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Hon. Ben Bernanke, Vice Chairman  
Financial Stability Oversight Council  
and Chairman, Federal Reserve Board  
20th Street and Constitution Avenue NW  
Washington, DC 20551

Hon. Timothy Geithner, Chairman  
Financial Stability Oversight Council  
and Secretary of the Treasury  
1500 Pennsylvania Avenue NW  
Washington, DC 20520

January 25, 2012

Dear Chairman Bernanke and Secretary Geithner,

Public Citizen, a public interest nonprofit organization representing more than 250,000 members and supporters nationwide, hereby petitions the Board of Governors of the Federal Reserve System (the “Board”) and the Financial Stability Oversight Council (the “Council”) to recognize that the Bank of America Corporation (“Bank of America” or “the bank”) poses a “grave threat” to the stability of the United States financial system and to mitigate that threat, as provided by section 121 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act” or the “Act”).<sup>1</sup> Pursuant to the authority in the Act, the Board and the Council should reform Bank of America into one or more institutions that are smaller, less interconnected, less complex, more manageable and, as a result, less systemically dangerous.

Under section 121 of the Dodd-Frank Act, if the Board determines that a financial institution poses a “grave threat” to U.S. financial stability, then the Board, with approval from the Council, “shall” mitigate that threat.<sup>2</sup> The Act offers regulators the flexibility to take a range of actions, including limiting the institution’s mergers and acquisitions,

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<sup>1</sup> Mitigation of Risks to Financial Stability, Dodd-Frank Wall Street Reform and Consumer Protection Act, § 121, 12 U.S.C. § 5331 (2010).

<sup>2</sup> *Id.*

restricting or imposing conditions on its products or activities, or ordering it to divest assets or off-balance sheet items.

Bank of America currently poses a grave threat to U.S. financial stability by any reasonable definition of that phrase. It is the second largest bank holding company in the U.S., holds assets equal to roughly one-seventh of gross domestic product, and is highly complex and interconnected with other financial institutions. Bank of America is too large and complex to manage or regulate properly, and its financial condition is poor and could deteriorate rapidly at any moment, potentially causing the market to lose confidence in the bank. An ensuing run on the bank could cause a devastating financial crisis.

If Bank of America in its present form were to experience a run, then financial regulators' options would be severely limited, putting at risk the Dodd-Frank Act's policies of minimizing federal assistance to failed or failing financial institutions while safeguarding financial stability. First, there would be tremendous pressure to bail out Bank of America rather than put it through an untested orderly liquidation process. In addition, orderly liquidation would be complicated and difficult for an institution as large, complex, interconnected, and systemically dangerous as Bank of America, and it might not succeed. Even a successful orderly liquidation would require up-front funding by the Treasury and likely involve the overpayment of creditors to avoid financial contagion. This would perpetuate the moral hazard that incentivizes financial institutions to take inappropriate risks. In the absence of aggressive action by financial regulators, a scenario in which regulators choose among limited, poor options in the shadow of an imminent crisis appears increasingly likely.

For these reasons, the Board and the Council (collectively, "the Agencies") should act immediately under section 121 of the Dodd-Frank Act to mitigate the threats posed by Bank of America. In theory, the Agencies need not break up the institution, but in practice, any sufficient restriction on the products or activities of the institution would likely result in the institution being broken up. Also, the section 121 authority could be used in concert with liquidation procedures, for example by breaking up Bank of America and putting some portion of the company through orderly liquidation or bankruptcy immediately.

This petition does not urge a particular course. The petitioners are not privy to the full range of information available to financial regulators, which is likely necessary to form specific recommendations. But publicly available information is sufficient to show that financial regulators must take dramatic, assertive action to foreclose the possibility of catastrophic damage from Bank of America and fulfill the purposes of the Dodd-Frank Act. The regulators should be able to break up Bank of America into smaller institutions that would be less likely to fail and less dangerous in the event of failure—and for which orderly

liquidation would be more likely to succeed should it become necessary. The time to use section 121 is well in advance of a crisis. In the case of Bank of America, that means now.

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## **I. In Its Current Form, Bank of America Poses a Grave Threat to the Stability of the United States Financial System.**

Bank of America poses a grave threat to U.S. financial stability by any reasonable definition of that phrase. The Dodd-Frank Act does not define “grave threat,” nor does it appear in banking law. The Oxford English Dictionary defines “grave” in relevant part as “Weighty, important; in later use chiefly, requiring serious thought, serious.”<sup>3</sup> As applied to the risk that Bank of America poses to the U.S. financial system, that definition is a vast understatement. As this section discusses, Bank of America’s size, interconnectedness, lack of manageability, and the moral hazard problems it perpetuates make it extraordinarily dangerous. As a result of these factors, the institution at any point could experience a sudden, unexpected run that triggers a financial crisis.

To be sure, the same analysis applies to other large U.S. financial institutions as well. But publicly available information suggests that Bank of America is the riskiest and the nearest to financial crisis.

### **A. Bank of America is systemically dangerous due to its size and interconnectedness.**

There is little doubt that Bank of America’s size and interconnectedness make it systemically dangerous. It is clear that financial regulators agree with this position, having viewed Bank of America as too systemically significant to permit its failure (the notion popularized as “too big to fail”). For example, in 2008 and 2009, the bank received \$45 billion from Troubled Asset Relief Program. The bank also received assistance from the Board. Between 2007 and 2011, the Board’s lending to the bank totaled over \$1.017 trillion on a non-term adjusted basis,<sup>4</sup> and peaked at \$91.4 billion in February 2009.<sup>5</sup> That financial support would have been unjustified absent the conclusion that a Bank of America failure would be too damaging to the financial system to permit. Since those bailouts, the bank’s systemic significance has not diminished.

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<sup>3</sup> THE COMPACT OXFORD ENGLISH DICTIONARY 702 (2d Ed. 1987). Merriam-Webster defines “grave” in relevant part as “meriting serious consideration,” “likely to produce great harm or danger” or “significantly serious.” Merriam-Webster.com, MERRIAM-WEBSTER (2011), available at <http://bit.ly/rX1ucX>. In recent decades, courts increasingly have used dictionaries to assist their interpretation of ordinary words in statutes. See generally Jeffrey Kirchmeier & Samuel Thumma, *Scaling the Lexicon Fortress: The United States Supreme Court’s Use of Dictionaries in the Twenty-First Century*, 94 MARQ. L. REV. 77 (2010).

<sup>4</sup> James Felkerson, *\$29,000,000,000,000: A Detailed Look at the Fed’s Bailout by Funding Facility and Recipient*, THE LEVY ECONOMICS INSTITUTE OF BARD COLLEGE WORKING PAPER COLLECTION, Dec. 2011, available at <http://bit.ly/tAKvKw>.

<sup>5</sup> Bob Ivry, Bradley Keoun and Phil Kunt, *Secret Fed Loans Gave Banks \$13 Billion Undisclosed to Congress*, BLOOMBERG NEWS, Nov. 27, 2011, available at <http://bloom.bg/tEtA4u>.

A recent study by the Volatility Institute at New York University's Stern School of Business provides a more concrete framework for considering systemic risk. Researchers defined systemic risk as an aggregate capital shortfall in the financial sector, then used publicly available data to analyze and rank each financial institution's individual contribution to that shortfall—and therefore to overall systemic risk.<sup>6</sup> Bank of America ranks most risky among U.S. firms, contributing 19.3 percent of U.S. systemic risk.<sup>7</sup> This ranking demonstrates that among U.S. financial institutions, Bank of America not only is the most susceptible to financial crises, but also will contribute the most to their creation or extension.<sup>8</sup>

## **B. Bank of America cannot be managed or regulated soundly.**

Bank of America is also “too big to manage.” It is the second largest bank holding company in the U.S. It has assets of \$2.1 trillion, equal to more than 14 percent of U.S. gross domestic product,<sup>9</sup> and \$1 trillion in deposits, or 14 percent of U.S. deposits.<sup>10</sup> It is a conglomeration of several different lines of business, many of which are relatively new to the institution.

Already a behemoth, between 2006 and 2008 Bank of America acquired several other institutions, including Countrywide Financial, Merrill Lynch, MBNA, US Trust, and La Salle Bank. It grew 51 percent based on its acquisitions of Countrywide and Merrill Lynch alone.<sup>11</sup> Bank of America's acquisitions have resulted in a massive destruction of value. The bank spent \$148 billion on acquisitions from 1998 to 2011 but is currently worth approximately \$70 billion.<sup>12</sup> Although Bank of America conducted a year's worth of due

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<sup>6</sup> Viral Acharya, Thomas F. Cooley, Robert Engle and Matthew Richardson, *Overseeing systemic risk*, VOX, Feb. 27, 2011, available at <http://bit.ly/e4Fp61>.

