Still Too Big To Fail

Opportunities for Regulatory Action Seven Years after the Bear Stearns Rescue

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About the Corporate Reform Coalition

The Corporate Reform Coalition is made up of more than 75 organizations and individuals from good governance groups, environmental groups and organized labor, and includes elected officials and socially responsible investors. The coalition seeks to promote corporate governance solutions to combat undisclosed money in elections. For more information, please visit www.CorporateReformCoalition.org.

Corporate Reform Coalition
Democracy through Accountability

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Summary

Seven years after the financial crisis began, many of the conditions that helped cause the near collapse of our banking system — and that were used to rationalize the multi-trillion dollar U.S. government rescue — endure.

The top six bank holding companies are considerably larger than before, and are still permitted to borrow excessively relative to the assets they hold. They are dangerously interconnected and remain vulnerable to sudden runs, because they borrow billions of dollars from wholesale lenders who can often demand their cash back each and every day. Banks can still use taxpayer-backed insured deposits to engage in high-risk derivative transactions here and overseas. Compensation incentives fail to discourage mismanagement and illegality, given that when legal fees, settlements, and fines mount, it is usually the shareholders, not the corporate executives who pay.

Should one of these giant banking firms fail again, it appears that the damage will not be contained. Based on thirteen of the largest banks' own "living wills," none could file for bankruptcy "without precipitating a financial crisis," according to Thomas Hoenig, vice chairman of the Federal Deposit Insurance Corporation ("FDIC"). The new "resolution" process to shutter or sell such a distressed firm in lieu of bankruptcy requires upfront funding from the U.S. Treasury. In other words, "too big to fail" and the prospect of future taxpayer-funded bailouts have not yet gone away.

Fortunately, with the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"), Congress gave federal regulators tools to address many of the problems that led to the financial crisis. New powers were granted and hundreds of rulemakings mandated. While progress has been made, in several meaningful areas, the regulators have behaved timidly. For some mandated reforms, the enacted rules are too mild or the effective dates delayed far into the future. For others, deadlines have passed with rules not finalized or even proposed. As the years pass, painful memories of the damage caused by bank predation and recklessness will continue to fade. All the while, financial industry efforts to rollback and repeal the strongest Dodd-Frank provisions, and to dilute and delay implementation meet increasingly diminished resistance.

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-THOMAS HOENIG, VICE CHAIRMAN OF THE FDIC

Ideally, by now, Congress would have stepped in where regulators have left gaps. Such action in the public interest, however, would require a sufficient number of legislators who truly serve the public and are not influenced by both overt and hidden political spending by financial firms. After the 2010 Supreme Court decision in *Citizens United*, corporations can spend unlimited amounts to influence elections. Upon opening the floodgates, the five-member Court majority anticipated that such political spending would be promptly and fully disclosed to the public. However, presently, there is no general legal requirement that corporations disclose their political spending. While some corporations have stated they will limit or disclose certain types of political spending, this is entirely voluntary and could be reversed.

Compliance with the many reforms already implemented largely depends upon accurate and appropriately detailed data and honest bankers. Yet, presently compensation incentives still discourage risk management officials and other insiders from fully sharing information with regulators. As the behavior of many banking executives and directors during the run up to the financial crisis demonstrates, corporate insiders can not always be trusted to put the long-term interests of their shareholders ahead of their own personal gain.

This report is intended to refresh our memories of the 2008 crisis and to show how Congress did provide tools in the Dodd-Frank Act to address many of the conditions that helped cause the crisis so as to prevent another one. It identifies in plain language (and in chart form), opportunities for regulatory action in six key areas. This includes: (1) ending bailouts by requiring the largest banks to provide credible "living wills" that show how they can file for bankruptcy or be resolved by the FDIC without triggering a financial crisis, and providing more accountability for the Fed's use of emergency loans; (2) further reducing excessive borrowing by the top six banks, (3) reducing dependence by banks and other financial firms on overnight and other short-term borrowing and providing transparency concerning securities lending transactions; (4) prohibiting banks from evading derivatives regulation through use of foreign subsidiaries, (5) improving bankers' accountability through incentive pay and claw-back rules, and (6) requiring corporate political spending disclosure so as to begin to deal with the influence peddling that impacts Congress and regulators.

