts, based on recordings made at the time, reveal the ignorance of Fed officials about economic conditions during the climactic months of the financial crisis. Officials repeatedly fretted about overstimulating the economy, only to realize time and again that they needed to redouble efforts to contain the crisis.”).

¹³ E-mail from Donald Kohn, Vice Chairman, Fed. Reserve Bd. of Governors, to Benjamin Bernanke, Chairman, Fed. Reserve Bd. of Governors (June 13, 2008, 8:19 a.m.), <http://web.stanford.edu/~jbulow/Lehmandocs/docs/US%20TREASURY-BRD%20of%20GOV/FRB%20to%20LEH%20Examiner%20000781-000782.pdf>.

¹⁴ Andrew Ross Sorkin, *At Lehman, Watchdogs Saw It All*, N.Y. TIMES, Mar. 15, 2010, http://www.nytimes.com/2010/03/16/business/16sorkin.html?_r=0.

agency oligopoly freely bestowed triple A ratings on asset-backed securities comprised of unsustainable subprime mortgages, inflating the housing bubble and fueling speculative excesses in the financial markets. Investors could be forgiven for placing blind faith in the rating agencies' assessments of default risk and failing to conduct their own due diligence, since the agencies operated with the imprimatur of the federal government and under a statutory framework that placed the equivalent of a government "Good Housekeeping Seal of Approval" on their ratings.¹⁵

- **The Community Reinvestment Act.** Enacted in 1977, the Community Reinvestment Act began to have a marked effect on bank lending in 1995, when federal regulators promulgated rules for approving bank mergers that emphasized affordable housing goals. To meet these government mandates, banks relaxed their traditional underwriting standards, contributing to a downward spiral in mortgage credit quality that would have disastrous consequences.¹⁶

But perhaps the most significant regulatory failure dates back to 1984, when the government tacitly adopted the "too big to fail" doctrine in dealing with the failure of the Continental Illinois Bank and Trust Company.¹⁷ Government regulators deployed the "too big to

¹⁵ See generally Emily McClintock Ekins & Mark A. Calabria, *Regulation, Market Structure, and Role of the Credit Rating Agencies*, POL'Y ANALYSIS, Aug. 2012, available at <http://www.cato.org/sites/cato.org/files/pubs/pdf/PA704.pdf>.

¹⁶ See, e.g., Peter Wallison, *The True Origins of the Financial Crisis*, AM. SPECTATOR, Feb. 2009, available at <http://spectator.org/print/42211>; Stan J. Liebowitz, *Anatomy of a Train Wreck: Causes of the Mortgage Meltdown*, INDEP. POL'Y REV., Oct. 2009, available at http://www.independent.org/pdf/policy_reports/2008-10-03-trainwreck.pdf; Sumit Agarwal, Effi Benmelech, Nittai Bergman & Amit Seru, *Did the Community Reinvestment Act (CRA) Lead to Risky Lending?* (Nat'l Bureau of Econ. Research, Working Paper No. 18609, 2012), available at <http://www.nber.org/papers/w18609>.

¹⁷ When the government rescued Continental Illinois, Representative Stewart B. McKinney "declared that the government had created a new class of banks, those too big to fail." Eric Dash, *If It's Too Big to Fail, Is It Too Big to Exist?* N.Y. TIMES, June 20, 2009, <http://www.nytimes.com/2009/06/21/weekinreview/21dash.html>. As McKinney put it, "Let us not bandy words. We have a new kind of bank. It is called too big to fail. T.B.T.F., and it is a wonderful bank." James Surowiecki, *Too Dumb to Fail*, NEW YORKER, Mar. 31, 2008, http://www.newyorker.com/talk/financial/2008/03/31/080331ta_talk_surowiecki.

fail” doctrine in full force during the 2008 financial crisis, using hundreds of billions of dollars to shore up the financial system.

Continental Illinois

Following a business model that eerily foreshadowed that of many institutions in 2008, Continental Illinois pursued an aggressive growth strategy funded by borrowing cheaply on the wholesale funding market. After billions of dollars of its loans went bad, Continental Illinois, at the time the seventh largest bank in the U.S. as measured by deposits, found itself on the wrong end of what the FDIC described as a “high-speed electronic bank run.” Fearing that the failure of Continental Illinois would lead to the collapse of the entire banking system, the FDIC extended billions of dollars in aid to protect uninsured depositors and creditors, and the federal government took an 80% interest in Continental Illinois, which it held for seven years. In 1994, Bank of America acquired Continental Illinois, bringing down the curtain on the first act in the “too big to fail” drama but setting the stage for another.

Long-Term Capital Management

The second act in the “too big to fail” drama unfolded in 1998 with the near-failure—and rescue—of Long-Term Capital Management (LTCM), a highly-leveraged hedge fund that regulators feared would bring down the financial system if it were permitted to suffer the consequences of its losing bets on interest-rate derivatives. Concerned about LTCM’s liquidity and the severe strains that would be put on financial markets if LTCM began unwinding its positions, the President of the Federal Reserve Bank of New York—with then-Federal Reserve Chairman Alan Greenspan’s blessing—called a meeting of all of LTCM’s major banks and prime brokers to get them to work on a solution to the problem. Unlike the bailout of Continental Illinois—which ultimately cost the government \$1.1 billion—the LTCM rescue did

not cost the government a penny: the costs of the LTCM bailout were covered by its creditors. Nonetheless, the LCTM rescue reinforced the lesson of Continental Illinois: government could—and would—intervene if it feared that the failure of a firm would jeopardize the financial system.¹⁸ As George Mason University economics professor Tyler Cowen explains:

At the time, it may have seemed that regulators did the right thing. The bailout did not require upfront money from the government, and the world avoided an even bigger financial crisis. Today, however, that ad hoc intervention by the government no longer looks so wise. With the Long-Term Capital bailout as a precedent, creditors came to believe that their loans to unsound financial institutions would be made good by the Fed—as long as the collapse of those institutions would threaten the global credit system.

[. . .]

[The Long-Term Capital episode] was important precisely because the fund was not a major firm. At the time of its near demise, it was not even a major money center bank, but a hedge fund with about 200 employees. Such funds hadn't previously been brought under regulatory protection this way. After the episode, financial markets knew that even relatively obscure institutions—through government intervention—might be able to pay back bad loans.¹⁹

Professor Cowen argues that if the government had refused to intervene in LTCM's rescue, creditors might have learned that "bad loans to overleveraged institutions would mean losses, and that neither the Fed nor the Treasury would make those losses good." Had creditors learned that lesson, there might not have been a financial crisis in 2008, because creditors would not have made those loans. Instead, creditors learned that as long as they could persuade the government that an institution was "systemic"—and LTCM's relatively small size showed that

¹⁸ The fact that the government did not expend any funds to carry out the LTCM rescue operation does not detract from its importance in the evolution of the "too big to fail" doctrine. As Philadelphia Federal Reserve Bank President Charles Plosser recently explained, "For this moral hazard to exist, it doesn't matter if the taxpayer or the private sector provides the funds. What matters is that creditors are protected, in part, if not entirely." Charles Plosser, *A Limited Central Bank*, Address Before the Cato Institute's 31st Annual Monetary Conference: Was the Fed a Good Idea? 11 (Nov. 14, 2013) [hereinafter Plosser Address to the Cato Inst.], http://www.phil.frb.org/publications/speeches/plosser/2013/11-13-13_cato-institute.pdf.

¹⁹ Tyler Cowen, *Bailout of Long-Term Capital: A Bad Precedent?* N.Y. TIMES, Dec. 26, 2008, <http://www.nytimes.com/2008/12/28/business/economy/28view.html>.

that was very low bar indeed—they had reason to hope that the taxpayers would rescue them from the consequences of their poor lending decisions.

Bear Stearns

These lessons were driven home with a vengeance in the spring of 2008, when the New York Federal Reserve rode to the rescue of Bear Stearns’s creditors. In March 2008, Bear Stearns—an investment bank which had gambled heavily on the subprime mortgage market and which financed itself with cheap, very short-term credit—found itself hemorrhaging cash. Fearing that Bear’s failure would devastate critical financial markets and perhaps bring down other firms, on Friday, March 14, the Federal Reserve Board voted to extend Bear Stearns \$13 billion to get it through the weekend, using JPMorgan Chase as an intermediary, pursuant to the Federal Reserve’s authority under Section 13(3) of the Federal Reserve Act to lend in “unusual and exigent circumstances.” A few days later, the Federal Reserve Board voted to make \$29 billion in funding available to help JPMorgan Chase purchase Bear Stearns, again using its 13(3) authority.²⁰

With support from the Federal Reserve, JPMorgan Chase offered to buy all of Bear Stearns’s common stock for \$2 a share, which it later raised to \$10. Because Bear Stearns’s stock had been trading as high as \$93 a share in February, Bear’s management and its shareholders did not see the Federal Reserve’s intervention or JPMorgan Chase’s offer as a

²⁰ The likelihood of the government being able to persuade a healthy institution to purchase a failing one in a future crisis—as it did in the case of Bear Stearns and several other “shotgun marriages” of large financial institutions during the fall of 2008—has been substantially reduced by recent government enforcement actions against firms for the pre-merger conduct of the companies they acquired during the last crisis. No less an authority than former Committee Chairman Barney Frank has criticized government attempts to hold firms liable for wrongdoing by institutions they purchased at the government’s urging: “The decision now to prosecute JPMorgan Chase because of activities undertaken by Bear Stearns before the takeover unfortunately fits the description of allowing no good deed to go unpunished.” Aruna Viswanatha, *Barney Frank cries foul in government’s lawsuit against JPMorgan*, REUTERS, Oct. 22, 2012, <http://www.reuters.com/article/2012/10/23/us-jpmorgan-frank-idUSBRE89L1KI20121023>.

“bailout.” Bear’s CEO alone lost about a billion dollars as well as his job, Bear was absorbed into JPMorgan Chase, and many Bear employees lost their jobs as well.

But there *was* a bailout: Bear Stearns’s creditors were bailed out, even though its management and its shareholders paid the price for its failure.

The government’s intervention in Bear Stearns marked a significant expansion of the “too big to fail” doctrine for several reasons. First, Bear Stearns was an investment bank, not a commercial bank. It had never been supervised by the Federal Reserve, and by deciding to rescue it, Federal Reserve officials extended the Fed’s safety net beyond the banking system. The rescue of LTCM implied to market participants that the Federal Reserve *might* rescue the creditors of a non-bank firm, even if the Federal Reserve had no regulatory authority over the firm and did not supervise it. Ten years later, the Bear Stearns bailout confirmed that the Federal Reserve *would* rescue the creditors of a non-bank firm. Former Federal Reserve economist Vincent Reinhart publicly described the decision to rescue Bear Stearns’s creditors as “the worst policy mistake in a generation,” and predicted that it would set a bad precedent: after the Bear Stearns rescue, any time a large financial institution teetered on the brink of failure, the Federal Reserve would be expected to bring money to the table.²¹

Second, the Bear Stearns bailout showed that a firm did not have to be “big” for its creditors to benefit from the “too big to fail” doctrine. Although Bear Stearns was large, it was much smaller than many other financial institutions. Bear Stearns had only \$395 billion in assets as of November 2007, compared to \$691 billion held by the next largest investment bank, which happened to be Lehman Brothers. If Bear Stearns was “too big to fail,” then *a fortiori* Lehman

²¹ David Wessel, IN FED WE TRUST: BEN BERNANKE’S WAR ON THE GREAT PANIC 174 (2009). Former FDIC Chairman Sheila Bair has weighed in to the same effect, telling the *New York Times* in an interview shortly before leaving office: “I think that the Bear deal set up an expectation for government intervention that was really not helpful” and that “They should have let Bear Stearns fail.” Joe Nocera, *Sheila Bair’s Bank Shot*, N.Y. TIMES, July 9, 2011, http://www.nytimes.com/2011/07/10/magazine/sheila-bairs-exit-interview.html?pagewanted=all&_r=0.

Brothers was “too big to fail.” In fact, in December 2007, there were 16 financial firms that were bigger than Bear Stearns. As Princeton economist and former Federal Reserve Vice Chairman Alan Blinder puts it, “If you had taken a poll on the question in February 2008, I believe that most observers would have judged that Bear Stearns was *below* the too big to fail threshold. I know I did.”²²

Third, the Bear Stearns bailout created moral hazard among creditors who had made money by providing cheap credit to aggressive, risk-chasing institutions. Not only do creditors benefit from the heads-I-win, tails-you-lose payoffs that results from creditor bailouts, the Bear Stearns bailout encouraged creditors to keep lending and to lend even more to “too big to fail” institutions, both of which make future crises more likely.²³

When Bear Stearns found itself on the brink of failure in March 2008, government officials could have sent a clear message and ended the doctrine of “too big to fail” by refusing to rescue the creditors of Bear Stearns. Or government officials could have planned for the next big financial institution to fail, arranging in advance for a bankruptcy that imposed losses on creditors without bringing down the financial system. But government officials chose to do neither, further entrenching the market perception that the government would always ride to the

²² Alan Blinder, *AFTER THE MUSIC STOPPED: THE FINANCIAL CRISIS, THE RESPONSE, AND THE WORK AHEAD* 112 (2013).

²³ See Renee Hamilton & Jeffrey Lacker, *Should the Fed do Emergency Lending?* 1 (Fed. Reserve Bank of Richmond, Economic Brief, 2014), https://www.richmondfed.org/publications/research/economic_brief/2014/pdf/eb_14-07.pdf (“Given the costs of emergency lending—in terms of increasingly prevalent moral hazard and risk-taking in the financial system and the likelihood of political entanglements that compromise the Fed’s monetary policy independence—there is a strong argument for scaling back the Fed’s authority to conduct emergency lending.”). Minutes of meetings of the Federal Open Market Committee (FOMC) released on February 21, 2014, reflect virtually no discussion or recognition of the moral hazard created by the Fed’s interventions in 2008. For example, at a March 18, 2008, FOMC meeting held just two days after the Bear Stearns bail-out, “almost no concerns were raised . . . that by aiding this brokerage firm, other firms would assume that the government would also come to their rescue.” Gretchen Morgenson, *A New Light on Regulators in the Dark*, N.Y. TIMES, Feb. 23, 2014, <http://www.nytimes.com/2014/02/23/business/a-new-light-on-regulators-in-the-dark.html>.

rescue of creditors and counterparties of large, complex financial institutions, and setting the stage for the calamitous events of September 2008.

The Government-Sponsored Enterprises

On September 6, 2008, after decades of poor and dangerous regulation, the government-sponsored enterprises Fannie Mae and Freddie Mac were taken over by the federal government to prevent their collapse. Treasury purchased \$1 billion of senior preferred stock in each GSE, and was granted the option to purchase 79.9 percent of each of the GSEs' common stock.

Treasury also established a \$200 billion facility to purchase senior preferred stock in the GSEs to backstop their losses. In February 2009, the Obama Administration raised this commitment to \$400 billion. In addition to the initial \$2 billion commitment, the GSEs drew nearly \$187.5 billion from Treasury—\$116.1 billion by Fannie Mae and \$71.3 billion by Freddie Mac—making the conservatorship of the GSEs by far the costliest of all taxpayer bail-outs over the past five years.

Lehman Brothers

On September 15, 2008—five months after the Federal Reserve intervened to avert Bear Stearns's failure and a few days after the Treasury Department bailed out the GSEs—the government suddenly changed course: government officials decided that an investment bank that was twice the size of Bear Stearns was *not* “too big to fail” and let it fail. According to press reports, in September 2008, Secretary Treasury Hank Paulson told Federal Reserve Chairman Ben Bernanke and New York Federal Reserve President Timothy Geithner that “he would not support spending taxpayers' money—the Fed's included—to save Lehman.” As Secretary Paulson put it, “I'm being called Mr. Bailout. I can't do it again.”²⁴

²⁴ Wessel, *supra* note 21, at 174.

While Secretary Paulson’s commitment to market discipline in deciding not to intervene to rescue Lehman Brothers may have been commendable, unfortunately the time to draw a line in the sand would have been in March 2008, not September. As Professor Blinder explains, Bear Stearns

had, indeed, established a precedent. Call it moral hazard if you wish, though not many financial companies aspire to go the way of Bear. But whatever you call it, the market had acquired the view that the government was not going to let any financial giant fall messily. . . . The Lehman decision abruptly and surprisingly tore the perceived rulebook into pieces and tossed it out the window. Market participants were thus cut adrift, no longer knowing what game they were playing. That’s a formula for panic, for the replacement of greed by fear—which is exactly what happened on Lehman Day, September 15, 2008.²⁵

By Lehman Day, it was too late. Spooked by the government’s inability to articulate a coherent basis for its *ad hoc* interventions, markets in a wide range of asset classes seized up, and set the financial crisis in motion. Responding to the panic that it had created, the government again changed tack, and adopted a new strategy: “no more Lehmans,” or “when in doubt, bail it out.”

American International Group

On Monday, September 15, the government let Lehman fail. On Tuesday, September 16, the Federal Reserve again exercised its authority under Section 13(3) of the Federal Reserve Act to extend an \$85 billion loan to the insurance conglomerate American International Group (AIG). The Federal Reserve’s loan commitment to AIG eventually reached \$182 billion. As collateral for the loan, the Federal Reserve took assets of the parent company, the stock of most of AIG’s regulated insurance subsidiaries, and convertible preferred stock that would have given the Federal Reserve ownership of 79.9 percent of AIG.

²⁵ Blinder, *supra* note 22, at 128.

AIG was brought to its knees by the activities of its London subsidiary AIG Financial Products (AIG FP), whose business model was based on selling underpriced credit-default swaps on subprime-mortgage-backed securities to financial institutions, many of which were buying this insurance to avoid holding greater capital against these assets.²⁶ When times were good, AIG FP generated enormous profits for its parent company: it collected premiums for insuring mortgage-backed securities and never had to pay out. But when times turned bad, AIG was called upon to post collateral against the credit-default swaps that its subsidiary had written. The collateral calls became so great that the credit rating agencies downgraded AIG's AAA credit rating, which triggered even more collateral calls, which pushed AIG into insolvency.

In Chairman Bernanke's words, "There was no oversight of the Financial Products division. This was a hedge fund, basically, that was attached to a large and stable insurance company, made huge numbers of irresponsible bets—took huge losses." Contrary to Chairman Bernanke's suggestion, however, regulators had not only ample opportunity but the responsibility to oversee AIG Financial Products, as they did with all of the other financial institutions that failed or came close to failing during the financial crisis.²⁷ But as with these other institutions, the regulators failed to exercise the authority they had to oversee AIG FP. AIG was subject to consolidated federal supervision, under the auspices of the Office of Thrift Supervision (OTS), and its Acting Director acknowledged in testimony to Congress that the OTS failed to adequately supervise AIG

²⁶ The story of AIG's failure and its bailout has been recounted in numerous places. *See, e.g.*, Blinder, *supra* note 22; Roger Lowenstein, *THE END OF WALL STREET* (2010); Andrew Ross Sorkin, *TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM—AND THEMSELVES* (2009).

²⁷ *See generally* GUARDIANS OF FINANCE, *supra* note 3.

and its runaway subsidiary.²⁸ Chairman Bernanke nonetheless justified the bailout of AIG, saying “We had no choice but to try to stabilize the system because of the implications that the failure would have had for the broad economic system.”²⁹

Yet the bailout of AIG was not about saving AIG so much as it was bailing out the creditors and counterparties of its London subsidiary—large U.S. financial institutions, such as Goldman Sachs and Merrill Lynch, and foreign banks, like Deutsche Bank and BNP Paribas.³⁰ The Federal Reserve kept AIG FP up and running, and paid these counterparties off 100 cents on the dollar, all in the name of preserving financial stability.

Troubled Asset Relief Program

In the immediate aftermath of Lehman Brothers’ failure and AIG’s bail-out, the Bush Administration and the Federal Reserve turned to Congress, requesting immediate passage of emergency legislation to stabilize the financial system. In making the case for action, Federal Reserve Chairman Bernanke told a group of congressional leaders on Thursday, September 18, 2008, that if they did not act, “There will be no economy on Monday.”³¹ After one failed attempt, Congress passed the law that established the

²⁸ *American International Group: Examining What Went Wrong, Government Intervention, and Implications for Future Regulation: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. 50 (2009) (prepared statement of Scott M. Polakoff, Acting Director, Office of Thrift Supervision), available at <http://www.gpo.gov/fdsys/pkg/CHRG-111shrg51303/pdf/CHRG-111shrg51303.pdf>.

²⁹ Brady Dennis, *Bernanke Blasts AIG for ‘Irresponsible Bets’ that Led to Bailouts*, WASH. POST, Mar. 4, 2009, http://articles.washingtonpost.com/2009-03-04/business/36922308_1_aig-bailout-aig-situation-american-international-group.

³⁰ The bail-out of AIG’s foreign bank counterparties represented a small fraction of the support that the Federal Reserve provided to global banks during the crisis. For example, as of December 2008, the Fed had extended “liquidity swap lines” totaling \$580 billion to 14 foreign central banks, which in turn lent those funds to private banking institutions. See Neil Irwin, *Fed’s Aid in 2008 Crisis Stretched Worldwide*, N.Y. TIMES, Feb. 23, 2014, <http://www.nytimes.com/2014/02/24/business/feds-aid-in-2008-crisis-stretched-worldwide.html>.

³¹ *Interview: Barney Frank*, FRONTLINE (Feb. 17, 2009), <http://www.pbs.org/wgbh/pages/frontline/meltdown/interviews/frank.html>.

Troubled Asset Relief Program, popularly known as TARP. TARP allowed the U.S. Treasury to purchase or insure up to \$700 billion of “troubled assets.”

It soon became apparent to Treasury officials that the original plan of buying “troubled assets” from financial institutions was unworkable. Instead, Treasury officials announced that they would begin buying preferred stock and warrants in America’s nine largest banks. Eventually, the Bush and Obama Administrations would invest some \$416 billion in U.S. financial institutions, including Citigroup, Bank of America, JPMorgan Chase, Wells Fargo, Goldman Sachs, and Morgan Stanley, as well as hundreds of smaller institutions, some of which have still not paid the government back.

Other Government Programs to Stabilize the Financial System

TARP’s \$700 billion was an eye-popping sum. But it was a small fraction of the amount that the U.S. government—through various programs created by the Treasury, Federal Reserve, and Federal Deposit Insurance Corporation (FDIC)—committed to keep financial institutions from failing. In March 2009, *Bloomberg* estimated that the government had committed \$12.8 trillion to prop up the financial system.³² To put those figures in perspective, *Bloomberg* calculated that \$12.8 trillion worked out to \$42,105 for every man, woman, and child in the United States. Or viewed another way: \$12.8 trillion was 90% of the nation’s gross domestic product in 2008. In July 2009, the Special Inspector General for the Troubled Asset Relief Program estimated that the

³² Mark Pittman & Bob Ivry, *Financial Rescue Nears GDP as Pledges Top \$12.8 Trillion*, BLOOMBERG, Mar. 31, 2009, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=armOzfkwtCA4>.

government had rolled out a \$23.7 trillion safety net to keep the financial system from capsizing.³³

The Legacy of 2008's Financial Rescues: Entrenching "Too Big to Fail"

Although undertaken to stem a financial crisis, the bailouts carried out by the government in 2008 enshrined the "too big to fail" doctrine as a central feature of U.S. financial regulation. Government officials may have saved some financial firms in the short-term, but over the long-term, those bailout measures would weaken the financial system in several ways.

The problems with a system in which government regulators deem certain financial institutions as "too big to fail" are legion. First, "too big to fail" creates perverse incentives: if government officials and regulators in any way create the impression that some institutions are "systemically important," the inevitable conclusion that market participants will draw is that government will likely bail out its creditors in an emergency. That implicit guarantee allows the bank to borrow more cheaply than its smaller competitors. Second, the "too big to fail" doctrine makes the financial system even more fragile, which in turn makes bailouts more likely: the prospect of government bailouts makes creditors indifferent to the bets that financial institutions are making with the funds they borrow, which further increases risk in the financial system.³⁴ Third, "too big to fail" violates the basic tenets of a free enterprise system. It interrupts the normal operation of markets and rewards the imprudent and reckless while punishing the prudent and productive; it undermines equal treatment and the rule of law by privatizing profits and

³³ OFFICE OF THE SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, QUARTERLY REP. TO CONGRESS 137 (July 21, 2009), *available at* http://www.sigarp.gov/Quarterly%20Reports/July2009_Quarterly_Report_to_Congress.pdf.

³⁴ Jeffrey Lacker, the President of the Richmond Federal Reserve, has described "too big to fail" as consisting of "two mutually reinforcing problems. First, creditors of some financial institutions feel protected by an implicit government commitment of support should the institution become financially troubled. Second, policymakers often feel compelled to provide support to certain financial institutions to insulate creditors from losses." Ending 'Too Big to Fail' Is Going to be Hard Work, Address at the Global Society of Fellows Conference 1-2 (May 9, 2013), https://www.richmondfed.org/press_room/speeches/president_jeff_lacker/2013/pdf/lacker_speech_20130409.pdf.

socializing losses; and it undermines public faith in the economic system by failing to hold businesses and individuals accountable for the consequences of their actions.

The aftermath of the financial crisis might have been an opportunity to reconsider and reject the “too big to fail” doctrine. Instead, the Dodd-Frank Act codified “too big to fail” and made it a permanent part of the regulatory toolkit.