<sup>7</sup> NYU Stern Systemic Risk Analysis of U.S. Financials, available at <http://bit.ly/95setd> (as of Jan. 19, 2012).

<sup>8</sup> Viral Acharya, Thomas F. Cooley, Robert Engle, and Matthew Richardson, *Overseeing systemic risk*, VOX, Feb. 27, 2011, available at <http://bit.ly/e4Fp61>.

<sup>9</sup> Press Release, Bank of America, “Bank of America Reports Fourth-Quarter 2011 Net Income of \$2.0 Billion, or \$0.15 Per Diluted Share Full-Year 2011 Net Income of \$1.4 Billion, or \$0.01 Per Diluted Share,” (Jan. 19, 2012), available at <http://bit.ly/wm7gEV>. U.S. GDP was at \$14.58 in 2010, according to the World Bank. See World Bank, Data: United States, available at <http://bit.ly/cE1hhR>.

<sup>10</sup> Press Release, Bank of America, “Bank of America Reports Fourth-Quarter 2011 Net Income of \$2.0 Billion, or \$0.15 Per Diluted Share Full-Year 2011 Net Income of \$1.4 Billion, or \$0.01 Per Diluted Share,” (Jan. 19, 2012), available at <http://bit.ly/wm7gEV>.

<sup>11</sup> Richard W. Fisher, *Two Areas of Present Concern: the Economic Outlook and the Pathology of Too-Big-to-Fail (With Reference to Errol Flynn, Johnny Mercer, Gary Stern and Voltaire)*, Remarks before the Senior Delegates' Roundtable of the Fixed Income Forum, July 23, 2009, available at <http://bit.ly/yI2rjA>.

<sup>12</sup> Simon Johnson, *Bank of America Is Too Much of a Behemoth to Fail*, BLOOMBERG NEWS, Oct. 23, 2011, available at <http://bloom.bg/nZz8WD>. For a visual depiction of the bank's growth, see Dan Fitzpatrick and Joann S. Lubin, *Bank of America Ponders Retreat: Building a Troubled Titan Interactive Graphic*, THE WALL STREET JOURNAL, Jan. 13, 2012, available at <http://on.wsj.com/ymTr0U>. Bank of America's market capitalization is currently approximately \$70 billion, as of January 19, 2011. The bank's market capitalization fell to approximately \$56 billion in December 2011. See *Bank of America Corporation Historical Market Cap Data*, Ycharts.com, available at <http://bit.ly/zc5hTe>.

diligence before acquiring Countrywide Financial, the \$4 billion acquisition ultimately might cost Bank of America \$60 billion.<sup>13</sup>

Bank of America has tacitly acknowledged that it is engaged in too many activities. CEO Brian Moynihan has repeatedly stated that one of his chief goals is to focus the bank more on core activities and sell noncore assets.<sup>14</sup> These efforts are laudable but fall far short of guaranteeing that the bank will be manageable. Bank of America's size and complexity make it impossible for management or financial regulators to understand the institution fully or to assess adequately the range and severity of the risks it faces.<sup>15</sup> As Richard W. Fisher, President and CEO of the Federal Reserve Bank of Dallas, stated recently, "there is scant chance that managers of \$1 trillion or \$2 trillion banking enterprises can possibly 'know their customer,' follow time-honored principles of banking and fashion reliable risk management models for organizations as complex as these megabanks have become."<sup>16</sup>

### **C. The threat that Bank of America poses is increased by its financial condition, which is poor and could deteriorate rapidly.**

In addition to its size, complexity, interconnectedness, and lack of manageability, Bank of America's financial condition is poor and could worsen rapidly at any time. This section

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<sup>13</sup> Simon Johnson, *Bank of America Is Too Much of a Behemoth to Fail*, BLOOMBERG NEWS, Oct. 23, 2011, available at <http://bloom.bg/nZz8WD>.

<sup>14</sup> Bank of America Corporation Special Call, Participating on Fairholme Capital Management Fundholder Call, Wednesday Aug. 10, 2011, transcript available at <http://bit.ly/nlWB34>; Bank of America Corporation Q3 2011 Earnings Call, Oct. 18, 2011, transcript available at <http://bit.ly/pLOA4z>.

<sup>15</sup> See, e.g., Interview with Simon Johnson, Benzinga.com, Sept. 16, 2011, available at <http://bit.ly/sriA7N> ("I think Bank of America has become too big to manage. It needs to be broken up. The kinds of measures they've taken are stopgap, and repainting the deck chairs on the Titanic, in my assessment."); Richard W. Fisher, *Minsky Moments and Financial Regulatory Reform*, Remarks before the 19th Annual Hyman P. Minsky Conference on the State of the U.S. and World Economies, Apr. 14, 2010 available at <http://bit.ly/sD2Zve> ("[T]hese large institutions are sprawling and complex—so vast that their own management teams may not fully understand their own risk exposures, providing fertile ground for unintended 'incompetence' to take root and grow. It would be futile to expect that their regulators and creditors could untangle all the threads, especially under rapidly changing market conditions."); Jonathan Weil, *Bank of America Edges Closer to Tipping Point*, BLOOMBERG NEWS, Nov. 3, 2010, available at <http://bloom.bg/t0qcfD> ("The only certainty is there is none, aside from the knowledge that Bank of America's top executives have no idea what goes on inside the bowels of their company."); Jim Millstein, *Europe's Largest Banks Have Become Too Big to Save*, FINANCIAL TIMES, Nov. 14, 2011, available at <http://on.ft.com/skTPbL> ("The one inescapable conclusion we must all draw from the recent financial crisis is that the so-called "global systemically important financial institutions" are not only too big to fail and too big to save, but most importantly, they are also too big to manage. The risks they run are too complex for the small group of managers at the top of any one of these mammoth organisations to fully grasp, for regulators to supervise and for investors to understand and discipline.").

<sup>16</sup> Richard W. Fisher, *Taming the Too-Big-to-Fails: Will Dodd-Frank Be the Ticket or Is Lap-Band Surgery Required?* Remarks before Columbia University's Politics and Business Club, Nov. 15, 2011, available at <http://bit.ly/vUPkmk>. As a remedy, Fisher proposed "downsizing the behemoths over time into institutions that can be prudently managed . . . ."

reviews evidence regarding the bank's poor financial condition and its largest outstanding sources of risk.

## **1. Several indicators suggest current financial distress at Bank of America.**

### *a. Near-term financial indicators: stock price, price-to-book value, derivatives transfers, and CDS spreads*

Several short-term indicators demonstrate that Bank of America's financial condition is extremely poor. First, the bank's stock price has plunged, recently falling below \$5.00 per share.<sup>17</sup> That is approximately a 90 percent decrease since the first hints of financial crisis appeared in 2007,<sup>18</sup> and approximately a 65 percent decrease during 2011 alone.<sup>19</sup> The last time Bank of America's stock price fell so low was March of 2009, when the bank was in the depths of crisis.<sup>20</sup> Even at its current price of roughly \$7.00 per share,<sup>21</sup> that is a 50 percent decline in the last year.

More important than the stock price alone, there is a sharp discrepancy between Bank of America's claims regarding its value and the market's valuation. Bank of America's share price-to-tangible book value is extremely low, at less than 55 percent.<sup>22</sup> To put this in perspective, JPMorgan Chase's ratio is roughly 120 percent, Citigroup's is 85 percent, and Wells Fargo's is 180 percent.<sup>23</sup> Such an extremely low ratio indicates that something is fundamentally wrong with Bank of America. The market believes the bank is roughly half of what management claims it is worth.

Another critical indicator is that counterparties are losing confidence that Bank of America will meet its obligations under derivatives contracts. According to reports, the bank's derivatives counterparties requested that the bank transfer a sizeable portion of the bank's

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<sup>17</sup> On Monday, December 19, 2011, Bank of America's stock price fell to \$4.92 and closed at \$4.99. See *Bank of America Corporation (BAC) Historical Prices*, YAHOO! FINANCE, available at <http://yhoo.it/vZyh5R>.

<sup>18</sup> The stock traded above \$50 for much of 2007. See *id.*

<sup>19</sup> On January 3, 2011, the stock closed at \$14.19 per share. See *id.*

<sup>20</sup> The stock hit a low of \$3.00 on March 6, 2009. See *id.* At that time, Board support for the bank had just peaked at \$91.4 billion in loans. Bob Ivry, Bradley Keoun and Phil Kunt, *Secret Fed Loans Gave Banks \$13 Billion Undisclosed to Congress*, BLOOMBERG NEWS, Nov. 27, 2011, available at <http://bloom.bg/tEtA4u>.

<sup>21</sup> As of January 19, 2012. See *Bank of America Corporation (BAC) Historical Prices*, YAHOO! FINANCE, available at <http://yhoo.it/vZyh5R>.