Remembering Bear Stearns

While Bear Stearns was fighting to survive, chairman Jimmy Cayne was hundreds of miles away, playing cards.

On Thursday, March 13th, 2008, Cayne's team at the North American Bridge Championship in Detroit was doing well. Back in New York, his firm was not. Bear faced imminent collapse because, like other giant investment banks, it relied heavily upon very short-term, often overnight loans through the multi-trillion dollar repurchase agreement ("repo") market. Bear apparently relied on more than $50 billion in these overnight loans to fund most of its portfolio of mortgage-linked securities. These loans from money market funds and other financial firms to Bear were highly risky, as each and every day, the lenders could demand their cash back, or take the collateral. If they lost confidence in the value of that collateral, they could run with their money. By spring 2008, confidence was in short supply.

The value of the mortgage-linked securities in Bear's portfolio depended upon homeowners making monthly mortgage payments, which in turn depended upon ever-rising home prices. If prices did not rise, borrowers with teaser-rate loans, who needed to refinance (to avoid a jump in their monthly payment or to take cash out to pay bills), often could not. When the seven-year housing bubble burst, home prices stop rising and retreated. Mortgage defaults spread nationwide. In summer 2007 the rating agencies downgraded hundreds of mortgage-linked securities. Several large subprime mortgage originators failed. In early 2008, thousands more mortgage-linked securities were downgraded or put on credit watch. Now, investment banks like Bear Stearns that borrowed heavily to purchase those now toxic mortgage-related assets were on the edge.

Short-Term Lenders Run with their Cash

On that Thursday in mid-March, while Cayne played bridge, repo lenders pulled billions of dollars in cash from Bear. They didn't want the collateral, as it could not be sold at full price, if at all. As lenders demanded more cash, Bear would be forced to sell assets. This "fire sale" could further drive down prices and push the bank into insolvency. And the fire could spread, as the other financial firms bloated with debt to fund similar assets might face cash withdrawals and asset markdowns. Nevertheless, Cayne remained at the bridge tournament in Detroit through Saturday afternoon. By Sunday, the board of directors decided to sell the firm to JPMorgan Chase for $2 a share, later raised to $10. JPMorgan Chase was only willing to buy Bear due to a $29 billion emergency loan from the Fed using its authority under Section 13(3) of the Federal Reserve Act. This emergency funding meant the bank could immediately shed $30 billion in illiquid and otherwise undesirable assets that were in Bear's portfolio. If over time, the sale of those assets yielded less than full value, the Fed would absorb all but about $1 billion in losses.

One year earlier, Bear's common stock had traded at $171 per share. Afterward, Cayne acknowledged that as its former CEO, he was responsible for the excessive debt that brought the firm to its knees. "I didn't stop it. I didn't rein in the leverage." A public expression of regret was a small price to pay. Even after the decline, Cayne's personal net worth was pegged at around $600 million.

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Defending the Bear Stearns Rescue

While the federally-backed rescue of Bear Stearns temporarily warded off a system-wide collapse, it triggered public outrage. Millions of Americans would lose their homes to foreclosure, and no "bailout" had been provided to them. Critics also sensibly wondered whether rescuing Bear created "moral hazard." Many other firms in similar distress might expect such special treatment. Similarly, private investors who might otherwise step in to buy up or provide capital to those soon-to-be sinking firms might want a sweetener from the Fed.

In testimony before the Senate Banking committee that April, government officials defended the intervention. New York Fed president, Timothy Geithner explained that without the support, there would be "a greater probability of widespread insolvencies, severe and protracted damage to the financial system and ultimately, to the economy as a whole." Fed Chairman Ben Bernanke informed the committee that actually "Bear Stearns didn't fare very well in this operation . . . Shareholders took losses. I don't think it's a situation that any firm would be willingly choose to endure." He also asserted that "The benefit of our action is not Bear Stearns, or even Wall Street, it's Main Street." These explanations reflected what many experts, including current Fed vice chairman, Stanley Fischer has described as the "too big to fail" or TBTF problem. "The TBTF problem derives from the typical response of governments confronted by the potential failure of a large bank, which is to intervene to save the bank and some of its noninsured creditors."