Why the Committee Has Prepared this Report

The Committee undertook this review of the Dodd-Frank Act’s effectiveness in ending “too big to fail” for several reasons. First, the Rules of the House of Representatives direct the Committee to examine “on a continuing basis” the application, administration, and effectiveness of the statutes within its jurisdiction, including the Dodd-Frank Act.³⁵ Second, as outlined in greater detail throughout this report, a significant and growing number of financial experts, regulators, and market participants are beginning to think that the Dodd-Frank Act has failed to accomplish its objectives, and that rather than ending the practices that led to the financial crisis, the Dodd-Frank Act instead made them a permanent part of the regulatory toolkit. They fear that the Dodd-Frank Act gives even greater authority and responsibility to the same regulators who failed to anticipate the crisis in the first place, and whose failures worsened the crisis.³⁶ They also fear that rather than ending once and for all the expectations that government will come to the rescue of large financial institutions, the Dodd-Frank Act has encouraged those expectations by empowering the regulators to design a resolution

³⁵ Rules of the House of Representatives, Rule X (113th Cong.).

³⁶ See Gretchen Morgenson, *Wake Up the Banking Police*, N.Y. TIMES, Dec. 15, 2013, <http://www.nytimes.com/2013/12/15/business/wake-up-the-banking-police.html> (“Regulators for the most part have not been held accountable for their woeful performance in the years leading up to the financial debacle. Instead, they have received even greater powers.”).

regime that specifically “downstreams liquidity” through a failing holding company to its subsidiaries

After reviewing academic and professional literature and consulting financial regulators, market participants, and others, the Government Accountability Office (“GAO”) concluded in January 2013 that there is “no clear consensus on the extent to which, if at all, the Dodd-Frank Act will help reduce the probability or severity of a future crisis.”³⁷ And Cornelius Hurley, a former senior official at the Federal Reserve, categorically rejects the notion that the Dodd-Frank Act solved the “too big to fail” problem:

If the whole purpose of Dodd-Frank was to eliminate this concept of too-big-to-fail and you judge it by that standard, then it’s a failure. If I had to give it a grade, I’d give it a D.³⁸

Members of Congress have also grown increasingly concerned about the Dodd-Frank Act’s operation and effectiveness. Democratic Members of the Committee have introduced or co-sponsored legislation that would require or otherwise cause financial institutions to divest assets or operations, which implies that they believe that the Dodd-Frank Act has failed to end “too big to fail” despite its new regulatory standards and its “Orderly Liquidation Authority.” In April 2013, Representative Sherman introduced a bill that would require the Treasury Secretary to designate and break up “too big to fail” financial institutions, arguing that such institutions were able to borrow funds at artificially low rates because they benefited from a perceived government backstop.³⁹ In June 2013, Representative Capuano introduced legislation that would

³⁷ GOV’T ACCOUNTABILITY OFFICE, FINANCIAL REGULATORY REFORM: FINANCIAL CRISIS LOSSES AND POTENTIAL IMPACTS OF THE DODD-FRANK ACT 33 (2013), available at <http://www.gao.gov/assets/660/651322.pdf>.

³⁸ Nancy Cook, *The Fed’s Last Troublemaker*, NAT’L J., Oct. 31, 2013, <http://www.nationaljournal.com/magazine/the-fed-s-last-troublemaker-20131031>.

³⁹ Press Release, Congressman Sherman and Senator Sanders Stand Together in Support of “Too Big to Fail, Too Big to Exist,” Apr. 9, 2013, <http://sherman.house.gov/media-center/press-releases/congressman-sherman-and-senator-sanders-stand-together-in-support-of-too>.

require banks to hold additional capital in an amount equal to the “subsidy” enjoyed by each firm as a result of the market’s perception of government support.⁴⁰

Democratic Members of the Committee have also expressed skepticism that in the midst of a crisis, policymakers would abide by the restrictions put in place by the Dodd-Frank Act to end bailouts because policymakers would have strong incentives to do anything necessary to limit the costs to society that might result from an institution’s failure.⁴¹ Those fears are well-founded, given comments that then-Treasury Secretary Timothy Geithner made to the Special Inspector General for the Troubled Asset Relief Program (SIGTARP). As the SIGTARP wrote in a January 2011 report:

Secretary Geithner told SIGTARP, while the Dodd-Frank Act gives the Government “better tools,” and reduced the risk of failures, “[i]n the future we may have to do exceptional things again” if the shock to the financial system is sufficiently large. Secretary Geithner’s candor about the prospect of having to “do exceptional things again” in such an unknowable future crisis is commendable. At the same time, it underscores a TARP legacy, the moral hazard associated with the continued existence of institutions that remain “too big to fail.”⁴²

Members of the Senate Banking Committee have also introduced legislation premised upon a belief that the Dodd-Frank Act did not solve the “too big to fail”

⁴⁰ Ronald D. Orol, *Effort to break up big banks rolls on with Rep. Capuano bill*, WALL ST. J. MARKETWATCH (June 6, 2013, 10:01 AM), <http://blogs.marketwatch.com/capitolreport/2013/06/06/effort-to-break-up-big-banks-rolls-on-with-rep-capuano-bill/>.

⁴¹ See, e.g., *Who is Too Big to Fail: Does Title II of the Dodd-Frank Act Enshrine Taxpayer-Funded Bailouts? Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Fin. Services*, 113th Cong. 3 (2013) [hereinafter *Oversight Subcomm. Hearing on the OLA*] (statement of Rep. Sherman) (“They [financial institutions in 2008] were credibly able to tell the country that if we didn’t bail them out, they would take us down with them, and as long as there are institutions that can credibly make that claim, we have seen once that Congress is willing to pass whatever statute eventually they propose.”); *Id.* at 15 (exchange between Rep. Cleaver and Joshua Rosner, Managing Director, Graham Fisher & Co.) (Mr. Cleaver: [I]n an economic crisis, do you think that we will discard again the rule of law? [. . .] Mr. Rosner: The answer, unfortunately, I think is yes if we continue down the path that we are heading down.”).

⁴² OFFICE OF THE SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, *Introduction to EXTRAORDINARY FINANCIAL ASSISTANCE PROVIDED TO CITIGROUP, INC.* (2011), available at <http://www.sig tarp.gov/Audit%20Reports/Extraordinary%20Financial%20Assistance%20Provided%20to%20Citigroup,%20Inc.pdf>.

problem.⁴³ Notwithstanding that the Dodd-Frank Act promised to end taxpayer-funded bailouts,⁴⁴ these legislative initiatives reflect a broad consensus across political and ideological lines that the Dodd-Frank Act has failed to end the “too big to fail” problem and may have made it worse.

Finally, Congressional oversight is particularly appropriate in this instance because the Dodd-Frank Act was conceived in the midst of the financial crisis and enacted shortly after the most acute phase of the crisis ended. The Obama Administration proposed that Congress establish a new resolution regime in March 2009 and more fully described suggested reforms in a white paper released in June of that year, even as the government continued to employ extraordinary measures it believed were necessary to keep distressed markets functioning.⁴⁵ Judge Richard Posner described the Administration’s legislative proposals as premature because, as he put it, they “advocated a course of treatment for a disease the causes of which had not been discovered, or at least acknowledged. . . . [I]n the case of the economic crisis of 2007-2010, unless the causes of a problem are well understood an effective solution is unlikely.”⁴⁶

⁴³ On April 24, 2013, Senators Sherrod Brown and David Vitter introduced legislation that would, among other things, impose new capital requirements on large financial institutions in order to “prevent any one financial institution from becoming so large and overleveraged that it could put our economy on the brink of collapse or trigger the need for a federal bailout.” Press Release, Brown, Vitter Unveil Legislation That Would End “Too Big to Fail” Policies (Apr. 24, 2013), <http://www.brown.senate.gov/newsroom/press/release/brown-vitter-unveil-legislation-that-would-end-too-big-to-fail-policies>. In unveiling the legislation, Senator Brown argued that “[t]he truth, according to the markets, is that ‘too big to fail’ is alive and well with the Wall Street megabanks.” *Id.* On July 11, 2013, Senators Elizabeth Warren, John McCain, Maria Cantwell, and Angus King introduced the “21st Century Glass-Steagall Act,” which would “separate traditional banks that have savings and checking accounts and are insured by the Federal Deposit Insurance Corporation from riskier financial institutions that offer services such as investment banking, insurance, swaps dealing, and hedge fund and private equity activities.” Press Release, Senators Warren, McCain, Cantwell, and King Introduce 21st Century Glass-Steagall Act (July 11, 2013), http://www.warren.senate.gov/?p=press_release&id=178. “Despite the progress we’ve made since 2008,” Senator Warren noted, “the biggest banks continue to threaten the economy.” *Id.*

⁴⁴ Dodd-Frank Wall Street Reform and Consumer Protection Act § 214, 12 U.S.C. § 5394 (2012).

⁴⁵ See *The Financial Crisis: A Timeline of Events and Policy Actions*, FEDERAL RESERVE BANK OF ST. LOUIS, <http://timeline.stlouisfed.org/pdf/CrisisTimeline.pdf> (last visited July 14, 2014) (describing actions taken by the federal government during and after the financial crisis up to and including in 2009).

⁴⁶ Richard A. Posner, *THE CRISIS OF CAPITALIST DEMOCRACY* 166 (2010).

In fact, in its rush to pass financial reform, Congress enacted the Dodd-Frank Act before the “Financial Crisis Inquiry Commission” it created to examine the causes of the crisis had even issued its statutorily mandated report, standing the normal legislative process of fact-finding followed by policy-making on its head.⁴⁷ Now that the exigencies of the financial crisis have receded, the Committee has not only the opportunity but also the responsibility to assess whether the Dodd-Frank Act addressed the risks that precipitated the crisis, grounding its assessment on reason and experience rather than fear and emotion.⁴⁸

Scope of the Committee’s Review of the Dodd-Frank Act—Prior Hearings

This report’s assessment of the Dodd-Frank Act is based on a series of hearings conducted by the Committee and its Subcommittee on Oversight and Investigations from March 2013 to July 2013 (collectively, the “Committee Hearings”) at which eighteen witnesses representing a broad range of viewpoints testified.⁴⁹ Representatives of the Department of

⁴⁷ One consequence of this “rush to legislate” is that many of the provisions in the Dodd-Frank Act are impossibly vague and ambiguous, complicating the efforts of regulators to write the 400 new rules required by the law. For example, in a recent opinion upholding the Federal Reserve’s interpretation of the so-called “Durbin Amendment,” which caps the interchange fees that can be charged on debit-card transactions, the U.S. Court of Appeals for the D.C. Circuit wrote: “Perhaps unsurprising given that the Durbin amendment was crafted in conference committee at the eleventh hour, its language is confusing and its structure convoluted. But because neither agencies nor courts have authority to disregard the demands of even poorly drafted legislation, we must do our best to discern Congress’s intent and to determine whether the [Federal Reserve’s] regulations are faithful to it.” *NACS v. Bd. of Governors of the Fed. Reserve Sys.*, No. 13-5270, slip op. at 14 (D.C. Cir. Mar. 21, 2014).

⁴⁸ The Committee conducted extensive oversight of matters relating to the Dodd-Frank Act, the financial crisis, and housing reform in the 112th and 113th Congresses. In addition to the Committee Hearings that are the subject of this report, the Committee held in excess of 70 hearings on such matters through July 2014, in which hundreds of witnesses representing a variety of ideological viewpoints testified.

⁴⁹ See *Who is Too Big to Fail? GAO’s Assessment of the Financial Stability Oversight Council and the Office of Financial Research: Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Fin. Services*, 113th Cong. (2013); *Who is Too Big to Fail: Does Dodd-Frank Authorize the Government to Break Up Financial Institutions: Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Fin. Services*, 113th Cong. (2013) [hereinafter *Hearing on Regulators’ Authority to Break Up Financial Institutions*]; *Oversight Subcomm. Hearing on the OLA*, *supra* note 41; *Who is Too Big to Fail: Are Large Financial Institutions Immune from Federal Prosecution? Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Fin. Services*, 113th Cong. (2013); *Examining How the Dodd-Frank Act Could Result in More Taxpayer-Funded Bailouts: Hearing Before the H. Comm. on Fin. Services*, 113th Cong. (2013) [hereinafter *Hearing on Taxpayer-Funded Bailouts under Dodd-Frank*]; *Examining Constitutional and Legal Uncertainties in the Dodd-Frank Act: Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Fin. Services*, 113th Cong. (2013) [hereinafter *Hearing on Dodd-Frank’s Constitutional and Legal Uncertainties*].

Justice, the FDIC, the Federal Reserve, the Financial Stability Oversight Council (“FSOC”), the Office of Financial Research (“OFR”), and the GAO were among the witnesses who testified, as were two Federal Reserve Bank presidents and former senior officials from federal banking regulatory agencies. The Committee Hearings examined the following subjects:

- The FSOC and OFR and weaknesses and flaws in their operation and structure;
- The authority of federal regulators under the Dodd-Frank Act to break up financial institutions because of their size or risk to the financial system;
- The FDIC’s bailout authority under the “Orderly Liquidation Authority” and the continued existence of “too big to fail”;
- The Department of Justice’s prosecutorial decision-making in cases involving financial institutions that it believes are “too big to fail”; and
- Constitutional infirmities inherent in the Dodd-Frank Act that might lead to its invalidation or that could render it inoperative in the midst of a financial crisis.

Analysis of Title I of the Dodd-Frank Act

Title I of the Dodd-Frank Act purports to reduce the risk to the economy posed by large, complex financial institutions through a “macro-prudential” approach designed to make them less likely to fail, and easier to resolve in the event that they do fail. In order to carry out this approach, Title I established the FSOC and the OFR and charged them with the task of identifying risks to financial stability and addressing them before they threatened the broader economy. It also conferred authority on the regulators to designate firms for “heightened prudential supervision,” and to restrict those firms’ activities and require them to divest assets if

they cannot demonstrate that they can be safely resolved in bankruptcy.⁵⁰ And it authorized the Federal Reserve to restrict a firm’s activities or break it up if the Federal Reserve determines—and the FSOC agrees—that a firm poses a “grave threat” to the financial system.⁵¹ This section of the report analyzes these provisions of the Dodd-Frank Act to determine whether they have succeeded—as Dodd-Frank’s proponents claim—in making the financial system safer and ending “too big to fail.”

The Financial Stability Oversight Council is an unwieldy conglomeration of regulatory officials charged with identifying risks and taking steps to mitigate them

The Obama Administration proposed the establishment of the “Financial Services Oversight Council” in a June 2009 white paper.⁵² As conceived by the Administration, the Council would provide a forum for regulators to discuss issues of common interest, facilitate information-sharing and coordination among regulatory authorities, identify emerging risks to the financial system, and recommend that the Federal Reserve supervise bank holding companies and nonbank financial companies posing a systemic risk according to heightened prudential standards.⁵³ In addition to recommending specific firms for “heightened prudential supervision,” the Council would consult with the Federal Reserve regarding the standards to which such firms should be subject.⁵⁴

Under the Obama Administration’s proposal, the Federal Reserve would retain ultimate responsibility for identifying and supervising “systemically risky” bank and nonbank firms.

⁵⁰ Dodd-Frank Wall Street Reform and Consumer Protection Act § 113, 12 U.S.C. § 5323 (2012) (providing for “heightened prudential supervision” of certain entities); *Id.* at § 165(d), 12 U.S.C. § 5365 (authorizing restriction of firm’s activities or divestiture of assets if firm cannot submit “living will” that is “credible” and that “facilitate[s] an orderly resolution under the Bankruptcy Code).

⁵¹ *Id.* at § 121, 5 U.S.C. § 5331.

⁵² DEP’T OF THE TREASURY, A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION (2009), http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf [hereinafter OBAMA ADMINISTRATION WHITE PAPER].

⁵³ *Id.* at 20-21.

⁵⁴ *Id.* at 22.

“The public,” the Administration believed, “has a right to expect that a clearly identifiable entity, not a committee of multiple agencies, will be answerable for setting standards that will protect the financial system and the public[.]”⁵⁵ The Council, the Administration argued, would be less likely to act in a timely manner to adjust prudential standards known to be ineffective; rather than making a single regulator responsible and accountable for monitoring systemic risk, the Administration believed that the Council’s structure fragmented responsibility among several authorities, reducing each member agency’s share of the blame if something went wrong, and making it more difficult for the Council to act quickly by requiring that any potential measure gain the support of a sufficient number of members.⁵⁶

In considering the Obama Administration’s proposal for the “Financial Services Oversight Council”—eventually renamed the Financial Stability Oversight Council—Congress solicited the views of private and government experts concerning the FSOC’s structure and duties. Several witnesses agreed with the Administration that the FSOC could facilitate the exchange of information among its members⁵⁷ even as they advised Congress to go beyond the Administration’s proposal by conferring authority on the FSOC to regulate the financial services industry. The then-chairman of the FDIC, Sheila Bair, testified that the FSOC should have the authority to compel the Federal Reserve to supervise systemically risky financial institutions not

⁵⁵ *Id.*

⁵⁶ *Id.* (“Diffusing responsibility among several regulators would weaken incentives for effective regulation . . . For example, it would weaken both the incentive for and the ability of the relevant agencies to act in a timely fashion—creating the risk that clearly ineffective standards remain in place for long periods.”).

⁵⁷ See, e.g., *Establishing a Framework for Systemic Risk Regulation: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. 18 (2009) [hereinafter *Senate Hearing on Systemic Risk*] (statement of Hon. Mary Schapiro, Chairman, Securities and Exch. Comm’n.) (regulators will be more apprised of risks originating outside their jurisdiction); *Id.* at 11 (statement of Hon. Daniel Tarullo, Governor, Bd. of Governors of the Fed. Reserve Sys.) (“Collective bodies of regulators can serve many useful purposes; examining latent problems, coordinating a response to new problems, recommending new action to plug regulatory gaps and scrutinizing proposals for significant regulatory initiatives from all participating agencies.”).

otherwise subject to the Federal Reserve’s jurisdiction.⁵⁸ In addition, Chairman Bair and then-Chairman of the SEC Mary Schapiro testified that the FSOC should have authority to impose prudential regulatory standards on financial institutions—either by adopting them itself or by forcing the institutions’ primary regulators to promulgate appropriate standards.⁵⁹

Other witnesses were more circumspect in assessing the FSOC’s role in monitoring and mitigating risk to the financial system. Federal Reserve Governor Daniel Tarullo sought to temper expectations that the FSOC would be able to identify all emerging risks to the economy, noting that “Government observers can’t figure out every instance of systemic risk.”⁶⁰ Governor Tarullo additionally advised that the FSOC’s multi-member structure could inhibit its ability to promulgate and administer rules governing the financial services industry.⁶¹ Professor Allan Meltzer argued that it was unrealistic to expect the FSOC to mitigate economic risks when previous regulators had failed to act in advance of a crisis.⁶² Similarly, in a hearing before the Financial Services Committee, former Federal Reserve Chairman Paul Volcker questioned the FSOC’s ability to act effectively on matters requiring the agreement of its members, arguing that

⁵⁸ *Id.* at 14.

⁵⁹ *Id.* at 40-41. As a result of this authority, for example, the FSOC would be able to put in place new capital standards for insured depository institutions if it determined that the FDIC’s standards were too lenient. *Id.* at 27 (statement of the Hon. Sheila Bair). Chairman Bair disagreed with the view that the FSOC’s structure undermined its ability to regulate effectively by diffusing responsibility among the FSOC’s member agencies. *Id.* at 13. Instead, Chairman Bair viewed the FSOC’s structure as a benefit rather than a hindrance, arguing that “[t]he more eyes you have looking at this from different perspectives . . . is going to strengthen the entity, not weaken it.” *Id.* Chairmen Bair and Schapiro were not the only witnesses testifying in support of conferring regulatory authority on the FSOC. Paul Schott Stevens, President and CEO of the Investment Company Institute, argued that the FSOC should have the authority to undertake regulatory actions necessary to mitigate risks to the financial system. Mr. Stevens characterized such a role as requiring the exercise of a “very limited” regulatory authority rather than “day-to-day regulation” of the financial services industry. *Id.* at 48. Another witness argued that the FSOC should have “real powers to compel cooperation among the constituent agencies . . . if necessary.” *Id.* at 47 (statement of Vincent Reinhart, Resident Scholar, American Enterprise Inst.).

⁶⁰ *Id.* at 29.

⁶¹ *Id.* at 11 (arguing that “collective bodies often diffuse responsibility and attenuate the lines of accountability”).

⁶² *Id.* at 51 (“I am pleased to see that there’s a good deal of skepticism among the Members of the Committee about simply appointing another regulator and saying to them, do what secretaries of the Treasury [and] Chairmen of the Federal Reserve have done historically. That won’t work.”).

the agencies' differing statutory responsibilities would make it difficult to reach consensus.⁶³

Chairman Volcker advised that the FSOC's best chance of success would be to make a single federal authority responsible for directing its activities.⁶⁴

Ultimately, Congress vested the FSOC with more authority than the Administration proposed. Under the Dodd-Frank Act, the FSOC has a three-part mandate to monitor the financial system for risks attributable to the operation or failure of large, complex firms; eliminate the expectation that the government will shield shareholders and creditors from losses in the event of a firm's failure; and respond to threats to financial stability.⁶⁵ Among its several powers, the FSOC may designate nonbank financial companies for "heightened prudential supervision" by the Federal Reserve.⁶⁶ In addition, the FSOC may identify gaps in regulation that expose the financial system to risk, share information about financial stability with state and federal government authorities, and recommend changes in regulation to financial regulatory agencies for financial activities or practices deemed by the FSOC to be risky.⁶⁷ In making such a recommendation, however, the FSOC cannot compel the agency to adopt the recommended standard.

The FSOC is administered by a panel of ten voting and five nonvoting members. The voting members include the Treasury Secretary, who serves as the FSOC's chairperson, as well as the chairmen of the Federal Reserve, the SEC, the FDIC, the Commodity Futures Trading

⁶³ *Experts' Perspectives on Systemic Risk and Resolution Issues: Hearing Before the H. Comm. on Fin. Services, 111th Cong. 9 (2009) [hereinafter House Hearing on Systemic Risk].*

⁶⁴ *Id.* at 16.

⁶⁵ Dodd-Frank Act Wall Street Reform and Consumer Protection Act § 112(a), 12 U.S.C. § 5322(a) (2012).

⁶⁶ *Id.* at § 113, 12 U.S.C. § 5323. In contrast to the Obama Administration's proposal, bank holding companies with assets in excess of \$50 billion are subject to heightened prudential supervision without need for action by the FSOC. *Id.* at § 165(a), 12 U.S.C. § 5364(a).

⁶⁷ *Id.* at § 112(a)(2), 12 U.S.C. § 5322(a)(2). In the words of one of the Dodd-Frank Act's authors, Senator Chris Dodd, the FSOC's role is to serve as "an early warning system" that "will allow us to observe what is occurring on a regular basis so we can spot these problems before they metastasize." Peter J. Wallison, *Magical thinking: the latest regulation from the Financial Stability Oversight Council*, AM. ENTERPRISE INST. (Nov. 15, 2011), <http://www.aei.org/outlook/economics/financial-services/magical-thinking-the-latest-regulation-from-the-financial-stability-oversight-council>.

Commission (“CFTC”), and the National Credit Union Administration (“NCUA”).⁶⁸ Other voting members are the Comptroller of the Currency, the directors of the Consumer Financial Protection Bureau (“CFPB”) and the Federal Housing Finance Agency (“FHFA”), and an independent member having insurance expertise.⁶⁹ The FSOC’s nonvoting members serve in an advisory capacity and consist of the directors of the OFR and the Federal Insurance Office, as well as state insurance, banking, and securities officials.⁷⁰

The president exercises partial control over the FSOC. First, the Office of Management and Budget, which is within the Executive Office of the President, may review regulations adopted by the FSOC to determine whether they are consistent with applicable law and the president’s policy priorities, and whether they promote cost-effective regulation that addresses matters of compelling public need.⁷¹ Second, the president may direct or seek to influence the FSOC’s voting members on matters before the FSOC. Each voting member is accountable to the president in varying degrees based on the president’s authority to appoint and remove the member from office.⁷² For example, the president retains plenary authority to remove the Treasury Secretary, a cabinet officer serving at the pleasure of the president. By contrast, two voting members hold offices subject to statutory provisions that limit the president’s removal power to specified circumstances.⁷³ Other voting members hold offices that are not subject to

⁶⁸ Dodd-Frank Wall Street Reform and Consumer Protection Act § 111(b), 12 U.S.C. § 5321(b).

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ Exec. Order No. 12,866, 58 Fed. Reg. 51735 (Oct. 4, 1993).

⁷² Subject to the Senate’s advice and consent, the president appoints each of the FSOC’s voting members to their agencies or to the office of the independent insurance expert.