<sup>22</sup> Based on Bank of America's tangible book value per common share of \$12.95. Press Release, Bank of America, "Bank of America Reports Fourth-Quarter 2011 Net Income of \$2.0 Billion, or \$0.15 Per Diluted Share Full-Year 2011 Net Income of \$1.4 Billion, or \$0.01 Per Diluted Share," (Jan. 19, 2012), available at <http://bit.ly/wm7gEV>.

<sup>23</sup> Based on JPMorgan's share price of \$36.93 and tangible book value per share of \$30.29, Citigroup's share price of \$38.08 and tangible book value per share of \$42.69, and Wells Fargo's share price of \$30.15 and tangible book value of \$16.57. As of January 20, 2012. See <http://onforb.es/uSAORT>; <http://onforb.es/vKRm91>; <http://onforb.es/wLH4bf>.



derivatives contracts from the bank's investment subsidiary, Merrill Lynch, to the Bank of America NA, which is insured by the Federal Deposit Insurance Corporation (FDIC).<sup>24</sup> Bank of America is complying with the demand. While the circumstances and potential consequences are not fully clear, moving derivatives to the FDIC-insured subsidiary could benefit the bank and its counterparties by turning the riskiest assets with high collateral requirements into safer assets that take advantage of the Federal Reserve discount window subsidy and the FDIC subsidiary's higher credit rating to help lower the cost of posting margin.<sup>25</sup> Additionally, the possibility exists that the federal government may use taxpayer money in the FDIC insurance fund to subsidize losses under these troubled derivatives contracts.<sup>26</sup>

In addition, the prices of credit default swaps (CDS) on Bank of America recently rose to record highs. Because costs to buy credit protection rise as more investors seek to insure against a possible default, CDS spreads can indicate the market's faith in a company.<sup>27</sup> Recently, the five-year CDS spread on Bank of America rose to 489.72 basis points.<sup>28</sup> In comparison, JPMorgan Chase's CDS spread reached 183 basis points, Citigroup's rose to 323 basis points, and Wells Fargo's hit 179 basis points.<sup>29</sup> According to Wells Fargo's November 28, 2011 Equity Research report, "CDS spreads for the top 6 U.S. banks have widened materially over the past year but largely remain below the peak witnessed in the credit crisis of 2008-2009. The exception to this trend appears to be BAC . . . where its

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<sup>24</sup> Bob Ivry, Hugh Son and Christine Harper, *BofA Said to Split Regulators over Moving Merrill Derivatives to Bank Unit*, BLOOMBERG NEWS, Oct. 18, 2011, available at <http://bloom.bg/nzXv17>.

<sup>25</sup> *Id.* (Saule Omarova said, "Congress doesn't want a bank's FDIC insurance and access to the Fed discount window to somehow benefit an affiliate, so they created a firewall."); Yves Smith, *Bank of America Deathwatch: Moves Risky Derivatives from Holding Company to Taxpayer-Backstopped Depository*, NAKED CAPITALISM, Oct. 18, 2011, available at <http://bit.ly/rbtNbd> ("If you have any doubt that Bank of America is in trouble, this development should settle it . . . Now you would expect this move to be driven by adverse selection, that it, that BofA would move its WORST derivatives, that is, the ones that were riskiest or otherwise had high collateral posting requirements, to the sub. Bill Black confirmed that even though the details were sketchy, this is precisely what took place.").

<sup>26</sup> Simon Johnson, *Bank of America Is Too Much of a Behemoth to Fail*, BLOOMBERG NEWS, Oct. 23, 2011, available at <http://bloom.bg/nZz8WD> ("The move puts the Federal Deposit Insurance Corp. on the hook for any losses. The FDIC's deposit-insurance funds come from its member banks, but because the agency can tap a U.S. Treasury line of credit if the fund runs dry, taxpayers could be at risk, too . . . If Bank of America really had enough capital, it wouldn't have needed to move its derivatives risk onto its FDIC-insured deposit business."); Press Release, Senator Sherrod Brown, "Sen. Brown Leads 10 Senators in Letting Raising Concern Over Bank of America's Move of Risky Derivatives to Taxpayer-Backed Banking Unit," Oct. 27, 2011, available at <http://1.usa.gov/vMurM6> (discussing letter that raises concerns that the move violated the spirit of Section 23A of the Federal Reserve Act and the Volcker Rule).

<sup>27</sup> See generally Peter Tschir, *CDS - Hoarding and Downgrades and Collateral*, ZeroHedge.com, Sept. 22, 2011, available at <http://bit.ly/o91ygA>; Stefano Giglio, *CDS Spreads and Systemic Financial Risk*, Harvard University, May 2010, available at <http://bit.ly/v3Y0h3>.

<sup>28</sup> See Interactive Stock Chart for Bank of America Corp, BLOOMBERG NEWS, available at <http://bloom.bg/ulbHNV>.

<sup>29</sup> Matthew H. Burnell, Herman Chan and Jason Harbes, *Equity Research: Large Cap U.S. Banks: Market Monitor*, WELLS FARGO SECURITIES, Nov. 28, 2011.

current CDS spreads ended the week of November 25 35 percent wider than the peak experienced in 2008-2009.”<sup>30</sup> For much of 2007 before the crisis, these spreads were very low, at less than 50 basis points.<sup>31</sup>

With the high costs of credit protection and its recent credit downgrade,<sup>32</sup> Bank of America has become a credit risk. The bank’s counterparties could decide that the costs of protection are too high and decide to unwind or assign their securities positions with the bank. This unwinding or assignment of positions could have the same effect as a run if a prominent source of the bank’s funding is cut or if the bank is required to return collateral to counterparties under collateral agreements.<sup>33</sup>

*b. Long-term financial indicators demonstrate that Bank of America is becoming increasingly unstable.*

Bank of America posted a net loss of \$8.8 billion in the second quarter of 2011.<sup>34</sup> Of the losses, \$14.5 billion were attributed to consumer real estate services.<sup>35</sup> Although the bank declared a net profit of \$6.2 billion in the third quarter of 2011<sup>36</sup> and a net profit of \$2.0 billion in the fourth quarter of 2011,<sup>37</sup> it did so only because of non-cash accounting adjustments that do not reflect the company’s true financial position and one-time gains from asset sales and stock swaps.

Accounting adjustments for the third quarter of 2011 used by all major banks include favorable adjustment of loan loss provisions, income tax benefits, and Debt-Valuation Accounting (DVA). Under DVA, a bank can declare profits when its bonds decrease in value and credit spreads widen. Because the bank would show an improved balance sheet if it hypothetically bought back or called its bonds at the decreased values, DVA permits it to

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<sup>30</sup> *Id.*

<sup>31</sup> See Interactive Stock Chart for Bank of America Corp, BLOOMBERG NEWS, available at <http://bloom.bg/ulbHNNW>.

<sup>32</sup> Eileen AJ Connelly, *S&P Downgrades Goldman Sachs, Bank Of America, Wells Fargo And Citigroup*, THE HUFFINGTON POST, Nov. 29, 2011, available at <http://huff.to/v3QyBg>; Mark Gongloff, *Fitch Downgrades a Bunch of Banks, Including Bank of America and Goldman*, THE WALL STREET JOURNAL MARKETBEAT, Dec. 15, 2011, available at <http://on.wsj.com/tvwLsn>.

<sup>33</sup> Peter Tschir, *CDS - Hoarding and Downgrades and Collateral*, ZeroHedge.com, Sept. 22, 2011, available at <http://bit.ly/o91ygA>.

<sup>34</sup> Press Release, Bank of America, “Bank of America Reports Second-Quarter 2011 Financial Results,” (July 19, 2011), available at <http://bit.ly/nKHraj>.

<sup>35</sup> *Id.*

<sup>36</sup> Press Release, Bank of America, “Bank of America Reports Third-Quarter 2011 Net Income of \$6.2 Billion, or \$0.56 Per Diluted Share,” (Oct. 18, 2011), available at <http://bit.ly/w3Mq36>.

<sup>37</sup> Press Release, Bank of America, “Bank of America Reports Fourth-Quarter 2011 Net Income of \$2.0 Billion, or \$0.15 Per Diluted Share Full-Year 2011 Net Income of \$1.4 Billion, or \$0.01 Per Diluted Share,” (Jan. 19, 2012), available at <http://bit.ly/wm7gEV>.

show those bond price declines as profits.<sup>38</sup> Counter-intuitively, DVA effectively allows the bank to book profits when investors become more nervous about its ability to pay back its debts. JPMorgan Chase CEO Jamie Dimon has said that DVA “does not relate to the underlying operations of the company.”<sup>39</sup> In Bank of America’s case, \$1.7 billion or 27 percent of its declared profits from the third quarter of 2011 are the result of DVA.<sup>40</sup>

Bank of America has also benefited from the Financial Accounting Standards Board’s 2009 suspension of mark-to-market accounting requirements. Mark-to-market accounting requires a firm to value its assets based on current market prices, even if the firm does not sell those assets.<sup>41</sup> Now, the bank is not required to show the true values of its assets and can avoid recognizing substantial losses by holding them indefinitely.