Lehman, AIG, and the Bailouts

In retrospect, the Bear Stearns' rescue in March 2008 appears to have emboldened some bankers.

Dick Fuld, CEO of Lehman Brothers passed over opportunities for equity investments. Like Bear Stearns, Lehman was highly leveraged, borrowing more than $97 for every $100 in assets it owned. Lehman even increased its short-term repo funding, including through questionable (though apparently legal) accounting techniques. The investment bank depended upon about $200 billion in overnight repo loans. When it could not arrange a private rescue, and perhaps to disprove that "too big to fail" existed, the government let Lehman fail.

On September 15, 2008, Lehman filed for bankruptcy. With about $639 billion in assets, it was the largest bankruptcy filing in American history to date. On that same day, in order to get liquidity support from the Fed, Goldman Sachs and Morgan Stanley, the last two giant independent investment banks converted to bank holding companies. While Lehman shareholders were crushed, Fuld fared reasonably well. He had earned more than $500 million in compensation.

Post-Lehman Panic

Failing to bailout Lehman only proved the point that "too big to fail" was alive and well. The Lehman bankruptcy spread panic throughout the financial system. Lehman was dangerously interconnected, with more than 100,000 creditors. One money market fund that held a huge position in short-term Lehman debt collapsed, lowering its net asset value to less than $1 per share. Fearful that what they thought was as safe as a bank account could lose value, investors pulled more than $300 billion in cash from unrelated money market funds, thinking they too would "break the buck." Only with a Treasury Department $50 billion guarantee coupled with Fed emergency support was the run on money market funds stopped.

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Trouble at AIG

Contagion also spread through the derivatives markets. American International Group ("AIG") had sold credit protection (through credit default swaps) on many billions of dollars of mortgage-linked securities. Joe Cassano who headed up the London unit of AIG responsible for those credit default swaps earned $300 million during his tenure at AIG. A year earlier, he had assured participants on an investor phone call that "it is hard for us without being flippant, to even see a scenario within any kind of realm of reason that would see us losing $1 in any of those transactions." The CEO of AIG, Martin Sullivan chimed in, "That's why I am sleeping a little bit easier at night." Yet neither mentioned to investors during that 2007 call that under the swap contracts, AIG was required to pay money to counterparties even if the "insured" mortgage-linked securities did not actually default. If the prices of those mortgage-linked securities fell, for example, AIG would have to meet a collateral call and put up more cash. By summer of 2008, AIG had paid out billions of dollars in cash to back its credit default swaps.

AIG was also taking on enormous risks through its securities lending programs. Its life insurance subsidiaries invested customer premiums in relatively safe securities. AIG would then lend those safe securities to borrowers and take cash as collateral. AIG then invested the cash collateral in mortgage-backed securities. In the fall of 2008, the borrowers wanted to return the safe securities and get $24 billion in cash back from AIG. But AIG could not liquidate its mortgage-backed securities at full price to come up with the cash.

On September 16, when a private rescue failed, the government began a $182 billion bailout of AIG with an $85 billion emergency loan from the Fed. Promptly, $62 billion of this was used (as a backdoor bailout) to pay off more than twenty major U.S. and European financial firms. These included AIG's credit default swap and securities lending transaction counterparties. Recipients included Goldman Sachs at 100 cents on the dollar. The U.S. government took a nearly 80 percent equity stake in AIG, leaving its shareholders with substantial losses.

Failures also spread outside the financial system into the commercial sector. General Electric was concerned it would no longer be able to access credit to fund its day-to-day operations. American Electric Power wanted to amass a cushion of cash and thus drew down $2 billion from a line of credit held with twenty-seven banks, tapping into those banks dwindling liquidity.