⁷³ 12 U.S.C. § 5491(c)(3) (2012) (restricting removal of CFPB director to cases of “inefficiency, neglect of duty, or malfeasance in office”); 12 U.S.C. § 4512 (2012) (permitting removal of FHFA director “for cause”). The Supreme Court has not explicitly defined the circumstances in which the president may fire an individual who holds an office that is subject to a “for cause” tenure protection provision. 1 RICHARD J. PIERCE, ADMINISTRATIVE LAW § 2.5 (5th ed. 2010). The traditional view has been that tenure-protected officials have at least some discretion to develop and implement their agency’s regulatory agenda. However, scholars have argued that the president may be able to remove such officials for failure to follow the president’s direction on matters of policy. *Id.* (arguing that policy decisions can be made only by the president because of his constitutional duty to execute the laws and that officers

explicit removal protections; in those cases, whatever the extent of the president’s lawful removal authority, the president might not dismiss the officer before the expiration of his or her term if doing so would impose a significant political cost on the president.⁷⁴

Congress’s oversight of the FSOC is significantly limited. The Dodd-Frank Act deprives Congress of one of its most powerful oversight tools by allowing the FSOC to set its own budget,

subject to “for cause” tenure protection provisions can be removed for “failure to comply with any valid policy decision made by the president or his agent”); *cf. Morrison v. Olson*, 487 U.S. 654, 689-90 n. 28 (1988) (“[I]t is hard to dispute that the powers of the FTC . . . would at the present time be considered ‘executive,’ at least to some degree.”). Under this view, the president could exercise at least some influence on matters relating to the FSOC to the extent the FSOC’s voting members were called on to decide questions of policy.

⁷⁴ The president may remove Members of the Federal Reserve Board of Governors “for cause,” 12 U.S.C. § 242 (2012), but the statute does not include an explicit for-cause removal provision with respect to the Chair as such. *See* 12 U.S.C. § 242 (2012); *see also* Adrian Vermeule, *Conventions of Agency Independence*, 113 COLUM. L. REV. 1163, 1196 (2013) (“In other words, although the Chair and Vice Chairs may not be removed from their lesser posts as members [of the Board] without cause, on the face of the statutes there is no obstacle to the President removing them from their leadership posts [as Chair or Vice-Chair].”). The CFTC chairman is removable by the president at will, after which the former chairman would complete his term of service as a commissioner. 7 U.S.C. § 2(a)(2)(B) (2012). CFTC commissioners serve five-year terms; the statute is silent as to the president’s removal authority with respect to the commissioners. *See id.* The Comptroller of the Currency serves a five-year term “unless sooner removed by the President, upon reasons to be communicated by him to the Senate.” 12 U.S.C. § 2 (2012). The FDIC chairman serves a five-year term as chairman and a six-year term as a member of the FDIC’s Board of Directors; the statute is silent as to the president’s authority to remove the chairman and any appointed board member (the board’s membership includes the Comptroller of the Currency and the Director of the CFPB, who are non-appointed members). *See* 12 U.S.C. § 1812(b), (c) (2012). The NCUA chairman—one of three NCUA board members—serves a six-year term; the statute is silent as to the president’s removal authority. *See* 12 U.S.C. § 1752a(b), (c) (2012). The SEC Chairman is designated by the president from among the commissioners, who serve five year terms; one appellate court has held that the president may remove the chairman at will, after which the former chairman retains his or her status as a commissioner. *SEC v. Blinder, Robinson & Co.*, 855 F.2d 677, 681 (10th Cir. 1988). Finally, the FSOC’s independent member having insurance expertise serves for a six-year term; the statute is silent as to the president’s removal authority. 12 U.S.C. § 5321(b), (c) (2012).

A court might imply a limitation on the president’s ability to remove an official from his or her office even though the statute creating the office does not contain a tenure protection provision. *Wiener v. U.S.*, 357 U.S. 349, 355 (1958) (holding that officer enjoyed tenure protection where agency performed adjudicative function, giving agency an “intrinsic[ally] judicial character”); *see also Swan v. Clinton*, 100 F. 3d 973, 983 (D.C. Cir. 1996) (finding that evidence of Congress’s intent to limit president’s removal power over NCUA board members was ambiguous). In a recent case, the Supreme Court assumed without deciding that SEC commissioners have implied tenure protection such that the president may only remove them for inefficiency, neglect of duty, or malfeasance in office. *Free Enterprise Fund v. Public Co. Accounting Oversight Bd.*, 130 S. Ct. 3138, 3148-49 (2010). To the Committee’s knowledge, no court has held that the president is impliedly prohibited from removing the *head* of an FSOC member agency except “for cause.” If a voting member of the FSOC holds an office that is subject to implied tenure protection, however, the president may remove that officer only for cause, potentially limiting the president’s ability to direct or influence the member on FSOC-related matters.

rather than subjecting the FSOC to Congressional appropriations.⁷⁵ The FSOC funds itself by levying assessments on the financial services industry that are collected in a “Financial Research Fund,” which also serves as the source of OFR’s funding. In addition, only three of the FSOC’s member agencies are subject to congressional oversight through the appropriations process. The Treasury Department, the SEC, and the CFTC are subject to appropriations, but the Federal Reserve, the Office of the Comptroller of the Currency, the CFPB, the FDIC, the FHFA, and the NCUA are self-funded.⁷⁶

While it cannot influence the FSOC’s priorities through the appropriations process, under the Congressional Review Act, Congress may overturn an FSOC regulation by enacting a joint resolution of disapproval. In addition, the FSOC’s chairperson must testify annually before Congress on the financial stability of the United States,⁷⁷ and the GAO has express authority to audit the FSOC’s activities.⁷⁸

The FSOC has failed to live up to its statutory mission to identify and mitigate systemic risk

The Committee Hearings and other evidence indicate that even though the FSOC has facilitated dialogue among agency heads, the FSOC has failed to reduce risks to the financial system. In fact, the FSOC has undermined market discipline by designating some nonbank financial companies for supervision by the Federal Reserve, thereby conveying to the market that these companies are “too big to fail.” In addition, the record suggests that deficiencies regarding the FSOC’s record-keeping practices and transparency impede Congress’s oversight function and

⁷⁵ Dodd-Frank Wall Street Reform and Consumer Protection Act § 118, 12 U.S.C. § 5328 (2012); RULES OF ORGANIZATION OF THE FINANCIAL STABILITY OVERSIGHT COUNCIL § XXX.3(a)(3), available at <http://www.treasury.gov/initiatives/Documents/FSOCbylaws.pdf>.

⁷⁶ Note, *Independence, Congressional Weakness, and the Importance of Appointment: The Impact of Combining Budgetary Autonomy With Removal Protection*, 125 HARV. L. REV. 1822, 1823 n. 12 and 1836 (2012).

⁷⁷ Dodd-Frank Act Wall Street Reform and Consumer Protection Act § 112(c), 12 U.S.C. § 5322(c) (2012)

⁷⁸ *Id.* at § 122, 12 U.S.C. § 5332.

thus Congress’s ability to ensure that the FSOC adequately implements its statutory responsibilities.

Evidence before the Committee suggests that the FSOC has failed to identify and mitigate risks to U.S. financial stability. A 2012 GAO audit requested by Representatives Spencer Bachus and Randy Neugebauer concluded that the FSOC’s “Systemic Risk Committee”—which vets potential financial risks on behalf of the FSOC’s members—used procedures and tools that made it more likely that the FSOC would assess already known risks to the financial system rather than new ones.⁷⁹ The GAO also found that, as of the conclusion of the audit, the FSOC “ha[d] not yet developed comprehensive and systematic mechanisms to realize [the] goals” of identifying risks and potential emerging threats to U.S. financial stability.⁸⁰ The GAO also found that the FSOC’s annual reports to Congress failed to clearly prioritize risks or describe their likelihood of occurrence or their expected severity.⁸¹ The FSOC’s failure to prioritize risks in turn made it more difficult for government authorities to respond effectively to identified risks.⁸² Finally, the GAO found that the FSOC did not consistently assign responsibility for mitigating specific systemic risks within particular timeframes to its member agencies.⁸³

History suggests that even if the FSOC addresses the deficiencies identified in the GAO’s audit, it is unlikely to detect and act upon systemic threats until it is too late. There is no reason to

⁷⁹ GOV’T ACCOUNTABILITY OFFICE, NEW COUNCIL AND RESEARCH OFFICE SHOULD STRENGTHEN THE ACCOUNTABILITY AND TRANSPARENCY OF THEIR DECISIONS 22 (2012) [hereinafter GAO REPORT].

⁸⁰ *Id.* at 21.

⁸¹ *Id.* at 48-50.

⁸² *Id.*

⁸³ *Id.* at 53-54. Concerns regarding the FSOC have been expressed by others who have closely followed its proceedings. In a March 27, 2013 editorial, Barbara Rehm, the *American Banker’s* editor-at-large, argued that “[t]he Financial Stability Oversight Council, created by Dodd-Frank to get in front of the next systemic risk, has done nothing but study and propose and postpone.” “There is nothing,” Rehm continued, “that the umbrella group of regulators, led by Treasury, has done to inspire the public’s confidence. Nothing.” *Regulators’ Reputation Sinks Along with Industry’s*, AM. BANKER, Mar. 27, 2013, http://www.americanbanker.com/issues/178_60/regulators-reputation-sinks-along-with-industry-s-1057876-1.html.

think that the same regulators who failed to spot and understand the risks that led to the last financial crisis will be any more effective because they are now joined in a confederacy than they were when they acted individually. “The FSOC,” Chairman Hensarling has observed, “is an amalgamation of regulators heading agencies that either helped cause the financial crisis or were largely negligent in preventing it in the first place, notwithstanding that they had the regulatory power to do so.”⁸⁴

The authority to designate nonbank financial companies undermines market discipline by signaling that some firms are “too big to fail”

The Committee Hearings and other facts of public record show that rather than mitigating risks to financial stability, the FSOC’s authority to designate non-bank financial institutions for “enhanced prudential supervision” undermines financial stability in two ways. First, designations of nonbank firms undermine market discipline because these designations lead market participants to believe that they will be protected from losses if that firm fails. Second, structural flaws in the FSOC and the designation process will result in the designation of companies that do not pose a systemic risk, thus subjecting those companies to needlessly burdensome regulatory requirements.

In 2009, when Congress was considering whether to grant the FSOC the authority to designate large firms for “heightened prudential supervision,” several witnesses testified that such designation would have market-distorting consequences. Alice Rivlin, a former Vice Chairman of the Federal Reserve and director of the Office of Management and Budget during the Clinton administration, testified that regulators might seek to keep designated firms from failing at all costs, leading to a new class of “government-sponsored enterprises” that would

⁸⁴ *The Annual Report of the Financial Stability Oversight Council: Hearing Before the H. Comm. on Fin. Services, 113th Cong. 1 (2013).*

benefit from taxpayer-funded bailouts upon becoming distressed.⁸⁵ Former Federal Reserve Chairman Volcker similarly testified before the Financial Services Committee that designated firms “carrie[d] the connotation in the market that they’re ‘too big to fail,’” exacerbating problems of moral hazard.⁸⁶

Following the enactment of the Dodd-Frank Act, financial market experts continued to voice their concern that FSOC designation conferred a “too big to fail” status on these firms, along with those attendant competitive advantages. For example, in a May 16, 2012 hearing before the Financial Services Committee, Scott Harrington, a professor at the University of Pennsylvania’s Wharton School, testified that the designation of insurance firms and other nonbank entities had “significant drawbacks” because eventually “the designation . . . would likely translate as ‘too big to fail,’ regardless of assertions that creditors and shareholders of companies will not be bailed out in the event of financial distress.”⁸⁷

In the Committee Hearings, the Committee examined whether designating a nonbank financial company for “heightened prudential supervision” might perpetuate the market’s expectation that the government would shield shareholders and creditors from losses when the institution failed, contrary to the FSOC’s statutory duty to promote market discipline.⁸⁸ Richmond Federal Reserve Bank President Jeffrey Lacker and Dallas Federal Reserve Bank President Richard Fisher testified that designations would likely result in negative unintended consequences. According to Mr. Lacker, designating a firm for “heightened prudential supervision” could encourage shareholders and creditors of the firm and of similarly situated

⁸⁵ *Senate Hearing on Systemic Risk*, *supra* note 57, at 50.

⁸⁶ *House Hearing on Systemic Risk*, *supra* note 63, at 28-29.

⁸⁷ *The Impact of the Dodd-Frank Act: What it Means to be a Systemically Important Financial Institution: Hearing Before the Subcomm. on Fin. Institutions and Consumer Credit of the H. Comm. on Fin. Services*, 112th Congress 76 (2012) (prepared statement).

⁸⁸ Dodd-Frank Wall Street Reform and Consumer Protection Act § 112(a)(1)(B), 12 U.S.C. 5322(a)(1)(B) (2012).

firms to expect the government to shield them from losses during periods of distress.⁸⁹ As a result, the government might keep the distressed firm from failing to avoid the significant cost of unsettling the market's expectation that the government would support similarly situated firms.⁹⁰

Mr. Fisher testified that designated firms could borrow funds at artificially low rates:

[B]ased on my experience working the financial markets since 1975, as soon as a financial institution is designated systemically important, as required under Title I of the Dodd-Frank Act, and becomes known by the acronym SIFI, it is viewed by the market as being the first to be saved by the first responders in a financial crisis . . . the SIFIs . . . occupy a privileged position in the financial system.⁹¹

Mr. Fisher testified that the "subsidy" is palpable: "I believe it is measurable," Mr. Fisher advised, "and if it is not measurable, certainly you can feel it as a financial operator[.]"⁹²

The Dodd-Frank Act's designation authority lays bare the flaw that dooms it to failure, which is that it seeks to achieve two fundamentally irreconcilable objectives. On the one hand, the Dodd-Frank Act strengthens the regulators' powers to clamp down on risk-taking by allowing them to designate firms for more stringent regulation; at the same time, the Dodd-Frank Act claims to improve market discipline on financial institutions. By subjecting designated firms to more stringent standards, the Dodd-Frank Act tries to constrain these firms' risk-taking through stricter regulation. But the designation of these firms undermines market discipline because it sends a clear signal that government regulators think these firms are "too big to fail";

⁸⁹ See *Hearing on Taxpayer-Funded Bailouts under Dodd-Frank*, *supra* note 49, at 41 ("[T]he other animating philosophy which at times competes in Dodd-Frank is that we want to strengthen market incentives and the discipline that a competitive marketplace imposes on institutions . . . And from that point of view the designation of SIFI cuts in the other direction because of the implication . . . that it is there because they are viewed as likely to be rescued.").

⁹⁰ See *id.* at 18 (statement of Jeffrey Lacker) ("I think that discretion traps policymakers in a crisis. Expectations build up that they may use that discretion to rescue creditors and let them escape losses, and given that expectation, policymakers feel compelled to fulfill the expectation in order to avoid the disruption of markets pulling away from who they have lent to on the basis of that expected support.").

⁹¹ *Id.* at 11.

⁹² *Id.* at 21; but see Christine Harmer & Cheyenne Hopkins, *Goldman Sachs Research Disputes "Too Big to Fail" Subsidy*, BLOOMBERG, May 23, 2013, <http://www.bloomberg.com/news/2013-05-22/goldman-sachs-research-disputes-too-big-to-fail-bank-subsidy.html>. While it is beyond the scope of this report to determine the extent to which a designated firm would be able to borrow at lower rates due to a perceived government backstop, the GAO is expected to complete a study on that subject, requested by Senators Sherrod Brown and David Vitter, in mid-2014.

after all, that is the reason for subjecting these firms to “heightened prudential standards.”⁹³ Designation thus generates even greater risk-taking and moral hazard, because creditors and shareholders will not monitor the firm as scrupulously as they otherwise would, knowing that government regulators will not allow the firm to fail, which means that they will not suffer losses.⁹⁴ Or as one of the witnesses at the Committee Hearings put it, “Title I and Title II create a special class of GSE-like companies that benefit from an implied government guarantee.”⁹⁵

The FSOC’s voting structure displaces regulatory expertise and makes it a source of systemic risk

The proponents of the FSOC believed that by creating a 15-member committee that brought together the heads of the major financial regulatory agencies that had missed the last crisis—along with the heads of some newly-created agencies—they had succeeded in reducing the likelihood of future crises.⁹⁶ The proponents of the FSOC believed that if Treasury gathered enough regulators in one room, they could identify problems and solve them collectively in a way that they could not if they acted individually. There is, however, a significant flaw in the FSOC theory of regulation by super-committee: simply getting regulators in a room does not

⁹³ See *Hearing on Taxpayer-Funded Bailouts under Dodd-Frank*, *supra* note 45, at 41-42 (statement of Jeffrey Lacker) (acknowledging “cross-purposes” in designation of nonbank financial companies for “heightened prudential supervision”).

⁹⁴ In remarks before the International Insurance Society’s annual meeting in June 2013, Thomas Leonardi, Connecticut’s insurance commissioner and a member of the Treasury Department’s advisory committee on insurance regulation, reflected on the potential effects of designating an insurance company for “heightened prudential supervision,” noting that, “particularly on the life side, where people are buying a product for a 30- or 40-year promise, you want that financial stability; and if you say as a consumer this designation means the company has more supervision, that’s a good thing. It has more capital. That’s really good and, as it’s potentially ‘too big to fail,’ so the government is not going to let this company go.” Gavin Souter, *Stability, higher costs seen in systemic designation for insurers*, BUSINESS INSURANCE, June 19, 2013, <http://www.businessinsurance.com/article/20130619/NEWS04/130619774?tags=|306|76|73>. AIG’s nonexecutive chairman, Robert Miller, has made a similar point, referring to his firm’s SIFI designation as a government “seal of approval.” Leslie Scism, *AIG’s Benmosche and Miller on Villains, Turnarounds and Those Bonuses*, WALL ST. J. MONEYBEAT (Sept. 23, 2013, 2:32 P.M.), <http://blogs.wsj.com/moneybeat/2013/09/23/aigs-benmosche-and-miller-on-villains-turnarounds-and-those-bonuses>.

⁹⁵ *Oversight Subcomm. Hearing on the OLA*, *supra* note 41, at 10 (statement of Joshua Rosner).

⁹⁶ As the Treasury Department describes the FSOC on its website, the FSOC “brings together the expertise of federal financial regulators, state regulators, and an independent insurance expert appointed by the President.” FIN. STABILITY OVERSIGHT COUNCIL, <http://www.treasury.gov/initiatives/fsoc/Pages/home.aspx> (last visited July 14, 2014).

make them any more expert about the subjects over which they have jurisdiction, and it certainly does not give them expertise in the subjects over which they have no jurisdiction.⁹⁷

Proponents of the FSOC contend that the FSOC's structure gives regulators the opportunity to share information and collaborate on problems that cross the jurisdictional lines of multiple agencies. But nothing prevented regulators from sharing information or working with each other before the crisis, and indeed, the President's Working Group on Financial Markets shows that multi-agency task forces did not require an act of Congress to establish them. As a result, the FSOC structure was not necessary to foster inter-agency cooperation.

But even if a new inter-agency structure were needed to get financial regulators into the same room to share information, the FSOC is more than a clearinghouse for exchanging information or a forum for regulators to share their views about financial markets. Instead, the FSOC was established as a super-regulatory body, which could take action if a majority of its voting members decided to do so. In setting up the FSOC this way, its creators ensured that the FSOC—rather than mitigating systemic risk—would itself become a source of systemic risk through mis-regulation. Rather than leveraging the expertise of the regulators having primary responsibility for particular areas and institutions in the financial system, the FSOC's voting structure makes it possible for FSOC Members who know little or nothing about these matters to vote on questions affecting entire industries. The FSOC's proponents believed they were elevating expertise. Instead, by creating a multi-member panel drawn from regulators responsible for areas as diverse as housing policy and government-sponsored enterprises, federal credit unions, securities markets, consumer protection, and commercial banks, they carved up

⁹⁷ In this respect, the FSOC is symptomatic of what some have identified as a larger defect in the Obama Administration's approach to governing: "If [Obama] had a weakness, some of those who watched him said, it was . . . the belief that if you could just get enough smart people in a room, they could figure out a solution to whatever the problem was and the public would accept it." DAN BALZ, COLLISION 2012: OBAMA VS. ROMNEY AND THE FUTURE OF ELECTIONS IN AMERICA 28 (2013).

responsibility for financial regulatory policy among ten regulators—the Voting Members of the FSOC—ensuring that FSOC Members would be voting on issues they know little, if anything, about.⁹⁸

The FSOC's designations of non-bank financial companies to date underscore the flaws in its governance structure and statutory mandate

As of this writing, the FSOC has designated three nonbank financial companies for “heightened prudential supervision” by the Federal Reserve. It finalized the designations of AIG and GE Capital Corporation by unanimous vote on July 8, 2013. The proposed designation of the third company, Prudential Financial Inc., remained pending until September 19, 2013, when the FSOC finalized its determination after rejecting a July 2, 2013 challenge by the company to its designation.⁹⁹ In testimony before the Committee, noted Washington attorney Eugene Scalia criticized the manner in which the FSOC has exercised its discretion to designate nonbank financial companies:

When it comes to SIFI designation, FSOC has done little more than list numerous factors it will consider without identifying the relative weight the factors will be given or what constitutes a passing grade under any one factor. Moreover, its SIFI designation decisions to date have applied such loose and subjective reasoning that other companies being considered have no way of knowing

⁹⁸ This lack of expertise is arguably compounded by the fact that for those FSOC member agencies that operate as boards or commissions, the chairman exercises sole authority to exercise that agency’s prerogatives at the FSOC, and is under no obligation to solicit or even take into consideration the views of other presidentially appointed board members. This has prompted strong objections from both Republican and Democratic commissioners at the SEC, a bipartisan, five-member commission. Democratic Commissioner Luis Aguilar noted in an April 2014 speech that he and his fellow commissioners had been “cut out of” the FSOC process, and argued that “there needs to be a mechanism by which the full Commission, not just the chair and SEC staff, provide meaningful input and coordinate with the leadership of FSOC.” Republican Commissioners Daniel Gallagher and Michael Piwowar have registered similar concerns; Commissioner Piwowar’s request to attend meetings of the FSOC was denied. *See* Sarah N. Lynch, *At SEC, discontent grows over closed U.S. risk council meetings*, REUTERS, April 2, 2014, <http://www.reuters.com/article/2014/04/02/us-sec-risks-complaints-idUSBREA3124320140402>.

⁹⁹ FIN. STABILITY OVERSIGHT COUNCIL, BASIS FOR THE FINANCIAL STABILITY OVERSIGHT COUNCIL’S FINAL DETERMINATION REGARDING PRUDENTIAL FINANCIAL, INC., Sept. 19, 2013, <http://www.treasury.gov/initiatives/fsoc/designations/Documents/Prudential%20Financial%20Inc.pdf> ; *see also* Camilla Hall, *Regulators reject appeal by Prudential*, FIN. TIMES, Sept. 20, 2013, <http://www.ft.com/intl/cms/s/0/3ad819fc-2176-11e3-a92a-00144feab7de.html#axzz2kRaBGRtL>.

whether they will be designated or what changes they could make so they are not designated.¹⁰⁰

Two voting members and one nonvoting member of the FSOC dissented from the September 19th designation of Prudential. One of the dissenters was Roy Woodall—the FSOC’s Independent Member Having Insurance Expertise—who disputed the majority’s risk assessment, and pointed out that the majority had assumed, without justification, that Prudential would suffer a bank-style run of millions of insured policyholders, which was extraordinarily unlikely.¹⁰¹ Mr. Woodall, whose more than 50 years of experience in the insurance industry included a stint as the Kentucky Insurance Commissioner, noted that the administrative record did not support a finding that Prudential’s failure could disrupt the functioning of the financial system or cause a loss of confidence in similarly situated institutions. Mr. Woodall pointed out that majority who voted to designate Prudential simply did not understand the insurance industry: “[t]he underlying analysis utilizes scenarios that are antithetical to a fundamental and seasoned understanding of the business of insurance, the insurance regulatory environment, and the state insurance company resolution and guaranty fund systems.” John Huff, the state insurance commissioner serving as a nonvoting FSOC member, also questioned whether the FSOC Members who voted to designate Prudential understood the operation and risks of insurance firms such as Prudential, calling into question whether the FSOC could reliably make judgments on those matters.¹⁰²

¹⁰⁰ *Examining the Dangers of the FSOC’s Designation Process and its Impact on the U.S. Financial System: Hearing Before the H. Comm. on Fin. Services*, 113th Cong. 13 (2014) [hereinafter *Hearing on the FSOC’s Designation Process*] (statement of Eugene Scalia, Partner, Gibson, Dunn & Crutcher LLP) (draft transcript on file with H. Comm. on Fin. Services).

¹⁰¹ FIN. STABILITY OVERSIGHT COUNCIL, VIEWS OF THE COUNCIL’S INDEPENDENT MEMBER HAVING INSURANCE EXPERTISE 3, Sept. 19, 2013, <http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September%2019%202013%20Notational%20Vote.pdf>.

¹⁰² See FIN. STABILITY OVERSIGHT COUNCIL, VIEWS OF DIRECTOR JOHN HUFF, THE STATE INSURANCE COMMISSIONER REPRESENTATIVE 1, 3-4, Sep. 19, 2013, <http://www.treasury.gov/initiatives/fsoc/council->

Of the seven members of FSOC who voted to designate Prudential as systemically important, none appears to have any professional background or expertise in insurance. Yet the FSOC majority over-rode the consensus of the regulators who best understood the insurance industry and the risks that Prudential did and did not pose to the financial system. The Prudential designation left many observers wondering why the judgment of the chairmen of the Commodity Futures Trading Commission, the National Credit Union Administration, and the Consumer Financial Protection Bureau, to take just three examples, should be substituted for that of individuals who have spent their entire careers on insurance regulatory matters. The FSOC's voting structure thus does the opposite of what its proponents wanted the FSOC to do: rather than promoting the application of policy expertise to issues of financial stability, the FSOC's voting structure subverts it.