Bank of America benefited from one-time gains in the fourth quarter of 2011, including \$2.9 billion from the sale of a stake in China Construction Bank, \$1.2 billion from the sale of debt securities, and \$1.2 billion from swapping preferred stock for common stock.<sup>42</sup>

If one looks past the bank’s accounting techniques and one-time gains, its 2011 third and fourth quarter results are worrisome. In the third quarter, net income from deposits was down \$148 million from the second quarter; net income from card services was down \$675 million; net income from global wealth and investment management services was down \$159 million; and net income from global commercial banking was down \$331 million.<sup>43</sup> These troubling trends continued in the fourth quarter. Net income from deposits was down \$135 million from the third quarter; net income from card services was down \$241 million; net income from global wealth and investment management services was down \$98 million; and its global banking and markets unit, which includes Merrill Lynch, suffered a net loss of \$433 million.<sup>44</sup>

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<sup>38</sup> Elizabeth MacDonald, *The Accounting Move That’s Goosing Bank Profits*, FOX BUSINESS, Oct. 19, 2011, available at <http://fxn.ws/pZLZ6s>.

<sup>39</sup> Press Release, JPMorgan Chase, “JPMorgan Chase Reports Third-Quarter 2011 Net Income of \$4.3 Billion, or \$1.02 Per Share, on Revenue<sup>1</sup> of \$24.4 Billion,” (Oct. 13, 2011), available at <http://bit.ly/tqA4E0>.

<sup>40</sup> Press Release, Bank of America, “Bank of America Reports Third-Quarter 2011 Net Income of \$6.2 Billion, or \$0.56 Per Diluted Share,” (Oct. 18, 2011), available at <http://bit.ly/w3Mq36>.

<sup>41</sup> Kara Scannell, *FASB Eases Mark-to-Market Rules*, THE WALL STREET JOURNAL, Apr. 3, 2009, available at <http://on.wsj.com/2qxUKw>.

<sup>42</sup> Hugh Son, *Bank of America Swings to Fourth-Quarter Profit as Lender Rebuilds Capital*, BLOOMBERG NEWS, Jan. 19, 2012, available at <http://bloom.bg/wwKqpa>.

<sup>43</sup> Earnings Presentation, Bank of America, “3Q11 Financial Results,” (Oct. 18, 2011), available at <http://bit.ly/vlRWnl>.

<sup>44</sup> Earnings Presentation, Bank of America, “4Q11 Financial Results,” (Jan. 19, 2012), available at <http://bit.ly/pqB5Qs>.

In an attempt to lower costs, Bank of America has announced it will lay off approximately 30,000 members of its workforce in the next few years, roughly a 10 percent reduction.<sup>45</sup> Media reports also indicate that the bank plans to close approximately 750 of its 5,700 branches.<sup>46</sup>

## **2. Bank of America is likely undercapitalized, facing potential liabilities and market risks that could severely destabilize it.**

CEO Brian Moynihan and CFO Bruce Thompson have stated that Bank of America and the financial industry in general are fundamentally more stable than they were four years ago.<sup>47</sup> They have also stated that Bank of America is on track to clean up its balance sheet, raise capital reserves, and become a “leaner, more focused company.”<sup>48</sup> Despite these representations, Bank of America’s stability is in serious doubt.

Several analysts predict that Bank of America, which currently has a market capitalization of approximately \$70 billion, is woefully short of capital reserves.<sup>49</sup> Henry Blodget has indicated that the bank might need to raise between \$100 and \$200 billion to clean up its balance sheet.<sup>50</sup> Jeffries’ equity derivatives specialist Layla Peruzzi put the figure between \$40 and \$50 billion,<sup>51</sup> and Citigroup analyst Keith Horowitz found that the bank may require as much as \$32 billion.<sup>52</sup> As the financial crisis of 2008 demonstrated, it is virtually

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<sup>45</sup> Susanna Kim, *Bank of America Confirms 30,000 Layoffs*, ABC NEWS, Sept. 12, 2011, available at <http://abcn.ws/vPCT84>.

<sup>46</sup> Dan Fitzpatrick and Joann S. Lubin, *Bank of America Ponders Retreat*, THE WALL STREET JOURNAL, Jan. 13, 2012, available at <http://on.wsj.com/ymTr0U>.

<sup>47</sup> Bank of America Corporation Special Call, Participating on Fairholme Capital Management Fundholder Call, Wednesday Aug. 10, 2011, transcript available at <http://bit.ly/nlWB34>.

<sup>48</sup> Press Release, Bank of America, “Bank of America Reports Third-Quarter 2011 Net Income of \$6.2 Billion, or \$0.56 Per Diluted Share,” (Oct. 18, 2011), available at <http://bit.ly/w3Mq36>.

<sup>49</sup> According to Bank of America’s fourth quarter 2011 report, the company’s Tier 1 common equity ratio was at 9.86 percent and its tangible common equity ratio was at 6.64 percent. Press Release, Bank of America, “Bank of America Reports Fourth-Quarter 2011 Net Income of \$2.0 Billion, or \$0.15 Per Diluted Share Full-Year 2011 Net Income of \$1.4 Billion, or \$0.01 Per Diluted Share,” (Jan. 19, 2012), available at <http://bit.ly/wm7gEV>.

<sup>50</sup> Henry Blodget, *Here’s Why Bank of America’s Stock Is Collapsing Again*, BUSINESS INSIDER, Aug. 23, 2011, available at <http://bit.ly/oTXHXn>. Bank of America quickly responded to Blodget’s analysis, saying that he made “exaggerated and unwarranted claims.” Hugh Son, *BofA Says Blodget’s Analysis on Bank Is ‘Exaggerated’*, BLOOMBERG NEWS, Aug 24, 2011, available at <http://bloom.bg/oG4Mjz>.

<sup>51</sup> Christopher Dieterich, *The Debate: Will Bank of America Have to Sell Fresh Stock*, THE WALL STREET JOURNAL, Aug. 22, 2011, available at <http://on.wsj.com/nME8IG>.

<sup>52</sup> Dan Freed, *Bank of America Mortgage Woes Lurk Behind Earnings*, THESTREET.COM, Jan. 19, 2012, available at <http://bit.ly/z3zmka>.

impossible to know whether financial institutions are sufficiently capitalized until a crisis occurs, at which point it may be too late to remedy their shortfalls.<sup>53</sup>

Recently, Bank of America has increased its efforts to sell noncore assets to generate capital.<sup>54</sup> Since 2010, the bank has sold approximately 20 different businesses for about \$33 billion.<sup>55</sup> These efforts have fallen far short of what is necessary because only a fraction of the total sale prices are applied to capital calculations. For example, the bank disposed of Merrill Lynch's stake in Blackrock for \$2.5 billion, but netted only about \$377 million in new capital. It also sold half of its China Construction Bank for \$8.3 billion but netted only about \$3.3 billion. Additionally, it sold its Canadian credit card business for about \$8.5 billion but netted only about \$100 million according to FBC Capital Markets analyst Paul Miller. Bank of America disputed this, arguing that the figure is \$270 million under Basel I standards or \$477 million under Basel III.<sup>56</sup> Either amount is far short of the \$8.5 billion sale proceeds. And with fewer noncore assets available to sell, the bank must raise capital in other ways.

One such way would be through a stock offering. However, many analysts believe Bank of America could have difficulty doing so. Because the stock price is so low, selling enough stock to impact the bank's capital reserves would be painfully dilutive and therefore unattractive to management and current shareholders.<sup>57</sup>

### **3. Bank of America faces potential liabilities from litigation that it may be unprepared to meet.**

Ongoing litigation could result in substantially greater legal liabilities and asset depreciation than Bank of America has reserved for.<sup>58</sup> Two types of cases predominate:

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<sup>53</sup> Henry Blodget, *So, When's Obama Going to Start Freaking Out About The Banks?*, BUSINESS INSIDER, Oct. 3, 2011, available at <http://bit.ly/vidcqa> ("If there's one over-arching lesson of the 2008 crisis, though, it's that no one will ever know how well capitalized the banks are . . . until it is too late.").

<sup>54</sup> Bank of America Corporation Special Call, Participating on Fairholme Capital Management Fundholder Call, Wednesday Aug. 10, 2011, transcript available at <http://bit.ly/nlWB34> (CEO Brian Moynihan said that the firm was selling noncore assets "aggressively.").