Bush Signs Bailout Bill

On October 3, 2008, almost two weeks after President George W. Bush asked Congress to bailout the sinking financial system, he signed into law the Emergency Economic Stabilization Act. This legislation included the $700 billion Trouble Asset Relief Program commitment. Instead of using the funds to purchase illiquid mortgage-related assets from the banks to clean off their balance sheets, Treasury secretary Henry Paulson provided banks with fresh capital. Not all banks at that moment actually needed capital. Some were only facing liquidity (not insolvency) problems and could manage that with loans and other support from the Fed. However, Citigroup was apparently nearly insolvent, thus needed equity. The commitment in 2008 - 2009 of more than $476 billion in cash and guarantees to Citi was greater than any other bank received.

Silenced Whistleblowers and Lax Regulators

There were conscientious individuals inside of Citigroup that sounded the alarm. For example, executive Richard Bowen told the Financial Crisis Inquiry Commission ("FCIC") that in 2006, he discovered that 60 percent of the mortgages Citi was buying to securitize were defective. By late 2007, he had sent several emails to his superiors, including to Robert Rubin who was then chairman of the executive committee. Yet, Bowen said his concerns were not addressed. He told the FCIC that he was demoted from supervising around two hundred people to just two and received a poor review and a reduced bonus. In contrast, Rubin who apparently did not respond to Bowen's concerns, and who also apparently said he was unaware of other transactions that resulted in Citi losing $14 billion, earned more than $115 million

— plus stock options.

The FCIC would later determine that lax government oversight had contributed to Citi's demise. The commission's majority report determined that, "The Federal Reserve Bank of New York and other regulators could have clamped down on Citigroup's excesses in the run-up to the crisis. They did not."

Promising Main Street Reform to Gain Support for Bailouts

To gain public support for the bailouts, government officials repeatedly pointed to conditions that helped cause the crisis. Due to these factors, the only way to save Main Street was to rescue Wall Street. Even many who understood the connection were enraged that the banks were in such a position to begin with. Essential to calming the anger and restoring trust in government, officials promised that this would not happen again. As but one example, Fed chairman Ben Bernanke would explain in 2009, "[I]t wasn't to help the big firms that we intervened. It was to stabilize the financial system and protect the entire global economy. Now you might ask . . . Why are we doing that? It's a terrible problem. It's a problem called a too-big-to-fail problem. These companies have turned out to be too big to allow to collapse because . . . when the elephant falls down, all the grass gets crushed as well." He continued, "We really need - and this is critically important - we really need a new regulatory framework that will make sure that we do not have this problem in the future."

This problem of "too big to fail," became an umbrella term covering the conditions that caused the financial crisis and that also necessitated the multi-trillion dollar government rescue. Central among these conditions are the following six. First, certain supersized banking institutions were too big and too complex to file for bankruptcy without damaging the entire banking system and broader economy. As a result, both emergency loans from the Fed and cash to build their capital would be committed. Second, banks had grown too large through borrowing; they owed too much relative to the assets they owned. A slight downturn in asset values could make them quickly insolvent. Third, banks were vulnerable to sudden runs because they heavily borrowed cash from wholesale lenders who could demand repayment each and every day. Fourth, banks used FDIC-insured deposits to invest in unregulated, opaque derivatives. Fifth, incentives structures

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- BEN BERNANKE, CHAIRMAN OF THE FEDERAL RESERVE inside of financial firms favored short-term gains earned sometimes without regard to law or ethics, at the expense of long-term shareholder value and the entire system. And sixth, political favoritism influenced by big dollar spending by Wall Street firms worked to maintain the status quo.

The Dodd-Frank Act Aimed to end TBTF

Appropriately, Dodd-Frank aimed to address these problematic conditions. The preamble states its purposes: "To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail,' to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes." While the law does create requirements and prohibitions, it mainly goes about accomplishing its purposes by delegating authority to federal agencies to make rules.

For the problems identified above that fit under the "too big to fail" umbrella, Congress either mandated that specific regulators take action or in the statute provided or previously had provided tools to do so. Clear progress has been made under Dodd-Frank. The newly established Consumer Financial Protection Bureau and Office of Financial Research are operating effectively, and the other federal regulators have taken helpful steps toward making the financial system safer. However, the "too big to fail problem" persists.

Gaps and Opportunities for Regulatory Action

With Dodd-Frank, Congress gave federal regulators many additional tools to help address the problems that led to the crisis.