The questions surrounding the Prudential designation highlight another troubling aspect of the Title I regime. By giving the FSOC the authority to designate firms for “heightened prudential supervision,” the Dodd-Frank Act provides the government vast license to expand its own regulatory footprint. As American Enterprise Institute scholar Peter Wallison has observed, it is the very nature of government bureaucracies to seek to extend their jurisdictional reach, and Title I invites just such regulatory empire-building. Wallison suggests that this set of perverse incentives – combined with the lack of any “intelligible standard” in the Dodd-Frank Act for determining whether a firm poses a systemic threat – results in the FSOC “making what can only

[meetings/Documents/September%2019%202013%20Notational%20Vote.pdf](#). The only other member of the FSOC with insurance expertise, the Director of Treasury's Federal Insurance Office, is also a non-voting member, and did not express an opinion on Prudential's designation. In testimony before the Committee, Eugene Scalia noted that the problems with the Prudential designation “include unsubstantiated conjecture; a subjective, standardless notion of excessive risk; and repeated disregard . . . for the existing system of insurance regulation by the states.” *Hearing on the FSOC's Designation Process, supra* note 100, at 13. AEI Fellow Peter Wallison testified that the decision indicated that “[t]he FSOC seems to have no idea how to assess the danger of interconnections of any of the other reasons that SIFIs are considered such a threat to financial stability that they require Fed bank-like regulation. This means that decisions are completely arbitrary.” *Id.* at 18.

be called a political or ideological decision—choosing to designate firms . . . for no other reason than it wants to increase the government’s control over the financial system.”¹⁰³

The FSOC’s record-keeping practices undermine public and congressional oversight, reducing the FSOC’s accountability and increasing the likelihood that the FSOC will not remedy deficiencies in its operations

The Dodd-Frank Act confers vast authorities on the FSOC. The agency has the power to change the way that nonbank financial companies are regulated, leading to the imposition of new rules that could affect competition among firms and the offering of products and services to consumers. Upon a two-thirds vote of the FSOC, the Federal Reserve is empowered to break up the nation’s largest firms using an authority that the *Financial Times* compared to the Sherman Antitrust Act.¹⁰⁴ The Dodd-Frank Act grants the FSOC discretion to determine what constitutes a risk to the financial system and therefore when and how to exercise these authorities.

Given the sweeping power delegated to the FSOC under the Dodd-Frank Act, its exercise of those authorities must be subject to strong congressional oversight and public accountability. Yet the Committee Hearings and other evidence in the public domain demonstrate that the FSOC has failed to keep adequate records of its proceedings, which impedes Congress’ ability to fulfill its oversight responsibilities and frustrates public accountability. Through May 2014—the last month for which the FSOC had posted meeting minutes as of this writing—the FSOC had held 40 meetings at which substantive matters were considered, but the minutes for those meetings did not describe the FSOC members’ perspectives and insights concerning the matters discussed. Instead, the minutes listed the names of persons attending each meeting, the names of presenters,

¹⁰³ Peter J. Wallison, *What the FSOC’s Prudential decision tells us about SIFI designation*, AM. ENTERPRISE INST. (Mar. 31, 2014), http://www.aei.org/outlook/economics/financial-services/banking/what-the-fsocs-prudential-decision-tells-us-about-sifi-designation/?utm_source=new_research&utm_medium=paramount&utm_campaign=wallison.

¹⁰⁴ Dodd-Frank Act Wall Street Reform and Consumer Protection Act § 121; *see also Kanjorski Amendment*, FIN. TIMES LEXICON, <http://lexicon.ft.com/term?term=Kanjorski-Amendment> (last visited July 14, 2014).

and the subjects of their presentations. The minutes also contained copies of resolutions considered or adopted by the FSOC, an outline of subjects covered, and cursory statements reflecting that some attendees (often without specifying whom) asked questions of presenters. For example, on October 18, 2012, a Treasury Department official led a discussion on macroeconomic conditions affecting the financial system. The minutes noted that the Treasury Secretary asked the official, Janice Eberly, to begin her presentation, and then noted that:

Ms. Eberly explained that under current law, there are tax provisions that will expire and spending cuts to occur in 2013. She also discussed the potential economic impact and further described forecasters' expectations. After the presentation, members of the Council asked questions and had a discussion.¹⁰⁵

Several months later, on January 31, 2013, the FSOC again considered macroeconomic conditions, but the minutes only related that the Treasury Secretary "provided the Council with an update on recent fiscal developments, including an update on fiscal negotiations," after which "members of the Council asked questions and had a discussion."¹⁰⁶ On average, each meeting's minutes was five pages long, with half the pages devoted to memorializing attendees' names and resolutions considered.

The FSOC's policies governing the memorialization of its proceedings and the release of information to the public stand in stark contrast to those of the Federal Reserve, which releases transcripts of meetings of the Federal Open Market Committee ("FOMC"), the Federal Reserve's

¹⁰⁵ FIN. STABILITY OVERSIGHT COUNCIL, OCT. 18, 2012 MEETING MINUTES 3 (2012); *see also* GAO REPORT, *supra* note 79, at 27-28 (describing limited public information generally available in meeting minutes).

¹⁰⁶ FIN. STABILITY OVERSIGHT COUNCIL, JAN. 31, 2013 MEETING MINUTES 3 (2013). More recent meeting minutes continue to lack detailed information concerning the FSOC's deliberations. *See, e.g.*, FIN. STABILITY OVERSIGHT COUNCIL, FEB. 13, 2014 MEETING MINUTES (describing "a discussion of the current market environment, including the U.S. fiscal situation, municipal markets, and emerging market developments" and noting that presenters discussed the level of exposure of financial institutions to emerging markets" and that "[a]fter the presentation, members of the Council asked questions and had a discussion, including regarding the importance of Council members sharing information regarding any potential risks to U.S. financial stability that could arise from municipal markets or emerging markets"); FIN. STABILITY OVERSIGHT COUNCIL, JAN. 9, 2014 MEETING MINUTES (memorializing discussion concerning development and implementation of enhanced prudential standards as required by the Dodd-Frank Act).

interest rate-setting committee, as well as background material relied on by meeting participants and lengthy minutes that describe in detail the issues considered and the participants' perspectives on those matters.¹⁰⁷ The information is released on a delayed basis after each meeting, given the sensitive nature of the FOMC's work and the matters discussed, providing an illustrative example that the FSOC could follow when releasing public information to the extent that its minutes contained information that merited confidential treatment for a period of time.

The sparse detail of the FSOC's meeting records is of particular concern because the public is limited in its ability to monitor the FSOC in other ways. The public could not attend FSOC meetings because, as of May 2014, the FSOC had conducted approximately two-thirds of them in private in executive session, even though the FSOC's governance documents exhort it to hold public meetings "whenever possible."¹⁰⁸ These practices prompted Dennis Kelleher, the President and CEO of Better Markets, a non-profit organization that has consistently advocated for increased regulation, to remark that:

The FSOC's proceedings make the Politburo look open by comparison. No one in America even knows who they are. At the few open meetings they have, they snap their fingers and it's over, and they are all scripted. They treat their information as if it were state secrets.¹⁰⁹

¹⁰⁷ *H.R. 1207, The Federal Reserve Transparency Act of 2009: Hearing Before the H. Comm. on Fin. Services 111th Cong. 63 (2009)* (prepared statement of Scott G. Alvarez, General Counsel, Federal Reserve Board of Governors); see also *Transcripts and other historical materials*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., http://www.federalreserve.gov/monetarypolicy/fomc_historical.htm (last visited July 14, 2014).

¹⁰⁸ As of May 2014, the FSOC held 40 meetings excluding meetings at which only "notational votes" were held. All meetings were conducted at least in part in executive session. Twenty eight meetings (or 70%) were in executive session only with no public component. Twelve meetings were partially open to the public; no meeting was wholly public. On May 7, 2014, the FSOC adopted minimal changes to its transparency policy. The FSOC must now provide seven days' notice of any regularly scheduled meeting (including information about the agenda and, if appropriate, the reasons for closing the meeting to the public) and, as soon as practicable after each meeting, must make information about the meeting available on its website. FIN. STABILITY OVERSIGHT COUNCIL, TRANSPARENCY POLICY, available at <http://www.treasury.gov/initiatives/fsoc/Documents/The%20Council%27s%20Transparency%20Policy.pdf> (last visited July 14, 2014). The changes do not require that the FSOC conduct a greater portion of its business in public or that it keep transcripts or more detailed meeting minutes.

¹⁰⁹ Susan Crabtree, *Dodd-Frank offshoot cited as too secretive*, WASH. TIMES, Feb. 17, 2013, <http://www.washingtontimes.com/news/2013/feb/17/dodd-frank-offshoot-cited-as-too-secretive/?page=all>.

The dearth of information in the FSOC’s minutes makes it impossible for Congress to conduct effective oversight of the FSOC and to determine whether the agency has appropriately implemented the Dodd-Frank Act. For example, detailed minutes about the FSOC’s designation of nonbank financial companies for “heightened prudential supervision” would help Congress assess the effectiveness of the FSOC’s application of the statutory criteria for designation. Detailed minutes would help Congress judge whether the FSOC effectively identifies the firms that pose a risk to the financial system, or whether the FSOC applies those criteria too narrowly or too broadly. Detailed minutes would help Congress assess other matters, including the nature and quality of members’ discussions concerning systemic risk; the relationship between the FSOC and the several staff committees that assist it, including the extent to which the FSOC conducted independent analysis of matters before it or simply served as a “rubber stamp” for issues resolved by the staff committees; and how the FSOC incorporated data and analyses provided by the OFR as part of its deliberations.¹¹⁰

The Office of Financial Research is charged with collecting financial data to identify systemic risks

In early 2010, Senator Jack Reed introduced a bill creating the “National Institute of Finance, which originated in a proposal put forth by a group of academics and former financial

¹¹⁰ Importantly, any criticism by Congress resulting from the examination of these matters could prompt the FSOC to reform deficient policies and procedures or could suggest the need for legislative action by Congress. Cf. Robert G. Vaughn, *Transparency in the Administration of Laws: The Relationship Between Differing Justifications for Transparency and Differing Views of Administrative Law*, 26 AM. U. INT’L L. REV. 969, 970-73 (2011). Further, Congress cannot readily assess these matters by examining existing sources of information about the FSOC’s meetings. For example, while a congressional committee could subpoena background material provided to the FSOC’s members before meetings as well as related e-mail communications, those records likely would not reflect members’ opinions and the general tenor of debate concerning matters before the agency to the same extent as meeting minutes or transcripts. In addition, a congressional committee could question FSOC officials about deliberations at meetings, including through the use of informal interviews, depositions, or hearings, but the officials’ memory of meetings that may have taken place months or years earlier will not be as reliable a record of those deliberations as would minutes or transcripts of those meetings.

regulators.¹¹¹ Its supporters argued that the Institute was necessary because the federal government lacked the ability to determine what data were necessary to monitor risks to the financial system and to ensure that the government could collect that data for review.¹¹² In congressional hearings, the Institute’s proponents described it as an institution that would be able to detect oncoming financial disasters, much like the National Oceanic and Atmospheric Administration predicts hurricanes.¹¹³

The Institute’s architects claimed that it would be able to identify economic vulnerabilities soon after its establishment while developing more sophisticated research and forecasting capabilities over several years.¹¹⁴ They believed that within two years of its establishment, the Institute would develop “preliminary rudimentary maps” of the financial system that would identify potential vulnerabilities such as, for example, whether multiple institutions were taking the same position on a particular trade, or whether an institution had put on trades that it could not safely sustain.¹¹⁵ The Institute’s proponents believed that this information would help regulators identify risks such as those created by AIG before the 2008 financial crisis.¹¹⁶

¹¹¹ Arthur Small, *The Role of Transaction Data in US Regulatory Reform & the Quest to Monitor Systemic Risk*, DERIVSOURCE (June 17, 2010), <http://www.derivsource.com/articles/role-transaction-data-us-regulatory-reform-quest-monitor-systemic-risk>.

¹¹² As a result, the proponents emphasized that the Institute would have substantial authority to standardize the format of needed data and require its production.

¹¹³ *Equipping Financial Regulators With the Tools Necessary to Monitor Systemic Risk: Hearing Before the Subcomm. on Security and Int’l Trade and Finance of the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. 17 (2010) (statement of John C. Liechty, Associate Professor of Marketing and Statistics, Penn State University) [hereinafter *Nat’l Inst. of Fin. Hearing*]. However, Professor Liechty later noted that, while meteorologists had successfully modeled the weather by applying mathematical equations to recurring weather patterns, financial forecasting was “much more complicated” and that it remained to be seen whether researchers could develop models that accurately identified shocks to the financial system. *Id.* at 26; see also Sarah N. Lynch & Emily Stephenson, *Insight: U.S. early warning system for financial crises gets low marks*, REUTERS, Dec. 22, 2013, <http://www.reuters.com/article/2013/12/22/us-financial-regulation-ofr-insight-idUSBRE9BL04Y20131222> (noting that the OFR was supposed to be like the National Weather Service).

¹¹⁴ *Nat’l Inst. of Fin. Hearing*, *supra* note 113, at 28-29.

¹¹⁵ *Id.*

¹¹⁶ *Id.*

To insulate the Institute from influences that could potentially bias its research and analyses, its proponents suggested that it not be given responsibility for regulating the financial industry, because they believed that regulators would be inhibited from accurately assessing risks to the financial system if those assessments called past regulatory judgments into question.¹¹⁷ The Institute’s proponents also proposed that the Institute’s daily operations be beyond the control of elected officials. “When it speaks,” testified one professor, it is important that the Institute “is not speaking because it has some political agenda, because it has to worry about whether its budget is going to be cut or not cut,” but because “it is trying to serve the best interests of the nation.”¹¹⁸

As established by the Dodd-Frank Act, the Office of Financial Research (OFR) is similar to the “National Institute of Finance” that would have been created by Senator Reed’s legislation. Because the OFR is housed within the Treasury Department, the OFR is not a wholly independent entity as the Institute would have been. Nevertheless, the OFR retains substantial autonomy. The president appoints the OFR’s director to a six-year term.¹¹⁹ The president does not have the right to review and approve the director’s testimony before Congress.¹²⁰ Congress exercises limited oversight over the OFR. The director must testify before Congress annually on the work of the OFR.¹²¹ Like the Financial Stability Oversight

¹¹⁷ *Id.* at 22-23 (statement of Alan I. Mendelowitz, Founding Member, Committee to Establish the Nat’l Institute of Finance).

¹¹⁸ *Id.* at 23 (statement of John C. Leichty).

¹¹⁹ Dodd-Frank Act Wall Street Reform and Consumer Protection Act § 152(b), 12 U.S.C. 5342(b) (2012). Similar to Senator Reed’s bill, the Dodd-Frank Act does not explicitly limit the president’s authority to remove the OFR’s director before the expiration of this term.

¹²⁰ *Id.* § 153(d), 12 U.S.C. § 5343(d). However, any such testimony must include a statement acknowledging that the director’s views do not necessarily represent those of the president.

¹²¹ *Id.*

Council, however, the OFR is funded by assessments on financial institutions collected in a “Financial Research Fund” rather than through the appropriations process.¹²²

The Dodd-Frank Act charges the OFR with standardizing, collecting, and analyzing data to assess the stability of the U.S. financial system.¹²³ The OFR may require a financial company to submit reports to help the OFR assess whether financial activities or markets in which a company participates or the company itself threatens U.S. financial stability.¹²⁴ The Dodd-Frank Act requires the OFR to collect data on financial transactions and trading positions from financial companies.¹²⁵ Upon certification of its director, the OFR may subpoena any data that it deems necessary to fulfill the OFR’s duties.¹²⁶

Consistent with the role envisioned by the proponents of the “National Institute of Finance,” the OFR does not function as a financial regulator; its rulemaking authority is limited to the collection and standardization of data rather than regulating financial activities, products, and services. The OFR’s work is intended to support the FSOC, which retains overall responsibility under the Dodd-Frank Act to monitor and mitigate systemic risk.¹²⁷

The OFR has taken some steps to carry out its mission, but its progress has been unsatisfactory and its data collection efforts risk imposing substantial costs in return for speculative benefits

Since its creation, the OFR has taken preliminary steps to carry out its duties under the Dodd-Frank Act to monitor and assess risks to the financial system. The OFR defined the circumstances in which it would consider U.S. financial stability to be impaired¹²⁸ and evaluated

¹²² *Id.* § 155, 12 U.S.C. § 5345.

¹²³ *Id.* § 153(a), 12 U.S.C. § 5343(a).

¹²⁴ *Id.* § 154(b), 12 U.S.C. § 5344(b).

¹²⁵ *Id.*

¹²⁶ *Id.* § 153(f), 12 U.S.C. § 5343(f).

¹²⁷ *See id.* §§ 153(a) and 154(c), 12 U.S.C. §§ 5343(a) and 5344(c) (respectively charging the OFR with collecting data on behalf of the FSOC and requiring the OFR to report changes in systemwide risk levels to the FSOC).

¹²⁸ According to the OFR, financial stability would be impaired if one or more of the following occurred: the system could no longer make funds available to borrowers; turn short-term funding into longer-term loans; transfer some of

modeling techniques to determine whether they identified current risks to the financial system and could accurately predict emerging vulnerabilities.¹²⁹ The OFR began identifying potential weaknesses in the financial system as well as data that were needed to assess systemic threats that regulators had not collected,¹³⁰ and it developed a prototype “financial stability monitor” designed to measure economic stresses.¹³¹ In addition, through July 2014, the OFR released 16 “working papers” that discussed, among other things, financial institutions’ risk management practices and the conditions in which distress at one firm could destabilize the broader economy.¹³²

The OFR also began efforts to standardize data. The OFR, with the international regulatory community, sought to develop a “Legal Entity Identifier” to allow regulators and private entities to identify the parties to financial transactions. The OFR claims that the “Legal Entity Identifier” will enable it to track a company’s exposure to other institutions, providing it with a better understanding of the risks arising from connections between firms.¹³³ In addition, the OFR is developing a “Universal Mortgage Identifier” that, it says, will allow regulators to better understand potential systemic risks in the mortgage finance system;¹³⁴ is analyzing

the risk associated with lending funds from investors to financial intermediaries; determine fair market prices for financial assets; provide liquidity that allowed investors, borrowers, and lenders to engage in financial transactions; and process transactions and payments among market participants. OFF. OF FIN. RES., ANNUAL REPORT 10-12 (2012) [hereinafter 2012 ANNUAL REPORT].

¹²⁹ *Id.* at 38-44 (examining models that sought to identify risks by tracking instances in which Gross Domestic Product differed significantly from expected levels, that assessed divergences between stock returns and their historical behavior patterns, and that estimated probable system-wide losses associated with the distress of one large financial institution or the simultaneous distress of several smaller institutions). The OFR concluded that the models generally were more effective at identifying current vulnerabilities than oncoming crises, but that several models, if used together, could inform policymaking and that all models would benefit from better data. *Id.* at 33-34.

¹³⁰ *Id.* at 19-31 and 89-105; OFF. OF FIN. RES., ANNUAL REPORT 7-31, 71-95 (2013) [hereinafter 2013 ANNUAL REPORT].

¹³¹ 2013 ANNUAL REPORT, *supra* note 130, at 8.

¹³² See generally OFR WORKING PAPER SERIES, <http://www.treasury.gov/initiatives/ofr/research/Pages/working-paper-series.aspx> (last visited July 14, 2014).

¹³³ 2012 ANNUAL REPORT, *supra* note 128, at 109.

¹³⁴ Matthew McCormic & Lynn Calahan, *Common Ground: The Need for a Universal Mortgage Identifier 2* (Off. of Fin.Res., Working Paper No. 0012, 2013).

methods for the precise identification of financial products generally;¹³⁵ is considering ways to streamline data in the derivatives market;¹³⁶ and is seeking to develop reference databases for financial companies and instruments, as required by the Dodd-Frank Act.¹³⁷

Despite these efforts, however, the OFR has failed to identify or mitigate risks to the financial system, contrary to the expectations of Congress and the public. In its 2012 audit, the Government Accountability Office concluded that, as of the end of the audit period, the FSOC and the OFR had not developed and implemented “systematic and comprehensive mechanisms for identifying and monitoring . . . risks.”¹³⁸ And even though the OFR has characterized the development of the “Legal Entity Identifier” as “well underway,”¹³⁹ this standard—the OFR’s signal data standardization effort to date—is not fully operational more than three years after the OFR first called for its adoption.¹⁴⁰ Moreover, the usefulness of the OFR’s annual reports has been questioned; according to Simon Johnson, the International Monetary Fund’s former chief economist, the OFR’s 2013 report was “not impressive” and “read like some of the less informative systemic risk assessments that we saw prior to 2007.”¹⁴¹

¹³⁵ 2013 ANNUAL REPORT, *supra* note 130, at 107.

¹³⁶ *Id.* at 109.

¹³⁷ *Id.* at 110.

¹³⁸ GAO REPORT, *supra* note 79, at 22-23.

¹³⁹ 2013 ANNUAL REPORT, *supra* note 130, at 102.

¹⁴⁰ More than 100,000 “preliminary” “Legal Entity Identifiers” have been issued to an unspecified number of companies and their subsidiaries. 2013 Annual Report, *supra* note 130, at 104. Meanwhile, the OFR has continued to collaborate with domestic and international regulatory authorities to provide for the finalization and widespread adoption of the standard. *Id.* at 105-106. While the OFR has not provided a clear timeline for when the “Legal Entity Identifier” will be finalized, the OFR’s director has testified that the project is “nearing completion.” *The Annual Report of the Office of Financial Research: Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Fin. Services*, 113th Congress 23 (2014) [hereinafter *OFR Oversight Hearing*] (draft transcript on file with H. Comm. on Fin. Services). However, Representative Maloney has questioned whether the OFR will be able to successfully implement the “Legal Entity Identifier,” noting that some stakeholders had failed to comply with implementation efforts. *Id.* at 8. (“As I understand it, foreign areas are part of this, and they are refusing to cooperate”); see also Tom Groenfeldt, *Legal Entity Identifier (LEI) Progresses, Fitfully*, FORBES, July 1, 2013, <http://www.forbes.com/sites/tomgroenfeldt/2013/07/01/legal-entity-identifier-lei-progresses-fitfully/>.

¹⁴¹ Simon Johnson, *The Disappointing Office of Financial Research*, N.Y. TIMES ECONOMIX (Jan. 20, 2014, 12:01 A.M.), http://economix.blogs.nytimes.com/2014/01/30/the-disappointing-office-of-financial-research/?_php=true&_type=blogs&_r=0.

The OFR also failed its first high-profile test in identifying sources of “systemic risk.” In September 2013, the OFR released a report on the asset management industry—a collection of firms that facilitate the investment activities of individuals and institutions, often by acting as the investor’s agent—which it prepared at the FSOC’s request. The report concluded that the asset management industry could pose a systemic risk to the financial system because of the “extensive connections” between asset managers and other market participants as well as because of fire sales by asset management firms that could flood the market for a particular asset and thereby depress the asset’s price.¹⁴²

The Securities and Exchange Commission (SEC), which is the primary regulator of the asset management industry, solicited comments on the report. In response, the law firm Sidley Austin LLP advised that “many of the concerns and risks discussed in the Report are unsubstantiated or are based upon anecdotal assertions or generalized suppositions.”¹⁴³ The non-profit group Better Markets, usually an advocate for increased government intervention, commented that:

the Report adopts an arbitrary analytical framework; it provides little empirical support; it ignores or minimizes the significance of relevant factors; and it conveys its findings in such vague and amorphous terms that it proves to be of little value and is in fact misleading.¹⁴⁴

The Dean of Columbia University’s business school, the Chairman of the Brookings Institution, and the head of Harvard Law School’s program on international financial institutions wrote that the OFR’s report “presents an inaccurate and incomplete picture of the asset management market

¹⁴² OFF. OF FIN. RES., ASSET MANAGEMENT AND FINANCIAL STABILITY 21-23 (2013).

¹⁴³ Comment Letter from Sidley Austin LLP, to Elizabeth Murphy, Secretary, Securities and Exchange Comm’n (Nov. 1, 2013), <http://www.sec.gov/comments/am-1/am1-12.pdf>.

¹⁴⁴ Comment Letter from Dennis Kelleher, Robert Jenkins, and Stephen Hall, Better Markets, to Elizabeth Murphy, Secretary, Securities Exchange Comm’n (Nov. 1, 2013), <http://www.sec.gov/comments/am-1/am1-24.pdf> [hereinafter Better Markets Comment Letter].

and the risks it poses to the financial system.”¹⁴⁵ Even Michael Barr, a former senior Treasury official and one of the primary architects of the Dodd-Frank Act, drily noted in testimony before the Committee that the OFR’s asset management report “was not something I would hang my hat on.”¹⁴⁶

Finally, the OFR’s authority to collect data poses substantial risks. First, while the OFR now collects little information directly from financial institutions,¹⁴⁷ nothing prevents the OFR from exercising that authority in the future, which could impose significant costs on financial market participants while yielding little or no benefit. Even if the data is probative of a systemic threat, regulatory authorities may still fail to recognize its significance or mitigate the risk, just as they failed to identify and address emerging threats to financial stability in the run-up to the financial crisis, even though they had “real-time” access to detailed information on the risk profiles and activities of financial institutions. Second, the confidential information in the OFR’s possession—whether collected directly from firms or from other sources, as is presently the case—could be hacked by cyber-criminals, terrorists, or WikiLeaks-type organizations, or it could be disclosed by an OFR employee through inadvertence or incompetence. Recent data breaches that have resulted in the release of highly sensitive government information, including national security documents and individual Social Security Numbers, show that government

¹⁴⁵ Comment Letter from R. Glenn Hubbard, John L. Thornton, and Hal S. Scott, to Elizabeth Murphy, Secretary, Securities and Exchange Comm’n (Nov. 1, 2013), [http://op.bna.com/bar.nsf/id/cbre-9d2q8r/\\$File/commcapmktletter.pdf](http://op.bna.com/bar.nsf/id/cbre-9d2q8r/$File/commcapmktletter.pdf).