<sup>55</sup> Ben Protes, *Bank of America Sells Canadian Credit Card Business*, N.Y. TIMES DEALBOOK, Aug. 15, 2011, available at <http://nyti.ms/oQAcpz>; Hugh Son, *BofA Shrinking Assets Puts \$2.8 Billion Hole in Target*, BLOOMBERG BUSINESSWEEK, Jan. 19, 2012, available at <http://buswk.co/A8ddS9>.

<sup>56</sup> Kayla Tausche, *Bank of America's Race to Sell*, CNBC.com, Sept. 29, 2011, available at <http://bit.ly/t4BM0R>.

<sup>57</sup> Christopher Dieterich, *The Debate: Will Bank of America Have to Sell Fresh Stock*, THE WALL STREET JOURNAL, Aug. 22, 2011, available at <http://on.wsj.com/nME8IG> (quoting Peruzzi as stating, "Our traders and desk strategist think the reality is that the market is forcing BAC into a capital raise and the lower stock price goes, the worse it gets").

<sup>58</sup> Christopher Whalen, *Uncertainty and indecision threaten Bank of America and global markets*, REUTERS, Aug. 9, 2011, available at <http://reut.rs/qCxeFK>; ("[Bank of America] is now so vast and unstable that it threatens the global economy."); Henry Blodget, *Bank of America is Doomed, Says Chris Whalen Stop Firing People and Just Declare Bankruptcy Now*, BUSINESS INSIDER, Sept. 9, 2011, available at <http://bit.ly/uqYqke>.

claims regarding mortgage-related fraud and violations of representations and warranties, and claims for securities fraud.

**Mortgage related fraud and violations of representations and warranties.** Bank of America has reserved \$16 billion for its exposure to representations and warranties claims.<sup>59</sup> It has already paid \$13 billion.<sup>60</sup> Below is information on select pending cases or related potential liabilities.

- Bank of America recently settled one representations and warranties lawsuit with Fannie Mae and Freddie Mac for a total estimated value of \$3 billion.<sup>61</sup> However, because the settlement requires the bank to repurchase deficient mortgages, it may cost the bank more than it originally forecasted.<sup>62</sup> In the bank's 2011 fourth quarter earnings presentation, the bank estimated that it may be required to pay \$5 billion more than existing accruals.<sup>63</sup>
- Currently, Bank of America is being sued by twenty-two institutions that invested in mortgage-backed securities which were based on deficient mortgage loans.<sup>64</sup> The institutions claim that Countrywide (now owned by Bank of America) breached representations and warranties dictated by the securitization trust pooling and servicing agreements by misrepresenting that the underlying mortgages complied

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<sup>59</sup> Earnings Presentation, Bank of America, "4Q11 Financial Results," (Jan. 19, 2012), available at <http://bit.ly/pqB5Qs>.

<sup>60</sup> *Id.*

<sup>61</sup> Press Release, Bank of America, "Bank of America Announces Fourth-Quarter Actions With Respect to Its Home Loans and Insurance Business," (Jan. 3, 2011), available at <http://bit.ly/u4VipU>.

<sup>62</sup> Hugh Son, *BofA Says Loan Repurchase Costs May Exceed Previous Forecast*, BLOOMBERG NEWS, Aug. 5, 2011, available at <http://bloom.bg/qVOisY>.

<sup>63</sup> Earnings Presentation, Earnings Presentation, Bank of America, "4Q11 Financial Results," (Jan. 19, 2012), available at <http://bit.ly/pqB5Qs> ("Estimated range of possible loss related to non-GSE representations and warranties exposure could be up to \$5B over existing accruals at December 31, 2011. The company is not currently able to reasonably estimate the possible loss or range of possible loss with respect to GSE representations and warranties exposure over existing accruals at December 31, 2011."); Bank of America Corporation Form 10-Q, Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934, For the Quarterly Period Ended June 30, 2011, available at <http://bit.ly/tVDNij> ("While the Corporation has an established history of working with the GSEs on repurchase claims, its experience with them continues to evolve and impact the Corporation's estimated repurchase rates and liability. In addition, the recent FNMA announcement regarding mortgage insurance rescissions, cancellations and claim denials could result in increased repurchase requests from FNMA that exceed the repurchase requests contemplated by the estimated liability . . . . We are not able to anticipate changes in the behavior of the GSEs from our past experiences. Therefore, it is not possible to reasonably estimate a possible loss or range of possible loss with respect to any such potential impact in excess of current accruals on future GSE provisions if the behavior of the GSEs changes from past experience.").

<sup>64</sup> Press Release, Gibbs & Bruns LLP, "22 Institutional Investors in Countrywide-Issued RMBS Announce Global Settlement of Mortgage Repurchase and Servicing Claims for 530 Countrywide-Issued RMBS Trusts," (June 29, 2011), available at <http://bit.ly/tx9Y5e>.



with specific underwriting guidelines.<sup>65</sup> In June 2011, Bank of America proposed an \$8.5 billion settlement, hoping to end the suit and calm nervous investors.<sup>66</sup> But many interested parties objected to the settlement. New York Attorney General Eric Schneiderman intervened and rejected it as “unfair and inadequate.”<sup>67</sup> Other state attorneys general and the FDIC objected, arguing that they lacked information sufficient to assess its adequacy.<sup>68</sup> This suit therefore remains pending and is likely to involve a settlement of substantially more than \$8.5 billion.

- AIG is also suing Bank of America for \$10 billion, claiming that Bank of America, Merrill Lynch, and Countrywide Financial misrepresented the quality of the underlying mortgages that were securitized and sold to AIG.<sup>69</sup>
- Bank of America’s participation in the Mortgage Electronic Registration System (MERS) also might result in vast liabilities. MERS was created by many banks, including Bank of America, to circumvent centuries-old property law. Instead of publicly recording mortgage conveyances in county indexes, MERS allowed the banks to record property conveyances electronically. MERS was quick and inexpensive, and allowed for increasing mortgage origination and securitization. However, in the banks’ haste to turn mortgages into mortgage-backed securities, they allegedly failed to make complete transfers of mortgages, did not keep proper records of the failed transfers, and did not comply with the requirements of their own pooling and servicing agreements. Moreover, it may be difficult, if not impossible, to cure these errors. It is alleged that many banks, including Countrywide, engaged in document fabrication and securities fraud in attempts to remedy the deficiencies.<sup>70</sup>

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<sup>65</sup> *Bank of N.Y. Mellon v. Walnut Place LLC*, No. 11 Civ. 5988(WHP), 2011 WL 4953907, — F. Supp. 2d — (S.D.N.Y. Oct. 19, 2011).

<sup>66</sup> Press Release, Bank of America, “Bank of America Announces Agreement on Legacy Countrywide Mortgage Repurchase and Servicing Claims,” (June 29, 2011), available at <http://bit.ly/vFBSNE>.

<sup>67</sup> Memorandum of Eric T. Schneiderman, Attorney General of the State of New York, in Support of Motion to Intervene, *In the matter of the application of The Bank of New York Mellon*, Index No. 651786/2011, Supreme Court of New York, Aug. 4, 2011, available at <http://bit.ly/rHNx4L>; Verified Pleading in Intervention, Attorney General of the State of New York, *In the matter of the application of The Bank of New York Mellon*, Index No. 651786/2011, Supreme Court of New York, Aug. 4, 2011, available at <http://bit.ly/rXAv0B>.

<sup>68</sup> Notice of Intention to Appear and Object, Federal Deposit Insurance Corporation, *In the matter of the application of The Bank of New York Mellon*, Case 1:11-cv-05988-UA, Supreme Court of New York, Aug. 29, 2011, available at <http://bit.ly/t3KOze>; Agnes T. Crane, *Breakingviews: Big U.S. foreclosure settlement isn't dead yet*, Thomson REUTERS NEWS AND INSIGHT, Dec. 1, 2011, available at <http://bit.ly/vTK3wE>.

<sup>69</sup> Complaint, *American International Group Inc. v. Bank of America Corporation*, Supreme Court of New York, Aug. 8, 2011, available at <http://bit.ly/sB3eZt>.