New powers were granted and hundreds of rulemakings mandated. While some good progress has been made, in several meaningful areas, the regulators have appeared cautious. In some such cases, the enacted rules are too mild or the effective dates delayed far into the future. In others, deadlines have passed with rules not finalized or even proposed.

What follows is a description of six opportunities for regulatory action without the need for further legislation. These include: (1) ending bailouts by requiring the largest banks to provide credible "living wills" that show how they can file for bankruptcy or be resolved by the FDIC without triggering a financial crisis, and providing more accountability for the Fed's use of emergency loans; (2) further reducing excessive borrowing by the top six banks, (3) reducing dependence by banks and other financial firms on overnight and other short-term borrowing and providing transparency concerning securities lending transactions; (4) prohibiting banks from evading derivatives regulation through use of foreign subsidiaries, (5) improving bankers' accountability through incentive pay and claw-back rules, and (6) requiring corporate political spending disclosure so as to begin to deal with the influence peddling that impacts Congress and regulators.

1. Ending TBTF Bailouts with Living Wills and Emergency Lending Accountability

Bank size was one of the key contributors to the crisis and the need for bailouts. A recent brief released by the Office of Financial Research ("OFR") (an agency created under Dodd-Frank) reinforces this point that "Bank size is an important component of systemic risk." As of December 31, 2015, the top six bank holding companies had about $9.9 trillion in assets. Before the crisis, the top six had approximately $7 trillion. This growth in part is due to government-encouraged mergers. Relatively stronger banks, with taxpayer assistance were encouraged to buy up the weaker ones. This process left the survivors vulnerable to the problems on the balance sheets and cultures of the weaker ones, and struggling to integrate the information systems at the failed firms they swallowed. Moreover, the largest banks are more concentrated than before, holding a greater percentage of total system-wide assets than prior to the crisis.

While there were proposals during the Dodd-Frank legislative process to break up the banks by size, such measures failed to pass. However, the statute does have several other tools that are designed to curb too-big-to-fail instigated bailouts. Section 165(d) requires each of the largest banks to provide to the Fed and FDIC a credible resolution plan, detailing how it could in a rapid and orderly way be restructured or sold in the event of material financial distress or failure. These plans, sometimes referred to as "living wills," are meant to ensure that a single firm can fail without bringing down others or the broader economy. They are needed to avoid contagion and to help facilitate a bankruptcy or an FDIC-run resolution process.

In summer 2014, the Fed and FDIC announced that none of the eleven banks required to do so had provided a credible resolution plan. In a joint press release the two agencies stated that the each of the plans "fail to make, or even to identify, the kinds of changes in firm structure and practices that would be necessary to enhance the prospects for orderly resolution." In a separate statement, FDIC vice chairman, Thomas Hoenig wrote that, "Each plan being discussed. . . is deficient and fails to convincingly demonstrate how, in failure, any one of these firms could overcome obstacles to entering bankruptcy without precipitating a financial crisis." Neither the Fed nor the FDIC has yet deployed the full powers they possess under Dodd-Frank to begin the steps necessary to ultimately mandate those banks sell cer-

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tain assets or operations.

Another provision of Dodd-Frank was designed to end the types of secretive back-door bailouts through Fed lending programs and credit facilities that totaled in the many trillions of dollars during the height of the meltdown. Section 1101 of Dodd-Frank placed limits on the use by the Fed of its emergency lending authority under section 13(3) of the Federal Reserve Act. Section 1101 was designed to help ensure that any Fed emergency lending program or facility is used to provide liquidity to the financial system, and not to rescue a specific individual company. However, the Fed's proposed implementing rule provides too little accountability.

The proposed rule largely copies the statutory language. As Americans for Financial Reform explained in a comment letter,

> "The drafters take advantage of every opportunity to interpret the statute in ways that minimize limits on emergency lending authority. While the rule complies with the letter of the law, it does not fulfill the spirit of the Congressional mandate that emergency lending be limited to broad based programs assisting solvent companies with temporary liquidity issues."

In particular, the proposed rule provides too broad a definition of insolvency and places no limits on how long the loans can be outstanding.