¹⁴⁶ *Examining the Dangers of the FSOC’s Designation Process and its Impact on the U.S. Financial System: Hearing Before the H. Comm. on Fin. Services*, 113th Cong. 22 (2014) (draft transcript on file with H. Comm. on Fin. Services).

¹⁴⁷ OFR Oversight Hearing, *supra* note 140, at 15 (statement of Hon. Richard Berner, Director, Off. of Fin. Res.) (“Congressman, we are not collecting information from firms, with one exception . . . In serving the needs of the Financial Stability Oversight Council and in a ministerial role, as an agent role, for the council’s nonbank designation process, we have been asked to collect data to support that process from firms.”).

agencies are extremely vulnerable to data leaks, hackers, and information theft.¹⁴⁸ In light of these risks, the OFR must ensure that its security protocols and policies governing employees, contractors, and researchers with access to sensitive information minimize the likelihood of breaches or other misuses of information.¹⁴⁹

“Living wills” submitted under Section 165(d) of the Dodd-Frank Act give regulators greater understanding of the firms they regulate but do not end “too big to fail”

Section 165 of the Dodd-Frank Act requires that the Federal Reserve establish standards by which it will supervise large, complex financial institutions that have been designated by the FSOC for heightened prudential supervision. Under Section 165, the Federal Reserve must impose risk-based capital standards and leverage limits, liquidity requirements, and risk management requirements on these institutions.¹⁵⁰ The Federal Reserve must also require firms subject to “heightened supervision” to prepare and submit resolution plans, or “living wills,” that demonstrate how the firm can be resolved under the Bankruptcy Code without posing a risk to U.S. financial stability.¹⁵¹ The Dodd-Frank Act authorizes the Federal Reserve and the FDIC to restrict the business activities of a firm submitting a living will if the firm cannot demonstrate that it can be resolved in a safe and orderly manner under the Bankruptcy Code.¹⁵² If necessary to facilitate the firm’s resolution in bankruptcy, the Federal Reserve and the FDIC, after

¹⁴⁸ See, e.g., *Edward Snowden’s NSA Revelations Keep Coming*, NAT’L PUB. RADIO, Nov. 9, 2013, <http://www.npr.org/2013/11/09/244204131/edward-snowdens-nsa-revelations-keep-coming>; Brian Fung, *The IRS Mistakenly Exposed Thousands of Social Security Numbers*, NAT’L J., July 8, 2013, <http://www.nationaljournal.com/tech/the-irs-mistakenly-exposed-thousands-of-social-security-numbers-20130708>; David E. Sanger, *U.S. Blames China’s Military Directly for Cyberattacks*, N.Y. TIMES, May 6, 2013, <http://www.nytimes.com/2013/05/07/world/asia/us-accuses-chinas-military-in-cyberattacks.html>.

¹⁴⁹ Although the OFR has taken steps to safeguard information in its possession and the Treasury Secretary has promulgated a rule imposing restrictions on former OFR employees, these efforts cannot completely eliminate the risk of a data breach or improper self-serving behavior.

¹⁵⁰ Dodd-Frank Wall Street Reform and Consumer Protection Act § 165(b), 12 U.S.C. § 5365(b) (2012). However, where risk-based capital requirements and leverage limits are not appropriate because of the business activities conducted by the firm, the Federal Reserve must apply other standards that result in similarly stringent risk controls in addition to liquidity requirements, overall risk management requirements, and resolution planning requirements. *Id.*

¹⁵¹ *Id.*

¹⁵² *Id.* at § 165(d), 12 U.S.C. § 5365(d) (requiring that firms submit living wills that are “credible” and that “facilitate an orderly resolution” under the Bankruptcy Code).

consulting with the FSOC, may order the firm to divest assets or operations.¹⁵³ For that reason, proponents of the “living wills” believe that they can help regulators ensure that the government need not bail out the creditors of a failing institution.

For example, Jeffrey Lacker, the President of the Richmond Federal Reserve Bank, testified that “all features of a large financial firm that render it hard to contemplate putting it through unassisted bankruptcy are under our control now before the next crisis.”¹⁵⁴ Mr. Lacker and former FDIC Chairman Bair agreed that regulators, if necessary, could use the “living wills” process to impose Glass-Steagall-like restrictions on firms, prohibiting them from owning business units that engaged in investment banking or broker-dealer activities if they also owned entities that carried out traditional banking activities.¹⁵⁵

Proponents of “living wills” analogize them to pre-packaged bankruptcies, in which shareholders and creditors agree to the terms of a corporate reorganization before filing a bankruptcy petition. Proponents also believe that preparing these documents in advance and having them on file with the regulators will help correct one of the most obvious problems in the Lehman Brothers bankruptcy, which was that it happened with absolutely no planning whatsoever. As those who participated in Lehman’s bankruptcy have noted, one of the most important reasons that Lehman’s failure proved to be so destabilizing for markets was the failure of Lehman and government regulators to prepare for a bankruptcy filing. While “living wills” hold some promise for giving regulators greater knowledge about the firms they are charged with regulating and for forcing large financial institutions to streamline their operations, not even their

¹⁵³ *Id.*

¹⁵⁴ *Hearing on Taxpayer-Funded Bailouts under Dodd-Frank*, *supra* note 49, at 14.

¹⁵⁵ *Id.* at 33 (statement of Jeffrey Lacker) (“I think the living will process will get us there if we need to go there. I think it will identify what activities we need to push out, separate from, banking activities, if that is what is needed to make unassisted bankruptcy palatable.”); *accord id.* (statement of Sheila Bair).

strongest advocates would suggest that “living wills” have solved the problem of “too big to fail.”

“Living Wills” are not binding on either regulators or financial institutions

As a threshold matter, Title I does not require that a large financial firm file for bankruptcy if it fails, nor does Title I give the regulators the authority to force a firm to file for bankruptcy. In fact, if a large firm finds itself facing insolvency, it would have every incentive to avoid filing for bankruptcy in order to force the FDIC to bail it out using the “Orderly Liquidation Authority” established under Title II. During the financial crisis, for example, Lehman’s chief executive officer, Dick Fuld, could have prepared his firm for bankruptcy before its collapse in September 2008. As the Lehman bankruptcy examiner Anton Valukas found, Mr. Fuld believed that the government would rescue Lehman, just as it did Bear Stearns, particularly given that the Federal Reserve Bank of New York had proposed creating a special purpose vehicle similar to the one it had used to bail out Bear Stearns.¹⁵⁶ Given the possibility of suffering substantial losses in a bankruptcy proceeding, a firm’s management and its shareholders would have no incentive to file a voluntary petition for bankruptcy; they would instead prefer to take their chances and “gamble for resurrection” or lobby government officials for a bailout under Title II. Given the possibility that creditors would receive more under a Title II resolution, they would have no incentive to force the institution into an involuntary bankruptcy proceeding. And even if regulators believe that the firm could be resolved in a bankruptcy proceeding without threatening financial stability, they do not have the authority to initiate an involuntary bankruptcy proceeding under either the Dodd-Frank Act or the Bankruptcy Code.

¹⁵⁶ Abigail Field, *Lehman Report: Why the U.S. Balked at Bailing Out Lehman*, DAILYFINANCE (Mar. 15, 2010, 7:00 PM), <http://www.dailyfinance.com/2010/03/15/why-the-u-s-balked-at-bailout-out-lehman/>.

The analogy its proponents draw between “living wills” and pre-packaged bankruptcies is further undercut by the fact that in a prepackaged bankruptcy, the stakeholders agree to the terms of a corporate reorganization before the bankruptcy petition is filed, while the creditors of large financial institutions do not participate in the drafting of the “living wills” or in their review by the regulators, bankruptcy lawyers do not review them, and bankruptcy judges do not approve them. These “living wills” may thus contain terms and conditions that creditors may not agree to if the institution fails, or that a bankruptcy judge may refuse to approve in a bankruptcy proceeding. As Baruch University Law Professor Nizan Geslevich Packin explains, although “living wills” may be superficially similar to “pre-packaged” bankruptcies or Chapter 11 reorganization plans under the bankruptcy code, they are quite different:

[U]nlike traditional [bankruptcy] plans, [“living wills”] are not the result of multi-party negotiations and planning that result in a deal. As demonstrated in virtually all of the big corporate enterprise bankruptcy cases, reorganization and liquidation plans concerning funding, capital, liquidity and disposition of assets and properties are never developed in a vacuum. Such plans mandate the input of key creditors, different government agencies, and main stakeholders, based on each case’s circumstances. Therefore, it would be extremely difficult to prepare such plans without knowing, at least to some extent, which capital markets can or will provide funding to the planning [institution], if need be, and if so, on what terms they will do so, or which purchasers will be willing and able to consummate a purchase of assets.¹⁵⁷

As a result, “living wills” cannot provide market participants with the certainty they need to ensure that financial markets remain stable if a large, complex financial institution fails. As a threshold matter, market participants do not know and cannot know whether the firm will be resolved under the bankruptcy code or under Title II. As former Comptroller of the Currency John Dugan put it, “It’s hard to tell people exactly what’s going to happen because we’re saying,

¹⁵⁷ Nizan Geslevich Packin, *The Case Against the Dodd-Frank Act’s Living Wills: Contingency Planning Following the Financial Crisis*, 9 BERKELEY BUS. L.J. 29, 88-89 (2012).

‘Well, it might be bankruptcy and it might not.’”¹⁵⁸ And even though proponents of “living wills” claim that they remedy the lack of planning and disorganization that plagued the Lehman bankruptcy, they do not know the contents of these “living wills,” nor do they know whether the participants in the bankruptcy process will follow these plans or disregard them altogether.¹⁵⁹

The lack of transparency makes “living wills” unworkable and unusable

The irony of the “living will” submissions is that the parties that play the most significant roles in the bankruptcy process—the institution’s creditors, bankruptcy lawyers, and the bankruptcy courts—play absolutely no part in reviewing the “living wills” or passing on their credibility. And the reason for that is that the portions of the “living wills” that spell out—in detail—how the firm would be resolved are secret. While it is easy to understand the reasons that banks and regulators want to keep these plans confidential, the secrecy makes it impossible for anyone outside the regulatory agencies to assess their credibility. As former FDIC Chairman Sheila Bair put it, “It’s not a public process. So you kind of take it on faith that they’re really dealing with this.”¹⁶⁰

That secrecy gives rise to two problems. The first is that it is difficult to evaluate the actions of the regulators and to independently assess the credibility of these “living wills”: market participants, bankruptcy experts, creditors, and taxpayers are left to “take it on faith” that the banking regulators are correctly evaluating these “living wills.” And as Seton Hall University law professor Stephen Lubben points out, the banking regulators who are making

¹⁵⁸ Jesse Hamilton & Craig Torres, *Biggest Banks’ Wind-Down Plans Seen Failing to Cut Risks*, BLOOMBERG BUSINESSWEEK, June 26, 2013, <http://www.bloomberg.com/news/2013-06-26/biggest-banks-wind-down-plans-seen-failing-to-cut-risks.html>; see also *Oversight Subcomm. Hearing on the OLA*, *supra* note 41, at 10 (statement of Joshua Rosner) (“It is very problematic if the same institution has the possibility of going through two different insolvency regimes, depending on the whim of regulators.”).

¹⁵⁹ Section 165(d)(6) of the Dodd-Frank Act provides that “[a] resolution plan . . . shall not be binding on a bankruptcy court, a receiver appointed under Title II, or any other authority that is authorized or required to resolve the nonbank financial company supervised by the Board, any bank holding company, or any subsidiary or affiliate of the foregoing.”

¹⁶⁰ Hamilton & Torres, *supra* note 158.

these assessments are not themselves bankruptcy experts: “[T]he F.D.I.C. does not have a lot of in-house Chapter 11 experience. How are they determining that these plans represent a realistic bankruptcy approach?”¹⁶¹ The second problem is that the secrecy surrounding the living wills makes it impossible for market participants to know exactly how they will be treated in a resolution under the bankruptcy code, even if the bankruptcy court chose to follow the plan laid out in the “living will,” which it is under no obligation to do.

“Living wills” will be unworkable in the midst of a financial crisis

In addition to these problems, “living wills” are beset by a number of internal contradictions. The first of these problems is that in order to submit a “living will” describing how a firm could be “credibly” resolved in bankruptcy, the firm’s executives have to imagine the kinds of circumstances and events that could lead the firm to fail. But if the firm’s executives could imagine these circumstances and events, they would avoid them. On the other hand, the sudden events that could lead a firm to fail are, almost by definition, unpredictable, which makes them impossible to plan for.

As former Goldman Sachs banker Matt Levine puts it, every financial institution that has submitted a “living will” prefaces it “with several pages of ‘our balance sheet is a mighty fortress and this will never never never happen.’”¹⁶² On the other hand, rapidly changing economic conditions and the fast pace of financial innovation mean that living wills suffer from an obvious limitation: it is extremely difficult, if not impossible, to predict how and when a firm will fail and to plan accordingly.¹⁶³ Or as Goldman Sachs put it in the publicly available portion of the

¹⁶¹ Stephen Lubben, *Questions Remain About Unwinding Failing Financial Giants*, N.Y. TIMES DEALBOOK (Oct. 30, 2013, 2:28 PM), <http://dealbook.nytimes.com/2013/10/30/questions-remain-about-unwinding-failing-financial-giants>.

¹⁶² Matt Levine, *Banks Prove That They Are Not Too Big to Fail By Saying ‘We Can Fail’ on a Piece of Paper, Moving On*, DEALBREAKER (July 5, 2012, 10:40 AM), <http://dealbreaker.com/2012/07/banks-prove-that-they-are-not-too-big-to-fail-by-saying-we-can-fail-on-a-piece-of-paper-moving-on/>.

¹⁶³ Packin, *supra* note 157, at 75-76.

first version of its “living will”: “The circumstances leading to the failure of a systemically important financial institution will likely be different than the specific assumptions listed above.”¹⁶⁴

Some have noted that in the midst of a full-blown financial crisis, “living wills” may be impossible to implement. Dallas Federal Reserve Bank Richard Fisher has said that:

living wills are likely to prove futile in helping navigate a real-time systemic failure, in my experience.

Given the complexity and opacity of the TBTF institutions, their ability to move assets and liabilities across subsidiaries and affiliates, as well as off-balance sheet, a living will would likely be ineffective when it really mattered. I don’t have much faith in the living will process to make a material difference in too-big-to-fail risks and behaviors. The bank would run out of liquidity, not necessarily capital, due to reputational risk quicker than management would work with regulators to execute a living will blueprint.¹⁶⁵

Analysis of Title II of the Dodd-Frank Act

The framers of the Dodd-Frank Act claimed that they ended the problem of “too big to fail.” In addition to the vast and unaccountable authority the Dodd-Frank Act conferred on regulators in Title I, the Dodd-Frank Act also established an “Orderly Liquidation Authority” in Title II. The proponents of Title II promised taxpayers that the “Orderly Liquidation Authority” would end bailouts by giving the FDIC the authority to seize a firm whose imminent failure threatened the U.S. financial system, and wind it down in an “orderly” fashion, all without forcing taxpayers to bail out the shareholders and creditors of the failing institution. While the proponents of the “Orderly Liquidation Authority” have not been shy in declaring victory over the problem of “too big to fail,” the reality is quite different: rather than ending bailouts, the

¹⁶⁴ Goldman Sachs Group, Inc., Summary of Resolution Plan 4 (June 29, 2012), <http://federalreserve.gov/bankinforeg/resolution-plans/goldman-sachs-1g-20120702.pdf>.

¹⁶⁵ *Hearing on Taxpayer-Funded Bailouts under Dodd-Frank*, *supra* note 45, at 12.

“Orderly Liquidation Authority” has made them a fixture in the regulators’ toolkit, thereby subverting market discipline and making future bail-outs more (not less) likely.

The proponents of the Dodd-Frank Act never offered an adequate explanation of how the “Orderly Liquidation Authority” would end bailouts

Believing that one of the lessons of the financial crisis was that the bankruptcy laws did not sufficiently provide for orderly resolution of large non-depository financial institutions, the Obama Administration proposed the creation of a new “Orderly Liquidation Authority” in the spring of 2009.¹⁶⁶ The Administration fashioned its proposal after the FDIC’s authority to administer bank conservatorships and receiverships, which then-Treasury Secretary Tim Geithner characterized as a model that offered “a lot of promise.”¹⁶⁷ Under that model, when a bank failed, the FDIC paid depositors’ claims up to the insured amount of their deposits and disposed of the bank’s assets in the manner that imposed the least cost to the insurance fund from which it paid depositors. Tellingly, however, the Administration’s original proposal departed from the FDIC “least cost resolution” model, prompting critics of the plan to argue that the Treasury Department was seeking to give itself “extensive new powers to inject money into or seize systemically important firms in danger of failure.”¹⁶⁸

Throughout 2009 and 2010, Financial Services Committee Republicans pressed the Obama Administration for details on how its proposal for resolving large, complex financial

¹⁶⁶ OBAMA ADMINISTRATION WHITE PAPER, *supra* note 52, at 76-78 (arguing that “[t]he federal government’s responses to the impending bankruptcy of Bear Stearns, Lehman Brothers, and AIG were complicated by the lack of a statutory framework for avoiding the disorderly failure of nonbank financial firms, including affiliates of banks or other insured depository institutions”).

¹⁶⁷ *Addressing the Need for Comprehensive Regulatory Reform: Hearing Before the H. Comm. on Fin. Services*, 111th Cong. 10-11 (2009).

¹⁶⁸ See Jo Becker & Gretchen Morgenson, *Geithner, Member and Overseer of Finance Club*, N.Y. TIMES, Apr. 26, 2009, http://www.nytimes.com/2009/04/27/business/27geithner.html?pagewanted=all&_r=0. Lending resonance to the charge that Treasury’s authority under the Administration’s proposal was a veritable “blank check” to infuse money into systemically important firms was the fact that it had been drafted “in large measure” by the law firm of Davis, Polk & Wardwell, which represents many of the largest global banking institutions. This came to light when it was discovered that the “proposed legislation that Treasury sent to Capitol Hill bore the law firm’s computer footprints.” *Id.*

institutions would operate in practice. For example, at an October 2009 hearing, then-Ranking Member Spencer Bachus asked Secretary Geithner to explain how Lehman Brothers would have been resolved under the Administration’s approach. Secretary Geithner did not answer.¹⁶⁹ In a hearing in April 2010, Secretary Geithner was again asked to explain how much it would have cost to wind down Lehman Brothers under the “Orderly Liquidation Authority.” Secretary Geithner replied that the question was “unanswerable.”¹⁷⁰

That same month, Ranking Member Bachus again asked Secretary Geithner, this time in writing, to explain how the “Orderly Liquidation Authority” would work:

I am writing you to ask that you explain—in detail, using information that was available to the New York Federal Reserve Bank in September 2008—how the “resolution authority” the Administration has proposed would have resolved Lehman Brothers in an orderly manner that would have, in your words, “maximized return to the taxpayer and minimized risk of losses for the system.” Because Lehman Brothers has become the cornerstone on which arguments in favor of an open-ended government “resolution authority” have been grounded, the American people deserve to know how this authority would have addressed Lehman Brothers and at what cost. And they deserve to have that information before Congress passes legislation granting the government these broad powers.¹⁷¹

Four months later—and one month *after* the president signed the Dodd-Frank Act into law—Secretary Geithner responded with a two-page letter. The letter did not explain how the “Orderly Liquidation Authority” would have resolved Lehman Brothers, or at what cost.¹⁷² That explanation would have to wait for another day. Besides, the Dodd-Frank Act had been signed into law. Why start explaining now?

¹⁶⁹ Press Release, Comm. on Fin. Services, Bachus Asks Geithner Again to Explain Administration’s Plan for Bailout Authority in Advance of Senate Consideration of Financial Reform (Apr. 23, 2010), <http://financialservices.house.gov/news/documentsingle.aspx?DocumentID=227818>.

¹⁷⁰ *Id.*

¹⁷¹ *Id.*

¹⁷² Letter from Timothy Geithner, Secretary, Dep’t of the Treasury, to Spencer Bachus, Ranking Member, Comm. on Fin. Services (Aug. 6, 2010).

The Dodd-Frank Act’s drafters intended for the “Orderly Liquidation Authority” to “provide the necessary authority to liquidate failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates [that] risk and minimizes moral hazard.”¹⁷³ The Treasury Secretary must subject a financial company to resolution under Title II after receiving a written recommendation from the FDIC and Federal Reserve and determining, in consultation with the president, that: (1) the financial company is in default or in danger of default; (2) the failure of the company and its resolution under otherwise applicable insolvency law would have serious adverse effects on the financial stability in the United States; (3) no viable private sector alternative is available to prevent the default of the company; (4) any effect of a receivership on creditors, counterparties, and shareholders would be “appropriate” given the benefits of a receivership in terms of preserving financial stability; (5) establishing a receivership would avoid or mitigate the adverse effects on stakeholders relative to not undertaking such action; (6) a federal regulatory agency has ordered the financial company to convert all of its convertible debt instruments that are subject to the regulatory order; and (7) the company is a “financial company” as defined in the Dodd-Frank Act.¹⁷⁴ After making the required determinations, the Treasury Secretary must notify the financial company that it will be placed in a Title II proceeding.¹⁷⁵ The Dodd-Frank Act shields directors from liability to the firm’s shareholders and creditors for acquiescing in or consenting in good faith to the appointment of the FDIC as receiver.¹⁷⁶

¹⁷³ Dodd-Frank Wall Street Reform and Consumer Protection Act § 204, 12 U.S.C. § 5384 (2012).

¹⁷⁴ *Id.* at § 203(b)(1)-(7), 12 U.S.C. § 5383(b)(1)-(7). For broker-dealers, the SEC rather than the FDIC must vote to recommend that the Treasury Secretary subject the firm to resolution. *Id.* at § 203(a)(1)(B), 12 U.S.C. § 5383(a)(1)(B). For insurance companies, the Director of the Treasury Department’s Federal Insurance Office, in consultation with the FDIC, must make the required recommendation. *Id.* at § 203(a)(1)(C), 12 U.S.C. § 5383(a)(1)(C).

¹⁷⁵ *Id.* at § 203(c)(1), 12 U.S.C. § 5383(c)(1).

¹⁷⁶ *Id.* at § 207, 12 U.S.C. § 5387.

The Dodd-Frank Act requires that “Orderly Liquidation Authority” resolutions carried out under Title II meet particular requirements. The FDIC must ensure that any action taken in a resolution is necessary to ensure U.S. financial stability and is not being taken to preserve the financial company, that the company’s shareholders do not receive payment until all other claims are paid, that unsecured creditors bear losses in accordance with priority provisions established in the Act, that directors and managers responsible for the firm’s failure are removed, and that the government does not take an equity interest in or become a shareholder of the company or any “covered subsidiary.”¹⁷⁷

A resolution under Title II can be supported through private borrowing or by the “Orderly Liquidation Fund,” which contains, among other things, the proceeds of obligations issued by the FDIC and purchased by the Treasury Secretary.¹⁷⁸ Thus, the “Orderly Liquidation Fund” can be tapped to make loans to the firm being resolved or its “covered subsidiaries,” acquire debt, purchase assets or guarantee them against loss, assume or guarantee obligations, and make payments, including payments to creditors and counterparties of the failed firm.¹⁷⁹ The FDIC is specifically authorized to treat similarly situated creditors differently in order to maximize the value of the company’s assets, minimize the amount of its losses, or to maintain vital operations of the company in receivership.¹⁸⁰

The “Orderly Liquidation Fund” can also be used to provide operating funds to a bridge financial company established by the FDIC as well as to facilitate the winding-up of the bridge entity through its merger or consolidation with another entity, the sale of its capital stock, the assumption of its liabilities or the acquisition of assets, or its termination or dissolution as

¹⁷⁷ *Id.* at § 206, 12 U.S.C. § 5386.

¹⁷⁸ *Id.* at § 210(n), 12 U.S.C. § 5390(n).

¹⁷⁹ *Id.* at § 204(d), 12 U.S.C. § 5384(d).