<sup>70</sup> See L. Randall Wray, *Anatomy of Mortgage Fraud Part I, Mers's Smoking Gun*, THE HUFFINGTON POST, Dec. 9, 2010, available at <http://huff.to/eDv2XV>; L. Randall Wray, *Anatomy of Mortgage Fraud Part II, The Mother of All Frauds*, THE HUFFINGTON POST, Dec. 13, 2010, available at <http://huff.to/eoDug2>; *In re Agard*, 444 B.R. 231,

- In addition to potential liability, Bank of America may be unable to prove its interest in properties it purports to own, and therefore unable to establish standing to foreclose on them. Such a development could cause billions of dollars in additional losses for the bank.<sup>71</sup>

No one knows the extent of Bank of America's mortgage and mortgage securities liability, much of which is attributable to actions taken by mortgage giant Countrywide Financial before Bank of America bought it. Countrywide's liability may be so great for the bank holding company that CEO Brian Moynihan admitted to having considered putting the mortgage unit through bankruptcy.<sup>72</sup>

**Securities fraud.** Bank of America is also being sued by shareholders in a securities fraud class action.<sup>73</sup> The plaintiffs allege that when Bank of America bought Merrill Lynch, Bank of America deliberately failed to disclose to investors a \$15.31 billion loss so that investors would approve the deal quickly. The complaint further alleges that Bank of America's general counsel was unaware of the loss when he recommended approval, then was fired when he discovered the loss and tried to meet with the chief financial officer to discuss it. This suit is still pending. The Securities and Exchange Commission previously sued Bank of America over the same issue. In that case, the judge rejected an initial \$33 million settlement as inadequate before approving a \$150 million deal.<sup>74</sup> The judge called the final settlement and the lack of penalties for the CEO and CFO "half-baked justice at best."<sup>75</sup>

The firm's overall liability from outstanding litigation may range between \$30 and \$50 billion, enough in itself to cause the bank to fail.

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254 (Bankr. E.D.N.Y. 2011) (The court "leaves open the issue as to whether mortgages processed through the MERS system are properly perfected and valid liens."); Christopher Peterson, *Foreclosure, Subprime Mortgage Lending, and the Mortgage Electronic Registration System*, 78 U. CIN. L. REV. 1359 (2010); Press Release, Attorney General Martha Coakley, "Five National Banks Sued by AG Coakley in Connection with Illegal Foreclosures and Loan Servicing," (Dec. 1, 2011), available at <http://1.usa.gov/uHvAPt> (reporting on lawsuit by Massachusetts Attorney General Martha Coakley alleging unfair and deceptive trade practices by Bank of America, JP Morgan Chase, Citibank, GMAC, Wells Fargo, MERS, and MERSCORP).

<sup>71</sup> *Id.*

<sup>72</sup> Bank of America Corporation Special Call, Participating on Fairholme Capital Management Fundholder Call, Wednesday Aug. 10, 2011, transcript available at <http://bit.ly/nlWB34>. In response to a question about putting Countrywide through bankruptcy, CEO Brian Moynihan said, "When you're [sic] face liabilities like this, we thought of every possible thing we could, but I don't think I'd comment on any outcome." Moynihan also admitted regrets over the Countrywide acquisition, saying, "Obviously, there aren't many days that I get up and think positively about the Countrywide transaction in 2008." *Id.*

<sup>73</sup> Consolidated Second Amended Class Action Complaint, *In Re Bank of America Corp, Securities, Derivative, and Employee Retirement Income Security Act (ERISA) Litigation*, Case 1:09-md-02058-PKC, Oct. 22, 2010, available at <http://bit.ly/vaaW3Q>.

<sup>74</sup> Steven Davidoff, *A \$50 Billion Claim of Havoc Looms for Bank of America*, THE NEW YORK TIME DEALBOOK, Sept. 27, 2011, available at <http://nyti.ms/n4mWRb>.

<sup>75</sup> *S.E.C. v. Bank of America Corp.*, 2010 WL 624581 (S.D.N.Y. Feb. 22, 2010).



#### **4. Exposure to financial instability in Europe could devastate Bank of America.**

Bank of America risks great losses as a result of Europe's ongoing financial crisis. If the crisis becomes acute and contagion spreads throughout Europe, it would threaten both Bank of America and U.S. financial stability.

A systemic event in Europe presents two risks to Bank of America. First, the bank could be exposed directly through lending agreements. Second, American banks could suffer from indirect (counterparty) exposure through undisclosed and unknown interconnections between financial institutions. While direct exposure may be modest, indirect exposure could be immense.

The interconnections between global financial institutions are not fully known or disclosed to shareholders, creditors, management, or regulators. The potential consequences of these interconnections are therefore unpredictable until crisis strikes. As a result, financial actors are unable to assess risk in the financial system and act accordingly. Furthermore, there are no firewalls to stop a contagious event. Former Federal Reserve Chairman Alan Greenspan has expressed concern over these opaque connections, saying "I think it's very dangerous. Everyone's got their fingers crossed . . . This is an integrated system. The presumption that somehow the huge American banking system . . . is independent of Europe is, I think, just utterly unrealistic . . . It looks independent until it isn't."<sup>76</sup>

According to FFIEC Form 009, the form by which banks disclose their foreign exposure to regulators, U.S. banks risk \$175 billion in direct gross exposure and \$550 billion in "other potential exposure" to Portugal, Italy, Ireland, Greece, and Spain (the "PIIGS").<sup>77</sup> These figures do not include exposures to France and Germany.

Indirect exposure to crisis in France and Germany could be significant. If French or German banks have sold CDS on the PIIGS countries and those countries default, then the French or German banks would be liable under those CDS contracts. If the banks are not adequately capitalized to buffer against those losses, they could fail, triggering substantial ripple effects among U.S. banks.<sup>78</sup> Banks claim that their net exposures are much lower and more manageable than their gross exposures, but because interconnections are so complex and

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<sup>76</sup> Jeff Cox, *US Facing 'Dangerous' Threat From Euro Debt: Greenspan*, CNBC.com, Oct. 7, 2011, available at <http://bit.ly/nykN2Z>.

<sup>77</sup> John McDermott, *The Mystery of US Banks' European Exposure*, FINANCIAL TIMES ALPHAVILLE, Oct. 5, 2011, available at <http://on.ft.com/q2v7kn>.

<sup>78</sup> See Robert Reich, *Follow the Money: Behind Europe's Debt Crisis Lurks Another Giant Bailout of Wall Street*, THE HUFFINGTON POST, Oct. 5, 2011, available at <http://huff.to/rbQel7>.

not fully known, it is doubtful that losses will be minimized as well as banks expect.<sup>79</sup> The 2008 financial crisis demonstrated that banks sometimes assume that they have hedged risks better than they have.

Bank of America has admitted that a crisis in Europe would create trouble for the bank. CEO Brian Moynihan has recognized that the “contagion stuff is real.”<sup>80</sup> However, the bank’s third quarter 10-Q filing with the Securities and Exchange Commission and its supplemental fourth quarter 2011 financial information shed little light on the risks to which the bank is exposed. According to the most recent disclosures, the bank is exposed by a total \$14.4 billion to the PIIGS, but it is not clear whether that figure includes both direct and indirect exposures.<sup>81</sup> Additionally, Bank of America’s disclosures do not discuss exposure to French and German banks.

#### **D. Current policy toward Bank of America perpetuates and increases systemic risk.**

In light of its poor finances, Bank of America survives today only because of an implicit guarantee from the U.S. government. Because the market believes Bank of America is likely to be bailed out in the event of a crisis, the firm enjoys a higher credit rating and substantially lower costs of funding.<sup>82</sup>

These subsidies for a failed financial behemoth are not just a matter of resource misallocation. They also perpetuate and increase moral hazard. Because they will not suffer the full consequences of their own failures, Bank of America and its creditors have the

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<sup>79</sup> See David Enrich and Laura Stevens, *Banks Sit in a Tangled Web: Many European Lenders Have Sold Sovereign-Default Protection to One Another*, THE WALL STREET JOURNAL, Dec. 12, 2011, available at <http://on.wsj.com/s36MyR>; John McDermott, *The Mystery of US Banks’ European Exposure*, FINANCIAL TIMES ALPHAVILLE, Oct. 5, 2011, available at <http://on.ft.com/q2v7kn>; John McDermott, *Goldman predicts a fire sale of USD assets by French banks*, FINANCIAL TIMES ALPHAVILLE, Oct. 6, 2011, available at <http://on.ft.com/sLbOr8>.

<sup>80</sup> Hugh Son, *Moynihan Says Bank of America ‘Confident’ It Can Withstand Europe Turmoil*, BLOOMBERG NEWS, Oct. 5, 2011, available at <http://bloom.bg/mTuP3y>.

<sup>81</sup> See Table 58, Bank of America Corporation Form 10-Q, Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934, For the Quarterly Period Ended June 30, 2011, available at <http://bit.ly/tVDNij>; Page 39, Bank of America Supplemental Information Fourth Quarter 2011, available at <http://bit.ly/iqIM2> (current to Dec. 31, 2011).