2. Further Reduce Excessive Borrowing by the Top Banks

Excessive borrowing (or leverage) was a chief contributor to the crisis. Bankers and regulators alike have pointed to the leverage problem. Increasing the equity capital cushion at banks would make them more resilient and able to better weather falling asset prices. Borrowing $97 (or more) for every $100 in assets, as many large banks did in the lead up to the crisis, left them at great risk of illiquidity and insolvency with slight declines in asset values. Requiring banks to fund themselves with more equity instead of with debt can also help mitigate other risk factors. As the recent OFR brief explains:

> "The larger the bank, the greater the potential spillover if it defaults; the higher its leverage, the more prone it is to default under stress; and the

> greater its connectivity . . . the greater is the share of the default that cascades onto the banking system. The product of these three factors provides an overall measure of the contagion risk that the bank poses for the financial system. Five of the U.S. banks had particularly high contagion index values — Citigroup, JPMorgan, Morgan Stanley, Bank of America, and Goldman Sachs. . . Additional capital requirements for [them] could enhance the resilience of the financial system."

Dodd-Frank provided several tools to address the problem of excessive borrowing, particularly at the largest financial institutions. Section 171 sets a generally applicable leverage ratio, and section 165 requires the Fed to make rules for enhanced prudential standards, including reduced leverage for the largest and riskiest financial firms.

The final rules issued to date that require the largest banks to be less leveraged have made the system safer, but not safe enough. Far more equity capital is necessary, according to experts including Anat Admati and Martin Hellwig, who recommend at least a twenty percent equity capital cushion. To address the continued excessive leverage concerns, the Fed should implement a strong capital buffer rule for the eight U.S. banks designated as G-SIBs, but with substantial more equity capital, in the double digits.

3. Reducing Dependence on Short-Term Wholesale Loans and Providing Transparency

Short-term wholesale funding (including through the repo market) is a source of interconnection and systemic risk. The failure of Bear Stearns and Lehman Brothers were each precipitated when short-term repo lenders pulled their cash. Rescuing Bear through the JPMorgan Chase purchase involved a Fed emergency commitment to absorb up to $29 billion in losses. The Lehman bankruptcy filing triggered a $300 billion-single-week run on money market funds and spread panic through the financial system and into the commercial sector. In addition, AIG became unstable in part due to its securities lending program.

One of the three main potential threats to financial stability identified in the Office of Financial Research's 2014 Annual Report was "the risk of fire sales and runs in short-term

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wholesale funding markets." As the separate 2015 OFR brief explained, "the failure of a bank to meet payment obligations to other banks can accelerate the spread of a financial system shock if the bank is highly interconnected." Federal regulators including Fed board members and regional Fed presidents as well as academic experts continually express concern about the repo market. For example, Boston Fed President Eric Rosengren said in 2014:

> "Unfortunately that potential for problems has not been fully addressed . . .The collapse of Lehman was not an isolated failure of a single broker-dealer, but rather one of a string of crises for multiple broker-dealers . . .While repo borrowing has fallen from its peak before the financial crisis, it is still by far the largest source of borrowing for broker-dealers. . . The funding model, the core of the problem, hasn't changed at all."

According to the New York Fed, there was about $1.58 trillion in collateral posted through the triparty repo system in January 2015. This is just one part of the overall repo market and is called "triparty" as a custodial bank holds onto the pledged collateral. This is down from a peak of around $2.8 trillion, but is still of concern. This figure does not account for the less transparent bilateral repo market.

In addition, the opacity of the multi-trillion dollar securities lending market is still a serious problem. Securities lending is also a form of short-term financing. According to the OFR 2014 Annual Report, there is no "systematic, targeted data collection" done for "the benefit of regulators or the investing public" on the securities lending market. While some private vendors do collect data, what is available is incomplete and inconsistent.

Dodd-Frank provides tools to address the ongoing risk of fragile short-term funding as well as the lack of transparency around securities lending. This includes Section 165 that requires heightened prudential standards and also Section 984(b), which mandates that the SEC adopt rules making securities lending more transparent to investors, brokers, and dealers. The Fed and SEC should limit the use by banks and broker-dealers of overnight and other short-term lending backed by non-Treasury collateral. The Fed should increase capital and margin requirements for these and other securities funding transactions (and include short-term funding in its capital buffer requirements).