¹⁸⁰ *Id.* at § 210(b)(4), 12 U.S.C. § 5390(b)(4).

provided for under the Act.¹⁸¹ The FDIC must develop and secure approval of an “orderly liquidation plan” and a “mandatory repayment plan” before deploying the “Orderly Liquidation Fund” in connection with the resolution of a company. If the company cannot repay the funds, the FDIC must impose assessments on creditors and large financial institutions, including financial institutions that may not have transacted any business with the failed firm.¹⁸²

Additionally, the FDIC may claw back incentive payments and other compensation made to executives that contributed to the firm’s failure.¹⁸³

Almost four years after the Dodd-Frank Act’s passage, the effectiveness of the “Orderly Liquidation Authority” as a tool for addressing the failure of large, complex financial institutions remains seriously in doubt

As noted above, Title II of the Dodd-Frank Act is patterned after the FDIC’s long-standing authorities under the Federal Deposit Insurance Act to resolve failed depository institutions. Those who supported granting the FDIC “resolution authority” did so because they claimed that given the FDIC’s knowledge and experience in resolving small banks, the FDIC could use that expertise to seamlessly resolve large, complex financial institutions. Yet the types of institutions that the FDIC is typically able to seize and reopen over the course of a weekend bear little resemblance to the trillion-dollar financial institutions with thousands of operating units around the globe that it would be called upon to resolve under the Dodd-Frank Act.¹⁸⁴

¹⁸¹ *Id.* at § 210(h)(2)(G)(iv), (h)(9), 12 U.S.C. 5390(h)(2)(G)(iv), (h)(9).

¹⁸² *Id.* at § 210(o), 12 U.S.C. § 5390(o). If assessments on claimants receiving more than the liquidation value of their claims are insufficient to repay the obligations issued by the FDIC to the Treasury Secretary, bank holding companies with greater than \$50 billion in assets, and non-bank financial institutions that have been designated for “heightened prudential supervision” by the FSOC, are subject to assessments. *Id.*

¹⁸³ *Id.* at § 210(s), 12 U.S.C. § 5390(s).

¹⁸⁴ *Oversight Subcomm. Hearing on the OLA, supra* note 41, at 23 (statement of David Skeel, S. Samuel Arsht Professor of Corporate Law, Univ. of Pennsylvania Law School) (“We have been talking about what the FDIC does with its bank resolutions, what it has done for a long time. It is very important to keep in mind the normal FDIC bank resolution looks nothing like the institutions we are talking about. [. . .] The small mom-and-pop institution, all of its liabilities are deposits. This is a completely different creature and this is uncharted territory.”); *see also* Peter J. Wallison & David Skeel, *The Dodd Bill: Bailouts Forever*, WALL ST. J., Apr. 7, 2010, <http://online.wsj.com/news/articles/SB10001424052702303493904575167571831270694> (“It is wrong to think that

Witnesses at the Committee Hearings also noted that the “Orderly Liquidation Authority” would most likely be invoked during a period when more than one large financial institution was under stress, and questioned the FDIC’s ability to handle multiple simultaneous failures.¹⁸⁵

Other critics of Title II have questioned the wisdom of entrusting the same regulators that allowed a firm to reach the point of failure with the complex task of resolving it, when an alternative venue is available in the federal bankruptcy system:

Once a financial firm has become in need of resolution, there has already been a failure of regulation. Why the same regulators should be in charge of cleaning up the mess is something that continues to puzzle me. Certainly they deserve a say, and the special nature of financial institutions will often call for special solutions, but count me among those who remain unconvinced by the very “in-house” solution adopted by Dodd-Frank.¹⁸⁶

While the FDIC has received plaudits for many aspects of its crisis response, it has also come under criticism for failing in some instances to recognize and mitigate signs of stress at depository institutions that ended up failing on in its watch:

Even . . . with its bread and butter bank closings, FDIC resolution has hardly been an unqualified success. Under the mandates of the prompt corrective action rules, the FDIC theoretically should intervene early and should never lose money. But in many cases, things have not worked out this way in practice. In more than two-thirds of the bank closures during the recent crisis, the FDIC’s first intervention came when the bank was put in resolution. It never imposed the earlier warning obligations specified by the banking rules. Moreover, the FDIC has lost money in a significant number of these bank closings.¹⁸⁷

because the FDIC can handle the closure of small banks it is equipped to take over and close a giant, nonbank financial firm like a Lehman Brothers or an AIG.”).

¹⁸⁵ *Oversight Subcomm. Hearing on the OLA, supra* note 41, at 23 (statement of Joshua Rosner) (questioning the FDIC’s ability to handle the simultaneous failure of several large institutions).

¹⁸⁶ Stephen J. Lubben, *The FDIC’s Lehman Fantasy*, N.Y. TIMES DEALBOOK (Apr. 29, 2011, 10:36 AM), http://dealbook.nytimes.com/2011/04/29/the-f-d-i-c-s-lehman-fantasy/?_php=true&_type=blogs&_r=0.

¹⁸⁷ DAVID SKEEL, THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES 124 (2010). A 2011 analysis performed by the GAO reached a similar conclusion about the ineffectiveness of the Prompt Corrective Action regime as an “early warning system” during the crisis. See GOV’T ACCOUNTABILITY OFFICE, *Introduction to BANK REGULATION: MODIFIED PROMPT CORRECTIVE ACTION FRAMEWORK WOULD IMPROVE EFFECTIVENESS* (2011) (“GAO’s analysis of regulatory data and material loss reviews showed that actions to address early signs of deterioration were inconsistent and, in many cases, regulators either took no enforcement action or acted in the final days before an institution was subject to PCA or failed.”).

Even those who believe that Title II of the Dodd-Frank Act solves the “too big to fail” problem acknowledge that it will not work without cross-border cooperation and coordination—and the tools for cross-border cooperation and coordination are not in place. In December 2013, Treasury Secretary Jacob Lew stated:

Major financial institutions work globally, and for resolution of these firms to work fully, cross-border resolution must be part of it. The failure of Lehman Brothers demonstrated that the absence of cooperation between domestic and foreign authorities to resolve a financial company can endanger the global financial system—and underscored that, in the future, new resolution tools will need to work across borders.¹⁸⁸

And yet U.S. regulators and their foreign counterparts have made only fitful progress in building an international framework to resolve failed financial firms. More than five years after the crisis, their work is still not complete. In 2013, the Financial Stability Board reviewed the progress of foreign jurisdictions in establishing regimes for resolving so-called Global Systemically Important Financial Institutions (G-SIFIs). The Financial Stability Board concluded that implementation of these regimes “remains at an early stage, and many jurisdictions still lack the necessary powers and institutions to resolve effectively either G-SIFIs or other financial institutions.”¹⁸⁹ In a May 27, 2014, speech, International Monetary Fund Managing Director Christine Lagarde described the absence of a cross-border regime for resolving large banks as “a gaping hole in the financial architecture.”¹⁹⁰

¹⁸⁸ Jacob J. Lew, Address at the Pew Charitable Trusts (Dec. 5, 2013), <http://www.treasury.gov/press-center/press-releases/Pages/jl2232.aspx>.

¹⁸⁹ *Improving Cross-Border Resolution to Better Protect Taxpayers and the Economy: Hearing Before the Subcomm. on Security and Int'l Trade and Finance of the S. Comm. on Banking, Housing, and Urban Affairs*, 113th Cong. 32 (2013) (prepared statement of William C. Murden, Director, Office of Int'l Banking and Securities Markets, U.S. Dep't of the Treasury) (citing FIN. STABILITY BD., THEMATIC REVIEW OF RESOLUTION REGIMES: PEER REVIEW REPORT (2013)).

¹⁹⁰ Christine Lagarde, Economic Inclusion and Financial Integrity – an Address to the Conference on Inclusive Capitalism (May 27, 2014).

In early 2013, U.S. regulators showed that they had little hope for effective cross-border coordination in resolving G-SIFIs in connection with their review of “living wills” prepared by the largest U.S. financial firms. The *Financial Times* reported that the Federal Reserve and the FDIC instructed the firms that in preparing their plans for orderly resolution under the Bankruptcy Code, they were “not to assume that countries will work together to avoid the catastrophic failure of a financial group,” nor “count on regulators to cooperate.”¹⁹¹

The FDIC’s strategy for implementing Title II—the “Single Point of Entry”—is a recipe for future AIG-style bailouts

The Dodd-Frank Act grants the FDIC the authority to develop strategies for administering a Title II proceeding.¹⁹² The FDIC has developed a “Single Point of Entry” strategy to resolve firms subject to the “Orderly Liquidation Authority.” Under that method, the FDIC would be appointed receiver of the institution’s parent holding company.¹⁹³ The FDIC would then transfer the assets, derivatives and short-term obligations of the parent to a bridge holding company, thus allowing the firm’s operating subsidiaries to continue functioning and to be recapitalized by the bridge entity if necessary.¹⁹⁴ Under the Dodd-Frank Act, the bridge would be exempt from all taxes, including federal, state, and local taxes.¹⁹⁵ The Dodd-Frank Act authorizes the FDIC to maintain the bridge entity for as long as five years.¹⁹⁶ Under the SPOE strategy, the holding company’s shareholders and unsecured creditors would receive an interest

¹⁹¹ Tom Braithwaite, Patrick Jenkins & Shahien Nasiripour, *US Regulators Warn Banks on Living Wills*, FIN. TIMES, Jan. 27, 2013, <http://www.ft.com/intl/cms/s/0/a17d0e9a-688c-11e2-9a3f-00144feab49a.html>.

¹⁹² See Dodd Frank Wall Street Reform and Consumer Protection Act § 210, 12 U.S.C. § 5390 (2012).

¹⁹³ FEDERAL DEPOSIT INS. CORP. & BANK OF ENGLAND, RESOLVING GLOBALLY ACTIVE, SYSTEMICALLY IMPORTANT, FINANCIAL INSTITUTIONS 6 (2012) [hereinafter FDIC AND BANK OF ENGLAND JOINT PAPER], <http://www.fdic.gov/about/srac/2012/gsifi.pdf>.

¹⁹⁴ *Id.*

¹⁹⁵ Dodd-Frank Wall Street Reform and Consumer Protection Act § 210(h)(10), 12 U.S.C. § 5390(h)(10).

¹⁹⁶ *Id.* at § 210(h)(12), 12 U.S.C. § 5390(h)(12) (providing that the bridge holding company terminates two years after it is granted its charter, but the FDIC has the discretion to extend such status for up to three additional one-year periods).

in the recapitalized firm in satisfaction of their claims, as determined by the FDIC subject to the priority rules of the Dodd-Frank Act.¹⁹⁷

Proponents of the FDIC’s “Single Point of Entry” strategy claim that it solves the problems of bailouts by inflicting losses at the parent company level, wiping out shareholders and writing down the claims of its long-term unsecured creditors or converting those claims to equity, thereby recapitalizing the parent company and restoring it to solvency. But inflicting losses at the parent company level does nothing to minimize the moral hazard on the part of creditors and counterparties at the subsidiary level. In fact, according to testimony at the Committee Hearings, by using the equity and debt of the parent company to shield these creditors from loss, the “Single Point of Entry” makes the financial system even more fragile by increasing moral hazard:

Under the FDIC’s approach, a failing firm’s operating subsidiaries remain open and operating while the holding company would be subject to [the Orderly Liquidation Authority]. Thus, subsidiary creditors face greatly diminished chances of loss. After all, the FDIC has declared that these subsidiary banks and broker-dealers will probably never face insolvency. Counterparties will be less prudent if they think creditors of the holding company are on the hook.¹⁹⁸

Even if the shareholders and creditors of the parent company are ultimately forced to bear the losses of the subsidiary, protecting the creditors of the subsidiary makes the financial system all the more fragile, increasing the risk of another financial crisis.¹⁹⁹ And in the midst of a

¹⁹⁷ FDIC AND BANK OF ENGLAND JOINT PAPER, *supra* note 193, at 6.

¹⁹⁸ *Oversight Subcomm. Hearing on the OLA, supra* note 41, at 10 (statement of Joshua Rosner). Peter Fisher, a former high-ranking official at the New York Federal Reserve Bank and now senior director at the asset management firm BlackRock, agrees, telling a public forum hosted by the FDIC on December 11, 2013, that by forcing holding company creditors to absorb all the losses, the SPOE approach undermines market discipline at a firm’s operating subsidiaries. Barbara Rehm, *FDIC’s Own Experts Skeptical of Resolution Plan*, AM. BANKER, Dec. 12, 2013. Banking analyst Karen Shaw Petrou has also highlighted the moral hazard inherent in the “Single Point of Entry” strategy: “SPOE . . . needs a barrier so that taxpayer bailout risk isn’t downstreamed from big [bank holding companies] resolved through SPOE to subsidiaries into which investors park their risk in anticipation that holding-company resources combined with federal support will protect them.” Joe Adler, *How FDIC Can Fix SIFI Resolution Framework*, AM. BANKER, Feb. 24, 2014.

¹⁹⁹ *Hearing on Taxpayer-Funded Bailouts under Dodd-Frank, supra* note 49, at 13 (statement of Jeffrey Lacker, President, Federal Reserve Bank of Richmond) (“Title II gives the FDIC the ability to borrow funds from the

financial crisis, it may well turn out—just as it did in the last crisis with AIG—that losses at the subsidiary level are so great that the government will decide it has no choice but to step in if there are insufficient resources at the parent company to make the subsidiary whole. As FDIC Vice Chairman Thomas Hoenig has pointed out, this prospect of government support confers an important benefit on the subsidiaries of large, complex firms:

In times of financial stress, the knowledge that operating units will be provided funding to meet liquidity demands could serve to encourage corporate treasurers and others to place their funds with SIFIs' operating subsidiaries over other financial firms for whom such assurances are unavailable. Therefore, this assumption and access to funding provides SIFIs a significant competitive advantage.²⁰⁰

Indeed, the parallels between the “Single Point of Entry” strategy and the Federal Reserve’s decision to allow AIG’s subsidiaries to continue operating and pay their creditors and counterparties in full are striking. As Princeton University economist and former Federal Reserve Vice Chairman Alan Blinder writes, “the most serious economic issue posed by the AIG bailout was probably the decision to pay off AIG’s creditors one hundred cents on the dollar, rather than impose any losses on them. . . . [W]hen creditors who lent to, and counterparties who dealt with, AIG without bothering to worry about its creditworthiness are bailed out 100 percent, the government is inviting creditors and counterparties of other companies to assume the same.”²⁰¹ Writing in the immediate aftermath of the AIG bail-out, noted economist Willem Buiter put the matter even more bluntly in a piece he titled “The Fed’s Moral Hazard Maximizing Strategy”:

Treasury to make payments to creditors of the failed firm. This encourages short-term creditors to believe that they would benefit from such treatment. They would therefore continue to pay insufficient attention to risk and to invest in fragile funding relationships.”).

²⁰⁰ Joe Adler, *Likely Battle Ahead for FDIC’s ‘Single Point’ Resolution Plan*, AM. BANKER, Dec. 10, 2013.

²⁰¹ ALAN S. BLINDER, AFTER THE MUSIC STOPPED: THE FINANCIAL CRISIS, THE RESPONSE, AND THE WORK AHEAD 138-39 (2013).

U.S. banks and shadow-banks (like AIG’s Financial Products Division) took on excessive leverage and excessive risk. There was not only too much careless lending *by* US banks, there was too much careless lending *to* US banks. When this crisis is over and when, in the fullness of time, the real economy has recovered, we want to see less lending by and to US banks than we saw in the years 2004–2006. How do we get those who provided US banks and other financial institutions with too much funding at too low a cost to behave with greater prudence and caution in the future? Presumably by making sure that they pay the price for their reckless financial decisions. The counterparties of AIG who had been unwise enough to buy insurance against default on debt instruments they held, by acquiring CDS written by AIG should have been told to eat it.²⁰²

Yet instead of requiring the creditors and counterparties of the AIG subsidiaries to bear their losses—thus limiting losses to the taxpayers and ending the “moral hazard maximizing” strategy that began with Bear Stearns—the Federal Reserve bailed out these institutions, many of which were large European banks.²⁰³ As the Special Inspector General for the Troubled Asset Relief Program put it:

Questions have been raised as to whether the Federal Reserve intentionally structured the AIG counterparty payments to benefit AIG’s counterparties—in other words that the AIG assistance was in effect a “backdoor bailout” of AIG’s counterparties. Then-FRBNY President Geithner and FRBNY’s general counsel deny that this was a relevant consideration for the AIG transactions. Irrespective of their stated intent, however, there is no question that the *effect* of FRBNY’s decisions—indeed, the very *design* of the federal assistance to AIG—was that tens of billions of dollars of Government money was funneled inexorably and directly to AIG’s counterparties. Although the primary intent of the initial \$85 billion loan to AIG may well have been to prevent the adverse systemic consequences of an AIG failure on the financial system and the economy as a whole, in carrying out that intent, it was fully contemplated that such funding would be used by AIG to make tens of billions of dollars of collateral payments to the AIG counterparties. . . . Stated another way, by providing AIG with the capital to make these payments, Federal Reserve officials provided AIG’s counterparties with tens of billions of dollars they likely would not have otherwise received had AIG gone into bankruptcy.²⁰⁴

²⁰² Willem Buijer, *The Fed’s moral hazard maximizing strategy*, FIN. TIMES BLOGS (Mar. 6, 2009, 7:44 PM), <http://blogs.ft.com/maverecon/2009/03/the-feds-moral-hazard-maximising-strategy/>.

²⁰³ Michael Mandel, *German and French Banks Got \$36 Billion from AIG Bailout*, BLOOMBERG BUSINESSWEEK, Mar. 15, 2009, http://www.businessweek.com/the_thread/economicsunbound/archives/2009/03/german_and_fren.html.

²⁰⁴ OFFICE OF THE SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, FACTORS AFFECTING EFFORTS TO LIMIT PAYMENTS TO AIG COUNTERPARTIES 30 (2009),

The AIG bailout was egregious for any number of reasons. As the *New York Times* reported, “Of all the government rescues undertaken during the credit crisis of 2008, none has stirred more outrage and raised more questions than the bailout of AIG.”²⁰⁵ In testimony before the Senate Budget Committee, Federal Reserve Chairman Ben Bernanke said, “I think if there’s a single episode in this entire 18 months that has made me more angry, I can’t think of one [other] than AIG.”²⁰⁶ While he was still President Obama’s economic advisor Larry Summers said, “There are a lot of terrible things that happened [during the financial crisis], but what’s happened at AIG is the most outrageous.”²⁰⁷

Some critics of the AIG bailout have claimed that government officials—particularly Tim Geithner, as president of the New York Federal Reserve Bank—failed to use their leverage in negotiations with AIG’s counterparties to extract concessions and pay them less than the face value of their claims; others who defend the AIG bailouts claim that given the exigencies of the moment, government officials had no choice but to pay off AIG’s creditors and counterparties in full.²⁰⁸ Given that the decision to bail out AIG’s counterparties was made in the midst of a full-blown financial crisis, perhaps it is uncharitable to expect government officials would have bargained harder than they did.

But the “Single Point of Entry” was conceived and developed after the crisis had passed. Its designers cannot plead that they are responding to an emergency. Yet, the “Single Point of

http://www.sig tarp.gov/Audit%20Reports/Factors_Affecting_Efforts_to_Limit_Payments_to_AIG_Counterparties.pdf

²⁰⁵ Gretchen Morgenson & Louise Story, *Two at Fed Had Doubts Over Payout by AIG*, N.Y. TIMES, Jan. 26, 2010, http://www.nytimes.com/2010/01/27/business/27aig.html?pagewanted=all&_r=0.

²⁰⁶ *Economic and Budget Challenges for the Short and Long Term: Hearing Before the S. Comm. on the Budget*, 111th Cong. 19 (2009).

²⁰⁷ Mary Williams Walsh, *AIG Lists Banks it Paid with U.S. Bailout Funds*, N.Y. TIMES, Mar. 16, 2009, <http://www.nytimes.com/2009/03/16/business/16rescue.html>.

²⁰⁸ See, e.g., Eamon Javers, *Report Hits Geithner over AIG Bailout*, POLITICO, Nov. 16, 2009, <http://www.politico.com/news/stories/1109/29601.html>.

Entry”—by design—immunizes the creditors and counterparties of an operating subsidiary from the consequences of their poor choices. In doing so, the “Single Point of Entry” threatens to institutionalize the AIG approach to bailouts, encouraging recklessness on the part of creditors and counterparties to the holding company’s operating subsidiaries because they realize that even if the subsidiary fails and the parent company cannot support it, the FDIC is prepared to take over the parent and funnel liquidity through it to the insolvent subsidiary, much like the Federal Reserve did with AIG.

Moreover, recapitalizing an insolvent institution at the parent company level does not solve the acute liquidity problems that arise when financial institutions fail. Wiping out shareholders and writing down creditor claims or converting them to equity makes the firm solvent. It does not, however, generate liquidity. As Professor Lubben points out, “inflicting pain on holding company stakeholders also does nothing to address the financial institution’s immediate liquidity needs. This is where the Dodd-Frank Act’s lending mechanism between the U.S. Treasury and the FDIC would come in, but it is easy to imagine such lending quickly could become a stealth bailout of subsidiary creditors.”²⁰⁹

As Professor Lubben’s comment suggests, the FDIC’s “Single Point of Entry” would ultimately work much like the Federal Reserve’s bailout of AIG using its authority under Section 13(3) of the Federal Reserve Act. In fact, had the “Orderly Liquidation Authority” been in place when AIG failed, under the “Single Point of Entry” the only thing different would have been the source of funding. Those funds would have come from the U.S. Treasury, by way of the FDIC, rather than the Federal Reserve. Those funds still would have ended up in the pockets of AIG counterparties, because the whole point of the “Single Point of Entry”—like the AIG bailouts—

²⁰⁹ Stephen Lubben, *OLA After Single Point of Entry: Has Anything Changed?* in AN UNFINISHED MISSION: MAKING WALL STREET WORK FOR US 13, 16 (Roosevelt Inst. 2013), http://rooseveltinstitute.org/sites/all/files/Unfinished_Mission_2013.pdf.

is to keep the subsidiaries of the failed holding company up and running. To borrow the words of the Special Inspector General for the Troubled Asset Relief Program, the very *design* of the “Single Point of Entry” is that “tens of billions of dollars of Government money” will be “funneled inexorably” to the creditors and counterparties of the failed company’s operating subsidiaries.

Contrary to the claims of its proponents, the Dodd-Frank Act leaves taxpayers exposed to the costs of resolving large, complex financial institutions

Proponents of the “Orderly Liquidation Authority” claim that taxpayers will be paid back. Indeed, the Dodd-Frank Act categorically states that “taxpayers shall bear no losses from the exercise of any authority under [Title II],”²¹⁰ and Title II contains a provision that requires assessments to be imposed on other large financial institutions in order to pay back the taxpayer if the government loses money after it rescues creditors.²¹¹

But taxpayers have received such promises from their government before, only to find themselves holding the bag for billions of dollars in losses when disaster, whether natural or man-made, strikes. Put simply, the government’s track record in managing risk and administering “insurance” programs that are required to be self-sustaining does not inspire confidence that taxpayers will always be made whole when a financial catastrophe hits and the FDIC is forced to borrow from the Treasury to staunch the bleeding. The National Flood Insurance Program owes taxpayers \$24 billion, with no reasonable prospect of repayment. The Pension Benefit Guaranty Corporation is running a total asset deficit of approximately \$34 billion. And the Federal Housing Administration recently received an infusion of funds from the Treasury despite repeated assurances from the Obama Administration that the agency was in no danger of needing a government bailout.

²¹⁰ Dodd-Frank Wall Street Reform and Consumer Protection Act § 214(c), 12 U.S.C. § 5394 (2012).

²¹¹ *Id.* at § 210(o), 12 U.S.C. § 5390(o).

Fueling the concerns about taxpayer exposure under Title II of the Dodd-Frank Act is the sheer magnitude of the amounts that the FDIC is authorized to borrow from the Treasury to carry out an “orderly liquidation.” As detailed above, Title II gives the FDIC the power to lend to a failing firm; purchase its assets; guarantee its obligations; and—most important—pay off its creditors. To carry out these responsibilities, the FDIC can borrow up to 10 percent of the book value of the failed firm’s total consolidated assets in the 30 days immediately following its appointment as receiver. After those 30 days, the FDIC can borrow up to 90 percent of the fair value of the failed firm’s total consolidated assets.

Because the next bailout has not happened—yet—it is impossible to say just how much it will cost the American taxpayer. But just how large the exposure might be is apparent from a review of the asset sizes of the largest financial firms, which in turn demonstrates just how much the FDIC can borrow from the Treasury under Title II to resolve these firms:

Institution	Total Assets
JPMorgan Chase & Co.	\$2.463 trillion
Bank of America Corporation	\$2.129 trillion
Citigroup Inc.	\$1.900 trillion
Wells Fargo & Company	\$1.488 trillion
Goldman Sachs Group, Inc.	\$923 billion
Morgan Stanley	\$832 billion ²¹²

Thus, to “resolve” JP Morgan Chase, the FDIC could borrow up to \$2.2 trillion. To resolve Bank of America, for example, the FDIC could borrow up to \$1.9 trillion. To resolve Citigroup, \$1.7 billion.