<sup>82</sup> In September 2011, Moody’s downgraded Bank of America on the belief that the U.S. government is somewhat less likely to bail it out in the event of crisis. Joe Rauch & David Henry, *Moody’s Downgrades Big Banks on Changed Policy*, REUTERS, Sept. 21, 2011, available at <http://reut.rs/sFosA2>. In contrast, Fitch Ratings reaffirmed in December 2011 that it believes Bank of America is one of eight firms that the U.S. government would bail out. *Fitch Sees US Govt. Financial Support for Banks Declining, Says Only 8 Are Candidates For Aid*, ASSOCIATED PRESS, Dec. 15, 2011, available at <http://yhoo.it/zj0GyH>. On lower costs of funding, see Dean Baker & Travis McArthur, *The Value of the “Too Big to Fail” Big Bank Subsidy*, CENTER FOR ECONOMIC POLICY RESEARCH, Sept. 2009. On both credit ratings and costs of funding, see Kenichi Ueda & Beatrice Weder di Mauro, *Quantifying the Value of the Subsidy for Systemically Important Financial Institutions*, conference paper for German Institute for Economic Research (DIW Berlin), *The Role of Finance in Stabilizing the Past, Present, and Future Real Economy*, May 20, 2011, available at <http://bit.ly/rMnpQ1>.

incentive to take inappropriate risks.<sup>83</sup> In short, U.S. support of Bank of America undermines rather than bolsters the long-term stability of the U.S. financial system.

## **II. The Board and the Council Should Act Immediately to Mitigate the Threat to U.S. Financial Stability That Bank of America Currently Poses.**

The Board and the Council should use their authority under section 121 of the Dodd-Frank Act to break Bank of America into separate institutions that would be less likely to fail, would not endanger the U.S. financial system in the event of failure, and for which orderly liquidation would be easier and more effective should it become necessary.<sup>84</sup> Section 121 is critical to fulfilling the Dodd-Frank Act's express goal to "end 'too big to fail.'"<sup>85</sup>

Section 121 establishes how the Agencies should respond to threats such as those posed by Bank of America. If the Board determines that a Systemically Important Financial Institution (SIFI) poses a "grave threat" to financial stability, the Board "shall" on a two-thirds vote of the Council mitigate the threat that the financial institution poses by limiting the institution's mergers and acquisitions, restricting or imposing conditions on its products or activities, or ordering it to divest assets or off-balance-sheet items.<sup>86</sup>

This authority must be exercised well in advance of financial distress at an institution that poses a grave threat to U.S. financial stability. Foremost, the section 121 authorities are intended to prevent the existence of situations in which institutions that pose a grave

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<sup>83</sup> See, e.g., Thomas M. Hoenig, Financial Reform—Post-Crisis?, speech at Women in Housing and Finance conference, Feb. 2011, available at <http://bit.ly/ycLsIF> ("In a competitive marketplace, where just a few basis points make a difference, these funding advantages are huge and represent a highly distorting influence within financial markets. I'll name three. They don't have to sell creditors on the strength of their condition. They have significant advantages in competing for funds. And, they have significant incentives to take on more risk, hold less capital, and book more assets."); Richard W. Fisher, *Minsky Moments and Financial Regulatory Reform*, Remarks before the 19th Annual Hyman P. Minsky Conference on the State of the U.S. and World Economies, Apr. 14, 2010, available at <http://bit.ly/sD2Zve> ("[B]ig banks may believe they can act recklessly without fear of paying the ultimate penalty. They and many of their creditors assume the Fed and other government agencies will cushion the fall and assume some of the damages, even if their troubles stem from negligence or trickery.").

<sup>84</sup> While section 121 does not require the Agencies to break up a financial institution when it poses a grave threat to U.S. financial stability, any action sufficient to mitigate the threat that Bank of America poses would likely result in the bank's breakup. First, merely limiting the institution's mergers and acquisitions is insufficient to mitigate the risks the bank presents. Second, any restriction or imposition of conditions on the institution's products or activities that is sufficient to mitigate the firm's risk will likely result in its breakup, whether nominally voluntary or explicitly ordered.

<sup>85</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. 111-203 ("To promote the financial stability of the United States . . . to end "too big to fail", to protect the American taxpayer by ending bailouts . . . and for other purposes."); cf. § 166; 12 U.S.C. § 5366 (directing the Board to "prescribe regulations establishing requirements to provide for the early remediation of financial distress" of a SIFI "except that nothing in this subsection authorizes the provision of financial assistance from the Federal Government").

<sup>86</sup> Mitigatory Actions, Mitigation of Risks to Financial Stability, Dodd-Frank Wall Street Reform and Consumer Protection Act, § 121(a), 12 U.S.C. § 5331(a) (2010).

threat to U.S. financial stability are in such dire financial distress that emergency action is required. If such a circumstance is permitted to arise, then section 121 will provide little or no assistance. Moreover, although the Agencies should move expeditiously to mitigate grave threats to financial stability, the Agencies should use their section 121 powers with due care and deliberation, not hastily or under duress. That means they must act well in advance of any potential crisis. Action under section 121 also must be taken in a manner that does not foment instability. The Agencies should state that Bank of America, while not in immediate danger, is structurally unsound, and the Agencies are acting under the Dodd-Frank Act to achieve an orderly transition to a more acceptable structure.

Section 121 also must be used well in advance of financial distress at an institution like Bank of America to ensure that other provisions of Dodd-Frank, particularly the orderly liquidation authority, work properly. Orderly liquidation would be difficult to conduct for an institution as large and complex as Bank of America. The Agencies should use section 121 not just to fashion firms that are less likely to fail, but to ensure that resolution is more likely to succeed in the event of a failure.

Finally, the language of section 121 confirms that the “grave threat” authorities should be used well in advance of any potential crisis. By its own terms, the section cannot be applied on an emergency basis. It simply takes too long and, unlike other relevant provisions of Dodd-Frank, it provides no emergency procedures. As a result, the Agencies must act immediately to mitigate threats posed by Bank of America, or they risk failure to do so until it is too late. The sections below discuss each of these points in turn.

#### **A. Section 121 provides authority to prevent crises caused by distress at institutions such as Bank of America, not to respond to crises.**

The Dodd-Frank Act requires regulators to combat systemic risk preemptively. To that end, the Act charges financial regulators with identifying threats to the stability of the U.S. financial system, promoting market discipline, and responding to emerging risks.<sup>87</sup> Section 121 is a critical part of this regime, providing the Agencies the tools to mitigate grave threats that financial institutions pose to U.S. financial stability well before those threats can become manifest in financial crises or other harms.

The authorities that section 121 provides—halting mergers and acquisitions, restricting or placing conditions on certain products or activities, and ordering divestitures<sup>88</sup>—supply the Agencies with the ability to take an institution that is excessively risky due to its size, activities, complexity, or interconnectedness, and remake it into a set of smaller institutions

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<sup>87</sup> Purposes and Duties of the Council, In General, Council Authority, Dodd-Frank Wall Street Reform and Consumer Protection Act, § 112(a)(1)(A-C), 12 U.S.C. § 5322 (2010).

<sup>88</sup> Dodd-Frank Act § 121(a), 12 U.S.C. § 5331(a).

that are less risky and more amenable to prudent private management and sound oversight by financial regulators. The resulting institutions should be less likely to fail, should pose less risk to the financial system in the event of failure (and therefore should be less likely to draw government support or require receivership), and should be easier to resolve through orderly liquidation if that becomes necessary. The Agencies should exercise these authorities well before any potential threat can materialize because, although the Agencies should act expeditiously to mitigate grave threats, decisions under section 121 must be made with due care and deliberation. The provisions would be difficult to use in haste or under the duress of impending disaster.

**B. Section 121 must be exercised to ensure the efficacy of other Dodd-Frank Act provisions such as orderly liquidation.**

If the Agencies do not use section 121 in advance of financial distress at a firm that poses a grave threat to U.S. financial stability, they risk undermining other critical Dodd-Frank Act provisions. Many Dodd-Frank Act provisions related to systemic risk would be far easier to implement if systemically important institutions were smaller and less complex. One of the most critical is the orderly liquidation authority in Title II.

If a large, systemically dangerous institution such as Bank of America were to fail, regulators would have only one course of action—to attempt orderly liquidation. To permit the institution to fail without intervening would result in financial disaster; to bail it out would sharply contradict the Dodd-Frank Act’s express policy of “protect[ing] the American taxpayer by ending bailouts.”<sup>89</sup> But the Dodd-Frank Act’s orderly liquidation procedures are untested and could prove difficult to implement in practice, particularly with respect to the largest and most complex institutions such as Bank of America.

One potential problem with the orderly liquidation authority is that U.S. officials lack jurisdiction over extraterritorial entities and therefore may be unable to put globally significant institutions through resolution. Currently, there are no existing international agreements regarding the resolution of a domestic institution’s entities that operate in foreign countries.<sup>90</sup> Without such agreements in advance, regulators would need to try to reach agreements, potentially requiring changes in the laws of multiple countries, in the midst of a crisis.