But even if the Orderly Liquidation Fund proves equal to the task of resolving a multi-trillion dollar financial institution, taxpayers are still not entirely off the hook. The healthy firms

²¹² *Nat’l Information Center*, FED. FIN. INSTITUTIONS EXAMINATION COUNCIL, <http://www.ffiec.gov/nicpubweb/nicweb/top50form.aspx> (last visited July 14, 2014) (figures listed in this report reflect asset values as of Sept. 30, 2013).

that are assessed to pay for the resolution of a failed competitor will pass the cost of those assessments on to their customers in the form of higher fees on financial products and services.²¹³ For this reason, Stanford University professor John Taylor testified at the Committee Hearings that Dodd-Frank’s assessment scheme “is, by definition, to me a bailout. It really doesn’t matter whether the funds come directly from the taxpayers or they come indirectly from the taxpayers through an assessment of financial institutions and higher prices to consumers of financial institutions.”²¹⁴

Several commentators have noted both the unfairness and moral hazard engendered by a system in which firms that operated prudently are “taxed” to pay the cost of resolving firms whose imprudence and poor risk management prompted their failure.²¹⁵ Professors at the New York University Stern School of Business have argued that the Title II assessment regime will encourage greater risk-taking among *all* financial firms:

[T]he *ex post* fund assessments would essentially require that prudent financial companies pay for the sins of the others. This would be bad enough But it gets worse. The Act’s plan for successful financial institutions to pay the creditors of failed institutions leads to a free rider problem. This will encourage even well-managed banks to take excessive risk. The ‘heads I win, tails you lose’ proposition just gets passed around in the financial sector, creating an even more risky and fragile financial system, making a crisis more likely in the first instance.²¹⁶

Witnesses at the Committee Hearings identified another source of taxpayer exposure from the operation of Title II: the fact that firms undergoing “orderly liquidation” are not required to pay taxes on their franchise, property or income, giving them a competitive

²¹³ *Oversight Subcomm. Hearing on the OLA, supra* note 41, at 17 (statement of John Taylor, Mary and Robert Raymond Professor of Economics, Stanford University).

²¹⁴ *Id.* at 9.

²¹⁵ *Id.* at 29-30 (statement of David Skeel) (“[E]ven if some of [the costs of resolution] were ultimately recovered from the industry down the road after five years or whatever, that is a tax of sorts . . . Effectively what we are doing is taxing a particular industry to support the resolution of the failed institution.”).

²¹⁶ Viral V. Acharya, Barry Adler, Matthew Richardson & Nouriel Roubini, *Resolution Authority*, in *REGULATING WALL STREET: THE DODD-FRANK ACT AND THE NEW ARCHITECTURE OF GLOBAL FINANCE* 213, 228 (Viral V. Acharya, Thomas Cooley, Matthew Richardson & Ingo Walter eds., 2011).

advantage and depriving the Treasury of tax revenue.²¹⁷ As Richard Fisher, President of the Dallas Federal Reserve Bank, put it, “During the five-year resolution period, incidentally, this nationalized institution does not have to pay taxes of any kind to any government entity, and to us this looks, sounds, and tastes like a taxpayer bailout just hidden behind the opaque and very difficult language of . . . Title II.”²¹⁸

In addition to favorable tax treatment, the bridge company established under the “Single Point of Entry” approach would enjoy other competitive advantages. Witnesses at the Committee Hearings testified that a firm able to rely upon funding from the FDIC would operate with less market discipline—and be more prone to taking excessive risks—than if required to obtain its liquidity from the private market.²¹⁹ This moral hazard is exacerbated by the substantial discretion that Title II affords the government to determine the appropriate rate at which to lend to the bridge entity.²²⁰ Failing to charge market rates for that credit would impose yet one more cost on taxpayers.²²¹

²¹⁷ *Oversight Subcomm. Hearing on the OLA, supra* note 41, at 7 (statement of David Skeel); *Id.* at 20 (statement of Joshua Rosner) (noting that the effects of lower-interest-rate borrowing and the tax exemption “would ultimately just reinforce the oligopolistic market power of that institution and the small group of institutions that are similar”).

²¹⁸ *Hearing on Taxpayer-Funded Bailouts under Dodd-Frank, supra* note 49, at 12 (statement of Richard Fisher). In his testimony, President Fisher also noted that the healthy firms subject to assessment by the FDIC to recapitalize the OLF after a failure could deduct the assessment as a business expense, further reducing revenue to the Treasury. *Id.* at 20-21.

²¹⁹ *Oversight Subcomm. Hearing on the OLA, supra* note 41, at 22 (statement of John Taylor) (“[S]ince [the bridge company] doesn’t have to worry about accessing the private market liquidity, you can take actions actually which are more risky than otherwise covered by that, and therefore that gives [them] a direct advantage.”).

²²⁰ *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 210(n)(5), 12 U.S.C. § 5390(n)(5) (2012); *Oversight Subcomm. Hearing on the OLA, supra* note 41, at 14 (statement of Joshua Rosner) (“[T]here is no obligation or mechanism within Title II to price the credit risk that is being taken on, and . . . that is an important part of the subsidy as well.”); *Id.* at 22 (statement of David Skeel) (“The FDIC can essentially cherry pick the rate it wants by picking obligations of the maturity that has an attractive interest rate. So there is very, very little limitation on them.”).

²²¹ *Id.* at 29 (statement of David Skeel) (“Taxpayers are paying if the interest rate on loans that the bridge institution has is a below-market interest rate.”).

The FDIC's authority under the Dodd-Frank Act to treat "similarly situated" creditors differently is susceptible to misuse

Title II authorizes the FDIC to treat similarly situated creditors differently to maximize the value of the company's assets, minimize the amount of its losses, or to maintain vital operations of the company in receivership.²²² The FDIC has insisted that this authority will be used sparingly, and has, by regulation, promised not to use its discretion in a manner that would result in preferential treatment of holders of long-term senior debt, subordinated debt, or equity holders.²²³ Yet witnesses at the Committee Hearings testified that the FDIC's authority to treat similarly situated creditors differently could violate the rule of law, and that statutory and regulatory constraints on the FDIC's authority could too easily be evaded:

I think that problem is probably the biggest issue to contend with, the ability to hand the FDIC the authority to treat similarly situated creditors differently at their whim under the guise of protecting the ability of potential counterparties to continue to serve in supporting essential functions of the institution. And so they do have far too much discretion. It is absolute discretion[.]²²⁴

At least one Democratic Member of the Committee seemed to share this concern.²²⁵

The "Orderly Liquidation Authority" has not ended "too big to fail"

Shortly after the Dodd-Frank Act was signed into law, its primary author, then-Chairman Barney Frank, made the following pronouncement: "We do have death panels [in this country]. Not for old ladies under health care reform, but for financial institutions under Dodd-Frank.

²²² Dodd-Frank Wall Street Reform and Consumer Protection Act § 210(b)(4), 12 U.S.C. § 5390(b)(4).

²²³ 12 C.F.R. § 380.27 (2013).

²²⁴ *Oversight Subcomm. Hearing on the OLA, supra* note 41, at 20 (statement of Joshua Rosner); *see also id.* at 14-15 (statement of John Taylor) ("If the bailout of certain creditors occurs at the expense of other creditors, that is also a problem because it is going against the direction of the rule of law which we have in the country.").

²²⁵ *Id.* at 21 (statement of Rep. Brad Sherman) (asking a witness to explain why "Title II provides for an almost crony capitalism as to which creditors get paid and which don't" and further noting that "I am familiar with regular bankruptcy; you are either a secured creditor or you are an unsecured creditor. All of the unsecured creditors are equal. Apparently in this world, some animals are more equal than others").

Much of [the] bill makes it less likely that financial institutions will get to the point of failure. But if an institution gets to that point, it will fail.”²²⁶

Yet some three years later, it has become apparent that the former Chairman’s dream of “death panels” for financial firms will remain unrealized. At a December 11, 2013 forum hosted by the FDIC on its “Single Point of Entry” strategy, former Federal Reserve Chairman Paul Volcker, whose rule barring proprietary trading at firms benefiting from the federal safety net is generally considered to be the Dodd-Frank Act’s centerpiece, pointed out that what awaits a failed firm under Title II of the Dodd-Frank Act is not death, but eternal life, under the auspices of the U.S. government:

“When I read [the “Single Point of Entry” proposal], it doesn’t sound like a liquidating situation,” he said. It sounds more like the FDIC “takes a little cancer out” and “the rest of it goes on as the Great Universal Bank of the US. A lot of people look at this and they say, ‘This is a fancy way to subsidize or temporarily assist the company so it can continue in its new life.’ That’s what happened last time.”²²⁷

Witnesses at the Committee Hearings echoed Chairman Volcker’s concerns. University of Pennsylvania law professor David Skeel pointed out that “the single point of entry won’t end Too Big To Fail at all. It will essentially rescue the troubled financial institution and is designed to ensure that the institution retains just as dominant a position after a financial crisis as before it.”²²⁸

²²⁶ Christopher Condon, *Frank Says ‘Death Panels’ Await Failing Banks Under Law Bearing His Name*, BLOOMBERG NEWS, Oct. 25, 2010, <http://www.bloomberg.com/news/2010-10-26/frank-says-death-panels-await-failing-financial-companies-under-new-law.html>.

²²⁷ Rehm, *supra* note 198. George Washington University law professor Arthur Wilmarth makes a similar point: “This doesn’t look like a liquidation. It looks like a restructuring or reorganization in which the systemically important financial institution survives to fight another day. Instead of liquidating or breaking up the institution it comes out the other end ... looking much like it did before in terms of its functions and operations.” Joe Adler, *Is the FDIC’s ‘Single-Point Resolution’ Plan a Stealth Bailout?* AM. BANKER, Dec. 12, 2013.

²²⁸ *Oversight Subcomm. Hearing on the OLA, supra* note 41, at 7-8 (statement of David Skeel).

The Dodd-Frank Act misses some obvious problems and creates new ones

Although the proponents of the Dodd-Frank Act put most of their faith that it solved the “too big to fail” problem in Titles I and II, it is worth pausing a moment to consider other parts of the Dodd-Frank Act and whether these parts of the Dodd-Frank Act have made government bailouts more likely. The drafters of the Dodd-Frank Act missed one obvious problem—the Government Sponsored Enterprises, and created another one—the so-called “Financial Market Utilities.” And although the drafters of the Dodd-Frank Act realized that the Federal Reserve had extended its emergency lending authority under Section 13(3) of the Federal Reserve Act as far as it lawfully could—and perhaps a bit beyond—they responded with limitations on that authority that are, at best, cosmetic. Given the inclination of regulators to do whatever it takes to rescue a large, complex financial institution to avert what they believe will be a financial crisis,²²⁹ these shortcomings—along with the weaknesses inherent in Titles I and II—have not only made it easier for government officials to bail out the next “too big to fail” institution that teeters on the brink of failure, they virtually guarantee that officials will have to. Finally, by imposing crushing new regulatory burdens on the entire financial services industry, Dodd-Frank serves to further entrench the “too big to fail” firms that can more easily bear those burdens than their smaller competitors.

²²⁹ As American Enterprise Institute Resident Scholar Alex Pollock put it, “When government financial officers . . . stand at the edge of the cliff of market panic and stare down into the abyss of potential financial chaos, they always decide upon government intervention.” ALEX J. POLLOCK, *BOOM AND BUST: FINANCIAL CYCLES AND HUMAN PROSPERITY* 49 (2011). This was borne out in the crisis of 2008-2009, as noted by the Republican Commissioners of the Financial Crisis Inquiry Commission: “For a policymaker, the calculus is simple: if you bail out AIG and you’re wrong, you will have wasted taxpayer money and provoked public outrage. If you don’t bail out AIG and you’re wrong, the global financial system collapses. It should be easy to see why policymakers favored action—there was a chance of being wrong either way, and the costs of being wrong without action were far greater than the costs of being wrong with action.” NAT’L COMM’N ON THE CAUSES OF THE FIN. AND ECONOMIC CRISIS IN THE U.S., *FIN. CRISIS INQUIRY REPORT 433* (2011) (dissenting statement of Keith Hennessey, Douglas Holtz-Eakin & Bill Thomas), available at <http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf>.

The Government-Sponsored Enterprises are still “too big to fail”

Perhaps the most striking part of a statute that describes itself as ending “too big to fail” is what the statute missed: the largest source of systemic risk this country has ever seen, the Government-Sponsored Enterprises Fannie Mae and Freddie Mac. After decades of lax regulation, after decades of benefitting from implicit taxpayer subsidies, after failing spectacularly and devastating the U.S. housing market, and after requiring hundreds of billions of dollars in taxpayer support to make it through the crisis, the Government Sponsored Enterprises are scarcely mentioned in the Dodd-Frank Act. The Dodd-Frank Act required the Treasury Department to study them and report to Congress with alternatives—a statutory mandate the Obama Administration met by issuing a 31-page “white paper” in February 2011 widely derided for its lack of substance—but it did nothing to fix the problem. While Fannie Mae and Freddie Mac may have recently returned to some semblance of stability—thanks to cheap government funding and a near monopoly on housing finance—they remain a major source of systemic risk, much as they always have been, even when they appeared prudently managed to their somnolent regulators and their apologists in Congress. Even if Title I and Title II of the Dodd-Frank Act functioned exactly as promised, the total absence of housing finance reform in the Dodd-Frank Act means that it did not end “too big to fail.”

Financial Market Utilities are the next generation of government-sponsored enterprises

The Dodd-Frank Act not only failed to address the Government Sponsored Enterprises that helped precipitate the financial crisis, it also expanded the universe of financial institutions that regulators could bail out by creating a new category of institutions known as “financial market utilities,” or FMUs. Section 803 of the Dodd-Frank Act defines an FMU as “any person that manages or operates a multilateral system for the purpose of transferring, clearing, or settling payments, securities, or other financial transactions among financial institutions or

between financial institutions and the person.” In July 2012, the FSOC designated eight FMUs for regulation under Title VIII of the Dodd-Frank Act.²³⁰ Among the FMUs that the FSOC designated were large clearinghouses, such as the Chicago Mercantile Exchange, the Intercontinental Exchange, and the Options Clearing Corporation.

The FSOC’s designation conveys privileges upon the FMUs: Section 806 of the Dodd-Frank Act grants FMUs access to the Federal Reserve’s discount window. As financial journalist Gretchen Morgenson put it, “these large and systemically important financial utilities that together trade and clear trillions of dollars in transactions appear to have won the daily double—access to federal money, without the accountability.”²³¹ At a Committee Hearing, former FDIC Chairman Sheila Bair testified that granting FMUs access to the discount window “not only gives these firms a real advantage over other ‘non’ systemic competitors, it opens up taxpayers to potential losses and creates moral hazard.” Ms. Bair further testified that “Title VIII FMUs will very likely become the new [Government Sponsored Enterprises] and a new source of system instability,” and recommended that this “unwarranted expansion of the government safety net” be repealed.²³²

As amended by the Dodd-Frank Act, Section 13(3) of the Federal Reserve Act remains a powerful bailout tool

During the financial crisis, the Federal Reserve resorted several times to its emergency lending authority under Section 13(3) of the Federal Reserve Act, which allows it to make emergency loans to “any individual, partnership, or corporation” under “unusual and exigent circumstances.” As described above, the Federal Reserve used this authority to bail out the

²³⁰ FIN. STABILITY OVERSIGHT COUNCIL, 2012 ANNUAL REPORT app. A (2012), available at <http://www.treasury.gov/initiatives/fsoc/Documents/2012%20Annual%20Report.pdf>.

²³¹ Gretchen Morgenson, *One Safety Net That Needs to Shrink*, N.Y. TIMES, Nov. 3, 2012, <http://www.nytimes.com/2012/11/04/business/one-safety-net-that-needs-to-shrink.html>.

²³² *Hearing on Taxpayer-Funded Bailouts under Dodd-Frank*, *supra* note 49, at 70 (prepared statement of Sheila Bair).

creditors of Bear Stearns and AIG in the midst of the financial crisis. The Federal Reserve also used this authority to establish a series of lending programs to support credit markets, such as the Term Securities Lending Facility, the Primary Dealer Credit Facility, the Commercial Paper Funding Facility, and the Money Market Investor Funding Facility. These programs represented an unprecedented growth in the Federal Reserve's balance sheet, which ballooned to more than \$2.4 trillion by year-end 2010.²³³ These programs expanded the Federal Reserve's safety net far beyond the deposit-taking institutions that had been the traditional beneficiaries of that safety net to encompass non-bank institutions, such as investment banks and broker-dealers like Goldman Sachs and Merrill Lynch, and industrial companies like General Motors and General Electric.

The Federal Reserve's extensive use of Section 13(3) raised questions about the legality of its actions. Walker Todd, a former lawyer for the New York Federal Reserve Bank, pointed out that "[m]uch less of [the Federal Reserve's emergency] lending is based on clear statutory authority than one might prefer if one cared about the rule of law and the potential for tyrannical government."²³⁴ In particular, according to Todd:

The Fed interprets 13(3) as essentially giving it *carte blanche*. One has to read between the lines and off the edge of the page, however, to find authority for the Fed to purchase assets that are not "notes, drafts, and bills of exchange," or authority to create special subsidiaries to do so. It is difficult to disagree with economist Edward Kane when he states bluntly that the Fed in the last 18 months has exercised discretion it was never given.²³⁵

Given the Federal Reserve's expansive interpretation of its 13(3) emergency lending authority during the financial crisis, the drafters of the Dodd-Frank Act tried to limit this authority. Title XI of the Dodd-Frank Act requires that emergency lending programs established

²³³ GOV'T ACCOUNTABILITY OFFICE, FEDERAL RESERVE SYSTEM: OPPORTUNITIES TO STRENGTHEN POLICIES AND PROCESSES FOR MANAGING EMERGENCY ASSISTANCE 50 (2011), available at <http://www.gao.gov/assets/330/321506.pdf>.

²³⁴ Lawrence H. White, *The Rule of Law or the Rule of Central Banks?* 30 CATO J. 451, 456 (2010), available at <http://object.cato.org/sites/cato.org/files/serials/files/cato-journal/2010/11/cj30n3-3.pdf> (quoting Walker Todd, *The Tyranny of the Fed*, AMERICAN INST. FOR ECONOMIC RESEARCH COMMENTARIES (Apr. 3, 2008)).

²³⁵ *Id.*

under Section 13(3) must have “broad-based eligibility,” must be designed to provide “liquidity to the financial system” rather than to “aid a failing financial company,” must be “designed to ensure . . . the security for emergency loans is sufficient to protect taxpayers from losses and that any such program is terminated in an orderly and timely fashion,” and may not be made available to insolvent borrowers.²³⁶ Title XI also requires the Federal Reserve, in consultation with the Treasury Secretary, to promulgate regulations that set forth how its emergency programs will operate “as soon as practicable.”²³⁷

While proponents of the Dodd-Frank Act claim that it limited the Federal Reserve’s 13(3) emergency lending authority, others have pointed out that the changes in Dodd-Frank are largely cosmetic, and that they will not prevent the Federal Reserve from carrying out the same kinds of bailouts it did during the financial crisis.²³⁸ The reason that the “broad-based eligibility” requirement does not end the Federal Reserve’s ability to bail out individual institutions is easy to see: the Federal Reserve could easily design a program that meets the “broad-based eligibility” requirement with a particular institution in mind. In fact, the “broad-based” programs that the Federal Reserve established during the financial crisis show how easy it is to circumvent the prohibition on firm-specific assistance. As Professor Blinder points out, the Primary Dealer Credit Facility

made it much easier to lend money to securities firms by, for example, broadening the range of collateral. Bear executives maintained that they could have averted bankruptcy without requiring assistance, if they had been given access to the [facility]. [Bear Stearns Chief Executive Officer] told the [Financial Crisis Inquiry Commission] that the [facility] came “just about 45 minutes” too late to save his firm.²³⁹

²³⁶ Dodd-Frank Wall Street Reform and Consumer Protection Act, PUB. L. NO. 111-203, § 1101(a), 124 Stat. 1376, 2113 (2010) (amending 12 U.S.C. § 343 (2006)).

²³⁷ *Id.*

²³⁸ See, e.g., *Hearing on Taxpayer-Funded Bailouts under Dodd-Frank*, *supra* note 49, at 18 (statement of Jeffrey Lacker) (arguing that Section 13(3) limits are unclear, and may permit the Federal Reserve to lend to individual companies just as it did during the crisis).

²³⁹ Blinder, *supra* note 22, at 114.

In other words, Bear Stearns might have been rescued through a program with “broad-based” eligibility, even though it was the bailout of Bear Stearns that led the proponents of the Dodd-Frank Act to include the “broad-based” eligibility requirement to prevent the rescue of individual firms . . . like Bear Stearns.

For that reason, the Dodd-Frank restrictions on the Federal Reserve’s 13(3) emergency lending authority are an illusory constraint on the Federal Reserve’s bail-out authority. As a result, the Federal Reserve’s 13(3) authority continues to make the “too big to fail” problem worse. As Mark Calabria, an economist at the Cato Institute, explains:

Any serious restriction on bank bailouts must also address the Federal Reserve. The limits that Dodd-Frank places on the Fed’s rescue authority are largely cosmetic. If the Fed is to retain its role as a lender of last resort, its lending should be limited to the discount window, where it lends only against good collateral. The discount window works on similar terms for all banks. The days of the Fed’s picking winners and losers in our financial system should end. That will happen only with the elimination of the Fed’s “13.3” powers.²⁴⁰

Similarly, Philadelphia Federal Reserve Bank President Charles Plosser has said that the Federal Reserve’s authority under Section 13(3) should be limited, noting that “the central bank should set boundaries and guidelines for its lending policy that it can credibly commit to follow. If the set of institutions having regular access to the Fed’s credit facilities is expanded too far, it will create moral hazard and distort the market mechanism for allocating credit. This can end up undermining the very financial stability that it is supposed to promote.”²⁴¹

Even though Dodd-Frank’s restrictions on the Federal Reserve’s 13(3) authority have little practical effect, the Dodd-Frank Act still required the Federal Reserve, in consultation with the Treasury Department, to issue rules implementing these restrictions. The Federal Reserve

²⁴⁰ Mark Calabria, *An End to Bailouts*, NAT’L REV., Jan. 28, 2013, <https://www.nationalreview.com/nrd/articles/337357/end-bailouts>.

²⁴¹ Plosser Address to the Cato Inst., *supra* note 18, at 10.

did not begin the process for adopting these statutorily mandated rules until the waning moments of 2013, more than three years after the passage of the Dodd-Frank Act.²⁴² The Federal Reserve’s proposed rule does not solve the problem raised by 13(3)’s vast grant of lending authority to the Federal Reserve; it simply repeats the hortatory aspirations in the Dodd-Frank Act while it avoids setting effective constraints on the Federal Reserve’s emergency lending authority.

For example, the Federal Reserve’s proposed rule adopts an exceedingly narrow definition of when a firm is considered to be “insolvent” and therefore ineligible for support under Section 13(3). The proposed rule assumes that only firms already in a bankruptcy or receivership proceeding should be considered insolvent, which excludes firms that are insolvent but not yet in such a proceeding. In addition, the proposed rule does not specify whether a bridge financial company created pursuant to the Dodd-Frank Act’s Orderly Liquidation Authority, or pursuant to a bankruptcy or receivership process, is to be considered “insolvent” and thus ineligible for assistance under Section 13(3). The proposed rule does not provide specifications to ensure that a financial institution that receives support under Section 13(3) cannot act as a conduit to support an insolvent subsidiary, as happened when the Federal Reserve extended support to AIG pursuant to 13(3). Nor, for that matter, does the proposed rule prevent the Federal Reserve from providing assistance to insolvent firms by passing that assistance through a solvent firm, as in the case of the Federal Reserve Bank of New York’s facilitation of JPMorgan Chase’s purchase of Bear Stearns.

While the proposed rule purports to prohibit use of Section 13(3) to assist a “specific firm” in avoiding such a proceeding, that provision shares the same flaw as the “broad-based

²⁴² Extensions of Credit by Federal Reserve Banks, 79 Fed. Reg. 615 (proposed Dec. 23, 2013) (to be codified at 12 C.F.R. Part 201).

eligibility” criteria established in the Dodd-Frank Act, effectively permitting aid to a specific firm so long as other firms are offered the same assistance. The proposed rule provides no criteria for determining whether a 13(3) program is “broad-based” and not intended to benefit a specific institution, such as a maximum amount or percentage of support under a 13(3) program available to any one firm.

These deficiencies suggest that far from placing limitations on the Federal Reserve’s authority, the proposed rule is designed to ensure that the Federal Reserve retains maximum discretion to carry out the same kinds of bail-outs of large financial institutions that characterized its crisis response in 2008 and 2009.

The Dodd-Frank Act does not rein in other bailout authorities possessed by regulators

The Federal Reserve’s expansive interpretation of its 13(3) emergency lending authority was not the only example of regulators pushing their legal authority to the breaking point and beyond in the midst of a financial crisis. During the financial crisis, for example, the Treasury Department tapped the Exchange Stabilization Fund—a fund established to buy and sell foreign currency to stabilize the value of the dollar relative to other currencies—to protect investors in money-market mutual funds. Professor Blinder points out that “using the Exchange Stabilization Fund for this purpose was quite a stretch. . . . [W]ithout even a pretext of dealing in foreign exchange, the Treasury was going to use the [Exchange Stabilization Fund] to insure money funds.”²⁴³

Similarly, the FDIC stretched the “systemic risk exception” to the Federal Deposit Insurance Act far beyond what Congress intended to establish its “Temporary Liquidity Guarantee Program,” which insured debt issued by financial companies. For the first time in its 75-year history, the FDIC extended its safety net beyond insured deposits to “promissory notes,

²⁴³ Blinder, *supra* note 22, at 146.

commercial paper, inter-bank funding, and any unsecured portion of secured debt.” Moreover, the FDIC extended its safety net beyond deposit-taking banks to “holding companies”: the first institution to use the Temporary Liquidity Guarantee Program was Goldman Sachs.²⁴⁴ The GAO reviewed the FDIC program, and found that “there are questions” about the regulators’ interpretation of the Federal Deposit Insurance Act, which the FDIC used to create “a broad-based program of direct assistance to institutions that had never before received such relief.”²⁴⁵

To be sure, Congress attempted to limit the ability of regulators to use the Exchange Stabilization Fund and the Systemic Risk Exception as they did in the financial crisis.²⁴⁶ But as these episodes show, government officials have proven to be remarkably adept at using the tools they have at their disposal to bail out large financial institutions in ways that were, at best, extremely creative and that required them to push their authority to the limits of legality, if not beyond. The actions send a clear signal to market participants that regulators stand ready to bend the law and take whatever steps they deem appropriate to avert a financial crisis—a signal that encourages the excessive risk-taking that makes the financial system more fragile than it otherwise would be, which in turn makes it more likely that regulators will not only face a financial crisis but will once again resort to extraordinary measures to avoid it. The irony is that because regulators resorted to extraordinary measures in the past, they will have to resort to extraordinary measures again.

The solution to this problem is to make it impossible for regulators to carry out bailouts and to make it clear to market participants that they alone will bear the consequences of the risks

²⁴⁴ *Id.* at 161-62.

²⁴⁵ GOV’T ACCOUNTABILITY OFFICE, *Introduction to FEDERAL DEPOSIT INSURANCE ACT: REGULATORS’ USE OF SYSTEMIC RISK EXCEPTION RAISES MORAL HAZARD CONCERNS AND OPPORTUNITIES EXIST TO CLARIFY THE PROVISION* (2010), available at <http://www.gao.gov/assets/310/303248.pdf>.

²⁴⁶ The Emergency Economic Stabilization Act of 2008 (PUB. L. NO. 110-343, 122 Stat. 3765 (2008)) bars the Treasury Department from using the Exchange Stabilization Fund to guarantee money market mutual funds, and Section 1105 of the Dodd-Frank Act limits but does not abolish the FDIC’s ability to guarantee the debt of banks and bank holding companies.

they choose to undertake. But instead of making it impossible for regulators to carry out bailouts and sending a clear message to market participants that there will be no more bailouts, the Dodd-Frank Act does the opposite: it makes it easier for regulators to bail out financial institutions by means of the “Orderly Liquidation Authority” in Title II.

Regulatory requirements imposed under the Dodd-Frank Act create compliance burdens that distort the free market by making it harder for small-to-medium sized financial institutions to compete with larger firms, further entrenching “too big to fail”

Yet one more way in which the Dodd-Frank Act perpetuates “too big to fail” is through its imposition of massive new regulatory burdens on the financial services sector. Because of their scale and the resources they are able to dedicate to compliance, the largest financial institutions have a far greater ability to absorb these burdens than do smaller firms.²⁴⁷ Federal Reserve Governor Jerome Powell recently noted that “[t]he Dodd-Frank Act has spawned a variety of new regulatory initiatives that add to the already-substantial regulatory burden faced by community banks.”²⁴⁸ Similarly, in a September 2012 report, the GAO found that regulators and industry officials expected that some of the Dodd-Frank Act’s provisions would “impose additional requirements on community banks and credit unions that could affect them disproportionately relative to larger banks.”²⁴⁹

²⁴⁷ Jim Purcell, the Chairman and Chief Executive Officer of State National Bank of Big Spring, Texas, made this point in testimony before the Committee in 2012: “[B]ig banks – the very banks at the center of the problems that spurred the enactment of Dodd-Frank – are among the new law’s great *beneficiaries*, precisely because they can much more easily shoulder Dodd-Frank’s compliance burdens. Big banks have armies of lobbyists, lawyers, consultants, and compliance staffers, without denting the banks’ profitability. Community banks, by contrast, lack those resources, and every extra dollar of compliance costs is one less dollar to spend on customer service, one more dollar of cost that ultimately must be passed through to customers.” *Who’s In Your Wallet? Dodd-Frank’s Impact on Families, Communities, and Small Businesses: Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Fin. Services*, 112th Cong. 81 (2012).

²⁴⁸ Jerome H. Powell, Community Banking: Connecting Research and Policy, Address at the Community Banking Research Conference 10 (Oct. 3, 2013), available at <http://www.federalreserve.gov/newsevents/speech/powell20131003a.pdf>.

²⁴⁹ GOV’T ACCOUNTABILITY OFFICE, *Introduction to COMMUNITY BANKS AND CREDIT UNIONS: IMPACT OF THE DODD-FRANK ACT DEPENDS LARGELY ON FUTURE RULEMAKINGS* (2012), available at <http://www.gao.gov/assets/650/648210.pdf>; see also *Regulatory Burdens: The Impact of Dodd-Frank on Community Banking: Hearing Before the Subcomm. on Economic Growth, Job Creation and Regulatory Affairs of the H. Comm. on Oversight and Gov’t Reform*, 113th Cong. 23 (2013) (prepared statement of Hester Peirce, Senior

Community bankers report a “trickle-down effect, where regulation originally meant for big institutions is being applied to smaller banks,” often in the form of bank examiners identifying those regulations as “best practices” that should be followed by institutions regardless of their size.²⁵⁰ Federal Reserve Board Governor Daniel Tarullo acknowledged the validity of this concern in a May 8, 2014 speech: “Even where regulatory frameworks try to place a lesser burden on smaller banks, there may be some risk of ‘supervisory trickle-down,’ where supervisors informally, and perhaps not wholly intentionally, create compliance expectations for smaller banks that resemble expectations for larger institutions.”²⁵¹

This disproportionate regulatory burden ultimately results in a less competitive marketplace, as smaller institutions overwhelmed by the volume and complexity of regulations are forced to exit business lines or seek to merge with other institutions.²⁵² As FDIC Vice Chairman Thomas Hoenig recently observed, “There should be little doubt that regulatory burden contributes to the trend toward consolidation as smaller banks work to control costs and to survive within a highly regulated industry.”²⁵³ Indeed, the pace of consolidation in the banking industry since the Dodd-Frank Act was enacted has increased markedly. At year-end 2010, there were 7,658 banks in the U.S.; by the end of 2013, that number had declined to 6,812. At the same time, small banks’ share of U.S. banking assets decreased by nearly 19 percent from

Research Fellow, Mercatus Center, George Mason Univ.) (“One of the key ways in which Dodd-Frank affects community banks is increased regulatory burden.”); *The Effect of Dodd-Frank on Small Financial Institutions and Small Businesses: Hearing before the Subcomm. on Fin. Institutions and Consumer Credit of the H. Comm. on Fin. Services*, 112th Cong. (2011).

²⁵⁰ Jackie Stewart, *A Quarter of Small Banks Expect to Sell in 2014: KPMG*, AM. BANKER, Nov. 21, 2013.

²⁵¹ Donna Borak, *Tarullo Calls for Second Look at Bank Regulations*, AM. BANKER, May 8, 2014.

²⁵² For example, new Dodd-Frank regulations in the areas of mortgage lending and remittance transfers have increased the compliance burden for community financial institutions to the point where some have chosen to no longer offer those products or services. A February 2014 survey of approximately 200 banks across 41 states with less than \$10 billion in assets each, conducted by scholars at George Mason University’s Mercatus Center, found that the Dodd-Frank Act’s “increased regulatory burdens have led small banks to reconsider their product and service offerings, including considering whether to stop providing residential mortgages.” Hester Peirce, Ian Robinson & Thomas Stratmann, *How Are Small Banks Faring Under Dodd-Frank?* (Mercatus Center, George Mason Univ., Working Paper No. 14-05, 2014).

²⁵³ Joe Adler, *Hoenig Casts Doubt on Reg ‘Carve-Out’ for Small Banks*, AM. BANKER, June 10, 2014.

2010 to 2013.²⁵⁴ As the industry consolidates and smaller players leave the field, the market power and “too big to fail” status of the largest institutions becomes further entrenched.²⁵⁵

The Dodd-Frank Act’s constitutional infirmities may impair its effectiveness in the midst of a financial crisis, undermining the Act’s ability to end “too big to fail”

The Dodd-Frank Act, Professor Richard Epstein has argued, “represent[s] a level of regulatory ambition that far exceeds in scope and complexity any New Deal regulation of financial markets.”²⁵⁶ As part of its examination of Titles I and II of the Dodd-Frank Act, the Committee considered whether those provisions raised constitutional issues that could be presented in litigation. The Committee considered these matters because the litigation of the Dodd-Frank Act’s constitutional infirmities—particularly in the midst of a financial crisis—could impede the functioning of Title I or Title II. Columbia University law professor Thomas Merrill testified:

The central point that I want to make is that it is true that Dodd-Frank has not been declared unconstitutional, but the problem is that it contains very serious constitutional problems. And any individual or entity that is opposed to being subjected to an orderly liquidation would have a strong incentive to raise these constitutional issues as a way of trying to increase their leverage with the government in the event of an orderly liquidation or to perhaps . . . derail it, and those constitutional issues will in fact work against the purposes of Title II, that Title II will in fact be undermined by the raising of these constitutional issues at a time when it is least appropriate that they be brought to the fore.²⁵⁷

²⁵⁴ Hester Peirce & Robert Greene, *The Decline of US Small Banks*, MERCATUS CENTER (Feb. 24, 2014) <http://mercatus.org/publication/decline-us-small-banks-2000-2013> (defining “small banks” as those with \$10 billion or less in assets).

²⁵⁵ Testifying at the Committee Hearings, former White House Counsel Boyden Gray observed that regulators “impos[e] regulatory burdens on smaller entities that are less able to handle them than their bigger competitors, and the bigger competitors end up not necessarily gobbling them up, but watching the consolidation take place.” *Hearing on Dodd-Frank’s Constitutional and Legal Uncertainties*, *supra* note 49, at 5.

²⁵⁶ RICHARD EPSTEIN, *DESIGN FOR LIBERTY: PRIVATE PROPERTY, PUBLIC ADMINISTRATION, AND THE RULE OF LAW* 172 (2011).

²⁵⁷ *Hearing on Dodd-Frank’s Constitutional and Legal Uncertainties*, *supra* note 49, at 6 (statement of Thomas Merrill, Charles Evans Hughes Professor of Law, Columbia Law School).

Determining whether parties could present a justiciable case and whether their claims might succeed in a lawsuit are not the only reasons that the Committee considered these questions, however. Congress has a responsibility to assess the constitutionality of potential and existing statutes whether or not litigation is pending.²⁵⁸ While courts have final authority to interpret the Constitution in cases before them²⁵⁹ and Congress is bound by the constitutional principle of separation of powers to leave undisturbed any adjudication of the rights of parties made in those proceedings,²⁶⁰ Congress nevertheless has long interpreted the Constitution for itself when exercising the legislative power.²⁶¹

The Committee Hearings suggest that the constitutionality of the Dodd-Frank Act is and will remain an important public policy question. One witness testifying before the Committee represented private and state government clients in a lawsuit challenging several provisions of the Dodd-Frank Act, including Titles I and II. The private plaintiffs have claimed that Title I of the Dodd-Frank Act violates the separation of powers by depriving the president of the ability to appoint certain nonvoting members to the FSOC's panel; by granting the FSOC "unlimited discretion" to designate any nonbank financial company for "heightened prudential supervision"; by permitting a designated company to obtain judicial review of the FSOC's decision only on the

²⁵⁸ Louis Fisher, *Constitutional Interpretation by Members of Congress*, 63 N.C. L. REV. 707, 708 (1985) ("Congress, by the very nature of our political system, shares with the executive and the judiciary the duty of constitutional interpretation . . . Congress can perform an essential, broad, and ongoing role in shaping the meaning of the Constitution.").

²⁵⁹ See, e.g., *Marbury v. Madison*, 5 U.S. (1 Cranch) 137, 177 (1803) ("[It] is emphatically the province and duty of the judicial department to say what the law is.").

²⁶⁰ See 2 COLLECTED WORKS OF ABRAHAM LINCOLN 516 (R. Basler ed. 1953) (address of Abraham Lincoln at Springfield, Ill., July 17, 1858) ("[I]n so far as [the Supreme Court] decided in favor of Dred Scott's master and against Dred Scott and his family, I do not propose to disturb or resist the decision [in *Dred Scott v. Sandford*]," but arguing that "the citizen [need not] conform his vote to that decision; the Member of Congress, his; the President, his use of the veto power," for in so doing the decision would be made "a rule of political action for the people and all the departments of government.").

²⁶¹ Fisher, *supra* note 258, at 708 (relating that Congress has independently considered constitutional questions concerning, among other matters, judicial review, the Bank of the United States, congressional investigative power, slavery, internal improvements, federalism, the war-making power, treaties and foreign relations, interstate commerce, the removal power, and the legislative veto).

basis of a limited “arbitrary and capricious” standard; and by failing to provide third parties with a right to seek judicial review of the FSOC’s decision.²⁶² Others have argued that the Dodd-Frank Act violates the constitutional principle of nondelegation,²⁶³ which seeks to curtail arbitrary action by administrative officers and limit Congress’s ability to abdicate its constitutional responsibilities by delegating its legislative power to individuals neither elected by nor responsible to the people.²⁶⁴

The Committee Hearings counseled that the Dodd-Frank Act may suffer from other constitutional infirmities as well. Witnesses testified that the Dodd-Frank Act violates the Due Process Clause of the Fifth Amendment because it does not afford sufficient notice and opportunity to challenge the Treasury Secretary’s decision to commence an “Orderly Liquidation” proceeding under Title II of the Dodd-Frank Act. According to the witnesses, a firm that the Treasury Secretary has determined should be subject to resolution under Title II would not have the opportunity to challenge that decision because it would not be afforded an administrative hearing²⁶⁵ and the Dodd-Frank Act gives the firm only 24 hours to present its case to a federal district court.²⁶⁶ The witnesses testified that the one-day review period would be too short to resolve the contested issues in a judicial proceeding. For example, if a firm disputed the

²⁶² Second Amended Compl. paras. 137-157, *State Nat’l Bank of Big Spring, et. al. v. Lew, et. al.*, No 1:12-cv-01032 (Feb. 19, 2013).

²⁶³ See Stephen A. Keen, *FSOC and Money Market Fund Reform: A Path to Nowhere*, REEDSMITH (Oct. 8, 2012), <http://m.reedsmith.com/fsoc-and-money-market-fund-reform-a-path-to-nowhere-10-08-2012/> and Epstein, *supra* note 256, at 176 (arguing that the FSOC has such vast discretion to designate a nonbank financial company that “it would be hard to find any decision that counts as right or wrong at all,” but acknowledging that under Supreme Court precedent it is very difficult to successfully argue that a delegation is an impermissible handoff of legislative power).

²⁶⁴ *Panama Refining Co. v. Ryan*, 293 U.S. 388 (1935); *J.W. Hampton & Co. v. U.S.*, 276 U.S. 394, 409 (1928) (requiring that delegations contain an “intelligible principle”); 3 Pierce, *supra* note 73, at § 17.1 (“[U]nlimited agency discretion would place in jeopardy the constitutional and statutory rights of all citizens. To the extent that courts are unable or unwilling to limit agency discretion by requiring agencies to remain within constitutional and statutory boundaries, all constitutional and statutory rights are vulnerable.”).

²⁶⁵ *Hearing on Dodd-Frank’s Constitutional and Legal Uncertainties*, *supra* note 49, at 89 (prepared statement of Thomas Merrill app.).

²⁶⁶ *Hearing on Dodd-Frank’s Constitutional and Legal Uncertainties*, *supra* note 49, at 22 (statement of Boyden Gray); see also *id.* at 101 (prepared statement of Thomas Merrill app.).

Secretary's finding that it was "in default or danger of default," the court would be required to examine "hundreds of disputed accounting issues, many of great complexity."²⁶⁷ In the witnesses' view, the Dodd-Frank Act exacerbated the potential Due Process problem by restricting the scope of judicial review to two of the seven determinations made by the Secretary.²⁶⁸

One witness also testified that the 24-hour review period afforded to the district court, together with the limited scope of review, violated the separation of powers doctrine. The witness testified that these restrictions supplanted the judicial power, precluding the court from exercising its independent judgment and reducing it to a rubber stamp in support of the Secretary's decision. The fact that the Act permitted appellate review without imposing a 24-hour time limit did not reduce the separation of powers concern, according to the witness, because it remained the case that the district court was "dragooned to act" and could not exercise independent judgment.²⁶⁹

Finally, the Committee Hearings highlighted many instances in which regulators enjoyed largely unbounded discretion to implement provisions of the Dodd-Frank Act.²⁷⁰ The FSOC may designate any nonbank financial company that could pose a threat to U.S. financial stability after considering ten factors relating to the firm's financial condition and business activities as

²⁶⁷ *Id.* at 102 (prepared statement of Thomas Merrill app.)

²⁶⁸ *Id.* at 17-18 (statement of Boyden Gray); *Id.* at 102-103 (prepared statement of Thomas Merrill app.) (noting that some of the omitted factors are "highly factual" and therefore particularly ripe for judicial review).

²⁶⁹ *Hearing on Dodd-Frank's Constitutional and Legal Uncertainties*, *supra* note 49, at 112 (prepared statement of Thomas Merrill app.).

²⁷⁰ As a general matter, the Dodd-Frank Act represents a massive transfer of authority to the federal bureaucracy, directing that roughly 400 new regulations be promulgated by the financial regulatory agencies. Given the magnitude of this delegation of power to the regulators, it should come as no surprise that nearly four years after Dodd-Frank's enactment, only about half of the rules mandated by the Act have been finalized, contributing to the regulatory uncertainty that hangs over the economy. DAVIS POLK & WARDWELL, DODD-FRANK PROGRESS REPORT 2 (July 2014).

well as “any other risk-related factors that the Council [FSOC] deems appropriate.”²⁷¹ The FSOC is responsible for setting these criteria and has broad discretion to determine their relative importance within its systemic risk assessment. The Dodd-Frank Act is silent on other important matters as well. For example, Federal Reserve Governor Daniel Tarullo has suggested that determining whether a firm’s size threatens the financial system, and therefore warrants regulatory action, is a difficult task because the Dodd-Frank Act does not contain criteria to guide regulators as they exercise their discretion in deciding whether the risk attributable to the firm’s size and interconnectedness outweighs the benefits.²⁷²

To the extent that delegations under the Dodd-Frank Act are open-ended, they may lead to a regulatory process in which administrative officials, in executing the law, create or alter rights and obligations with little meaningful guidance from Congress.²⁷³ As Chief Justice John Roberts recently observed:

The Framers did divide governmental power . . . for the purpose of safeguarding liberty. And yet . . . the citizen confronting thousands of pages of regulations—promulgated by an agency directed by Congress to regulate, say, “in the public interest”—can perhaps be excused for thinking that it is the agency really doing the legislating.²⁷⁴

The Dodd-Frank Act’s broad delegation of legislative authority to administrative agencies stands in tension with our constitutional order. As George Washington University law

²⁷¹ Dodd-Frank Wall Street Reform and Consumer Protection Act § 113(a), (b), 12 U.S.C. § 5323(a), (b) (2012).

²⁷² Daniel K. Tarullo, Financial Stability Regulation, Distinguished Jurist Lecture Before the Univ. of Pennsylvania 3-10, 22-24 (Oct. 10, 2012), <http://www.federalreserve.gov/newsevents/speech/tarullo20121010a.pdf>.

²⁷³ See *Whitman v. Am. Trucking Assns.*, 531 U.S. § 457, 475 (2001) (“But even in sweeping regulatory schemes we have never demanded . . . that statutes provide a determinate criterion for saying how much of the regulated harm is too much.”) (citations omitted) (internal quotation marks omitted); Glen O. Robinson, *Independent Agencies: Form and Substance in Executive Action*, 1988 Duke L. J. 238, 244 (1988) (“[W]hile Congress can specify the policy options and the standards that must be followed in making choices, it characteristically confers on agencies very broad discretion to choose among specified options—even on occasion to define what the policy options are.”); Louis Jaffe, *The Independent Agency: A New Scapegoat Regulating Business By Independent Commission*, 65 YALE L.J. 1069, 1073 (1956) (book review) (“[T]he most serious difficulty facing regulation today . . . is the radical lack of a meaningful statutory policy in many of the areas where the independent agencies function.”); 1 Pierce, *supra* note 73, at § 2.3 (regulators often “make rules of conduct that bind everyone based on the resolution of major policy issues”).

²⁷⁴ *City of Arlington, Tex. v. F.C.C.*, 133 S.Ct. 1863, 1879 (2013) (Roberts, C.J., dissenting).

professor Jonathan Turley explains, “Our carefully constructed system of checks and balances is being negated by the rise of a fourth branch, an administrative state of sprawling departments and agencies that govern with increasing autonomy and decreasing transparency.”²⁷⁵ The Dodd-Frank Act threatens more than our financial system. It threatens our democracy.

Conclusion

In 2009, the economists Carmen Reinhart and Kenneth Rogoff released their study of the history of financial crises under the title *This Time is Different*.²⁷⁶ As they explain it,

The essence of the this-time-is-different syndrome is simple. It is rooted in the firmly held belief that financial crises are things that happen to other people in other countries at other times. . . . We are doing things better, we are smarter, we have learned from past mistakes.

But if there is one constant in financial regulation, it is that we seem to be singularly incapable of learning from our mistakes, because we keep doing the same thing. And the same thing keeps failing. If regulation failed, we are told, the answer is more regulation. And if the regulators failed, the answer is to give those same regulators even greater powers over the financial system.

Yet those who claim that “more regulation must be the cure” forget that in the 2008 financial crisis, the most egregious financial failures occurred in the highly regulated world of commercial and investment banking, where regulation has been the most burdensome. The large bank holding companies that required massive infusions of federal tax dollars to stay alive were regulated by the Federal Reserve. Yet rather than hold the Fed to account for its failure in the run-up to the financial crisis, the Dodd-Frank Act gave it even more authority. The investment

²⁷⁵ Jonathan Turley, *The rise of the fourth branch of government*, WASH. POST, May 24, 2013, http://articles.washingtonpost.com/2013-05-24/opinions/39495251_1_federal-agencies-federal-government-fourth-branch.

²⁷⁶ Carmen M. Reinhart & Kenneth S. Rogoff, *THIS TIME IS DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY* (2009).

banks were regulated by the SEC. Yet the SEC's supervision was insufficient to prevent the collapse of Bear Stearns and Lehman Brothers. Commercial banks were supposedly under the oversight and supervision of federal banking regulators. Yet the heavy regulation of commercial banks yielded similarly abysmal results. Wachovia, formerly the nation's fourth largest bank, was regulated by the Office of the Comptroller of the Currency. Countrywide Financial was a national bank under OCC supervision until mid-2007, when it became a federal thrift regulated by the Office of Thrift Supervision. Washington Mutual and IndyMac were thrifts regulated by the Office of Thrift Supervision. All four were heavily regulated. All four failed spectacularly. When it comes to financial regulation, the "this time is different" syndrome manifests itself in the simple cry for "more regulation." "More regulation" allows politicians, regulators, and participants in the financial markets all to say, "We are doing things better. We are smarter. We have learned from our mistakes."

But more regulation will not solve our problems. It never has. And it never will. As the financial historian Bernard Shull pointed out in 1993:

Comprehensive banking reform, traditionally including augmented and improved supervision, has typically evoked a transcendent, and in retrospect, unwarranted optimism. The Comptroller of the Currency announced in 1914 that, with the new Federal Reserve Act, "financial and commercial crises or panics . . . seem to be mathematically impossible." Seventy-five years later, confronting the S&L disaster with yet another comprehensive reform—the Financial Institutions Reform, Recovery, and Enforcement Act—the Secretary of the Treasury proclaimed "two watchwords guided us as we undertook to solve this problem: Never Again."²⁷⁷

²⁷⁷ Bernard Shull, *The Limits of Prudential Supervision: Reorganizing the Federal Bank Regulatory Agencies* 15-16 (Jerome Levy Economics Inst. of Bard College, Public Pol'y Brief, 1993), <http://www.levyinstitute.org/pubs/ppb5.pdf>.

Lest anyone think that this time is different, all he or she needs to do is to consider the words of President Obama when he signed the Dodd-Frank Act into law: “Because of this law, the American people will never again be asked to foot the bill for Wall Street’s mistakes.”²⁷⁸

The 2008 financial crisis presented Congress, the regulators, and the financial markets with an opportunity to break decisively with the past—to do things better, to be smarter, to learn from our mistakes. But by resorting to the same failed strategies and misplaced confidence in the powers of regulation and regulators that led to the financial crisis in the first place, the Dodd-Frank Act squandered that opportunity. Instead, the Dodd-Frank Act further entrenched the problem of “too big to fail” by giving regulators even greater control over our financial system and a virtually unlimited pot of taxpayer money to bail out financial institutions when regulation inevitably fails.

So long as the Dodd-Frank Act remains our response to the financial crisis, the “next time” will be no different.

²⁷⁸ 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, 953 (2011) (quoting President Obama’s statement upon signing the Dodd-Frank Act), available at <https://scholarsbank.uoregon.edu/xmlui/bitstream/handle/1794/11137/Wilmarth%20--%20cropped.pdf>.