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<sup>89</sup> P.L. 111–203 (“To promote the financial stability of the United States . . . to end “too big to fail”, to protect the American taxpayer by ending bailouts . . . and for other purposes.”); *cf.* 12 U.S.C § 5366 (directing the Board to “prescribe regulations establishing requirements to provide for the early remediation of financial distress” of a SIFI “except that nothing in this subsection authorizes the provision of financial assistance from the Federal Government”).

<sup>90</sup> Simon Johnson, *The Myth of Resolution Authority*, N.Y. TIMES ECONOMIX BLOG, Mar. 31, 2011, available at <http://nyti.ms/icEK7g>.

A second potential difficulty with liquidating a large, systemically dangerous institution is that the FDIC likely would require massive loans from the Treasury to cover enough of the failed institution's obligations to prevent financial contagion. The larger and more complex an institution, the more taxpayer money would be placed at risk. Moreover, the larger, more complex, and more interconnected an institution is, the more difficulty regulators will have discerning the extent to which they must meet the failed institution's obligations to prevent contagion. Therefore they will need to err on the side of overpayment—in effect implementing at least a partial “bail out,” failing to discipline market actors appropriately, contributing to moral hazard, and contradicting the express intent of the Dodd-Frank Act.

The authorities in section 121 could vastly diminish these problems. Foremost, if a large and complex systemically dangerous institution were broken properly into smaller, simpler, less interconnected, less risky, and less dangerous institutions, the resulting firms would no longer be too big to manage or regulate. Firms that are easier to manage and regulate effectively are less likely to fail. If one does fail, then regulators should have a much easier time using the orderly liquidation authority successfully. Each of the potential problems for the orderly liquidation process stems in large part from institutional size, complexity, or interconnectedness.

In addition, it is possible that a smaller, simpler, less systemically significant institution could go through bankruptcy rather than orderly liquidation. For example, a bankruptcy of CIT Group proved successful in 2009. CIT Group, one of the nation's largest lenders to small and mid-sized businesses, had approximately \$80 billion in total assets at the end of 2008.<sup>91</sup> The bank suffered significant losses from subprime mortgages and student-lending. The firm failed and filed for bankruptcy in November 2009. Because the firm did not pose a systemic threat, its bankruptcy did not destabilize the financial system.<sup>92</sup>

At a recent *Buttonwood Gathering* sponsored by *The Economist*, mock regulators simulated a bank crisis, in which they put a gravely dangerous SIFI through orderly liquidation.<sup>93</sup> Several of the participants expressed reservations about the ability to manage such a crisis effectively. Some even considered a bailout, which the Dodd-Frank Act expressly forbids. The uncertainties that the participants voiced should inspire current regulators to mitigate grave threats preemptively.

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<sup>91</sup> Simon Johnson, *Will CIT Go Bankrupt?*, THE BASELINE SCENARIO, July 14, 2009, available at <http://bit.ly/14xqWh>.

<sup>92</sup> See Peter Cohan, *Why CIT Group's Bankruptcy Doesn't Matter*, DAILY FINANCE, Nov. 1, 2009, available at <http://aol.it/3b7wrm>; Andrew Ross Sorkin, *CIT Gets Restriction on Bank Lifted*, N.Y. TIMES DEALBOOK, Apr. 20, 2011, available at <http://nyti.ms/hkko1n>.

<sup>93</sup> “The Economist stress tests Dodd-Frank,” THE ECONOMIST, Nov. 2, 2011, available at <http://econ.st/vVAbbx>. The panel included H. Rodgin Cohen, Donald Kohn, Peter Fisher, Lawrence Summers, Jay Powell, Diana Farrell, and John Dugan.



**C. The plain terms of section 121 underscore that the Agencies must act immediately to mitigate the threat that Bank of America poses.**

The text of section 121 confirms that it must be used well in advance of financial distress at an institution that poses a grave threat to U.S. financial stability. The provision's time frames are incompatible with emergency action, and therefore underscore the need for the Agencies to begin mitigating Bank of America's threat immediately.

Under the plain terms of section 121, the Agencies lack the power to exercise their "grave threat" authority in less than one month unless the financial institution allows them to do so. Indeed, section 121 contemplates a process taking up to four months, not including the time taken to determine whether to use the provision in the first place. When the Board considers taking mitigatory action under section 121, it must provide written notice to the relevant financial institution.<sup>94</sup> The institution has a right to request a hearing within 30 days of receiving notice from the Board.<sup>95</sup> The hearing must take place within 30 days of the institution's request,<sup>96</sup> and the Board must notify the institution of the Agencies' final decision within 60 days of the hearing or, if there is no hearing, within 60 days of the original notice.<sup>97</sup> These procedures could take up to 120 days, not including the time required to determine whether to issue notice in the first place.

This time frame is wholly incompatible with the rapid action required when a systemically dangerous financial institution becomes distressed. In those instances, regulators must respond within a few days. For example, when rumors were sparked that Bear Stearns was suffering a solvency crisis on Friday, March 14, 2008, the firm's clients quickly lost confidence and began withdrawing their funds. With the firm on the verge of insolvency, regulators met over the weekend to broker a sale of the financial company. On Sunday, March 16, the Federal Reserve announced a deal in which JPMorgan Chase would acquire Bear.<sup>98</sup> Similarly, Lehman Brothers first appeared in trouble on Wednesday, September 10, 2008. The company deteriorated rapidly during the next few days. On Saturday, September 13, regulators met in an emergency meeting to discuss Lehman's options, but decided not to bail out the firm. Lehman announced it would declare bankruptcy on Monday, September 15.<sup>99</sup> The next day, on September 16, the Federal Reserve announced it would

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<sup>94</sup> Mitigation of Risks to Financial Stability, Dodd-Frank Wall Street Reform and Consumer Protection Act, § 121(b)(1), 12 U.S.C. § 5331(b)(1) (2010).

<sup>95</sup> *Id.* at § 121(b)(2), 12 U.S.C. § 5331(b)(2).

<sup>96</sup> *Id.*

<sup>97</sup> *Id.* at § 121(b)(3), 12 U.S.C. § 5331(b)(3).

<sup>98</sup> Yalman Onaran, *Fed Aided Bear Stearns as Firm Faced Chapter 11, Bernanke Says*, BLOOMBERG NEWS, Apr. 2, 2008, available at <http://bloom.bg/sr3wX0>.

<sup>99</sup> Andrew Ross Sorkin, *Lehman Files for Bankruptcy; Merrill Is Sold*, N.Y. TIMES, Sept. 14, 2008, available at <http://nyti.ms/cRKYq>.

provide an \$85 billion rescue package to AIG.<sup>100</sup> The following Thursday, September 25, the Office of Thrift Supervision seized Washington Mutual's assets and immediately sold them to JPMorgan Chase.<sup>101</sup>

In contrast to section 121, the Dodd-Frank Act provisions for early remediation and orderly liquidation provide means to respond to emergencies. Once established, the regulatory requirements under the Dodd-Frank Act early remediation provisions would be triggered automatically by financial distress at a SIFI.<sup>102</sup> The orderly liquidation provisions provide for financial regulators to place a financial institution into receivership without providing notice and a hearing first.<sup>103</sup> If the institution objects, then the Secretary of the Treasury may petition the United States District Court for the District of Columbia to appoint the FDIC as receiver. The court evaluates the Secretary's petition under a deferential standard of review. It must issue a ruling within 24 hours or the petition is automatically granted.<sup>104</sup>

The Agencies must exercise their section 121 authority to mitigate grave threats to financial stability far in advance of any potential emergency.

## Conclusion

The Agencies should act immediately to mitigate the grave threat that Bank of America poses to U.S. financial stability by reforming it into one or more institutions that are smaller, less complex, less risky, less systemically significant, and more amenable to sound management and regulation.

Respectfully submitted,



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David Arkush

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<sup>100</sup> Press Release, Board of Governors of the Federal Reserve, "The Federal Reserve Board on Tuesday, with the full support of the Treasury Department, authorized the Federal Reserve Bank of New York to lend up to \$85 billion to the American International Group (AIG) under section 13(3) of the Federal Reserve Act," (Sept. 16, 2008), available at <http://1.usa.gov/2iWRuJ>.

<sup>101</sup> Press Release, Office of Thrift Supervision, "Washington Mutual Acquired by JPMorgan Chase," (Sept. 25, 2008), available at <http://1.usa.gov/vWaUfe>.

<sup>102</sup> See generally Early Remediation Requirements, Dodd-Frank Wall Street Reform and Consumer Protection Act, § 166, 12 U.S.C. § 5366 (2010).

<sup>103</sup> Judicial Review, Dodd-Frank Wall Street Reform and Consumer Protection Act, § 202 (a)(1)(A)(i-v), 12 U.S.C. § 5382 (2010).

<sup>104</sup> *Id.* at § 202(a)(1)(A), 12 U.S.C. § 5382(a)(1)(A).