4. Close Loopholes for Evading Derivatives Regulation

Derivatives transactions were central to the financial crisis. In response, Title VII of Dodd-Frank focuses on regulating the derivatives market. This part of the law was designed to create transparency and minimize systemic risk in swap and securities-based swap ("swaps") transactions. Under the law most swaps must be cleared and must be executed on an exchange or through a swap execution facility. In addition, banking firms were to be prohibited from using insured customer deposits to transact in the riskiest of swaps. However, in late 2014, due to a Citigroup-drafted provision in a must-pass budget bill, the language requiring the riskiest swaps to be pushed out of depository institutions was repealed.

A growing concern today is that under current rules U.S. banks will use foreign subsidiaries to engage in risky derivatives transactions that could then result in a U.S. government bailout. They might attempt to avoid the Dodd-Frank required clearing, exchange trading, and margin requirements simply by having their foreign subsidiaries conduct these transactions. In 2014, SEC Commissioner Kara Stein raised this issue. While praising the new SEC rule for being a "small, but significant step toward implementing the law," Stein identified cracks in the foundation that "could lead to substantial problems down the line."

According to the 2015 OFR brief, cross-jurisdictional activity is a component of systemic risk. The brief states, "Banks with international operations can transmit problems from one region to another during a financial crisis. Global banks are also more difficult to resolve because they require coordination among national regulators. The scale of a bank's global activity is measured by its total foreign claims and its total cross-jurisdictional liabilities." In addition, trading in over-the-counter derivatives also factors into complexity, making a firm more difficult to resolve should it topple. The brief notes that, "A bank with highly complex operations is more difficult to resolve and has a broader impact if it fails." This is in part due to the uncertainty associated with cross-border insolvencies, including due to the variations in foreign law. The report also stated that "Complexity is measured by a bank's notional amount of over-the-counter (OTC) derivatives; total amount of trading and available-for-sale securities; and total illiquid and hard-to-value assets."

Accordingly, the SEC and the CFTC should close the loopholes in final rules that allow foreign subsidiaries to avoid regu-

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latory oversight. The CFTC should not allow U.S. Banks to avoid regulatory oversight of swaps conducted by their foreign subsidiaries simply by having the parent "deguarantee" them. And the SEC should close the loophole that exempts from regulation even parent guaranteed security-based swaps.

5. Accountability Through Pay Rules

Compliance with the many Dodd-Frank reforms already implemented, as well as oversight by regulators of such compliance, largely depends upon accurate and appropriately detailed data and honest bankers. As the behavior of many banking executives and directors during the run up to the financial crisis demonstrates, corporate insiders can not always be trusted to put the long-term interests of their shareholders ahead of their own personal gain. In testimony before the Financial Crisis Inquiry Commission, former SEC chair, Mary Schapiro explained, "Many major financial institutions created asymmetric compensation packages that paid employees enormous sums for short-term success, even if these same decisions result in significant long-term losses or failure for investors and taxpayers."

Too little has changed inside of firms. As Fed chair Janet Yellen lamented in a March 2015 speech. "It is unfortunate that I need to underscore this, but we expect the firms we oversee to follow the law and to operate in an ethical manner. Too often in recent years, bankers at large institutions have not done so, sometimes brazenly. These incidents, both individually and in their totality, raise legitimate questions of whether there may be pervasive shortcomings in the values of large financial firms that might undermine their safety and soundness."

Dodd-Frank provides tools to address perverse financial incentives. Section 956(b) requires the prohibition by several regulators of "any types of incentive-based payment arrangement, or any feature of any such arrangement, that the regulators determine encourages inappropriate risks." Despite making a proposal in 2011, the regulators required to do so (including the SEC) have not yet implemented a final rule on incentive pay. Moreover, the multiagency proposal was far too weak. For example, as Americans for Financial Reform ("AFR") commented, the proposed rule covers only "executive officers," not other high-level employees or traders. In addition, while it would require deferral of half of an executive officer's bonus over a three-year period, as AFR noted, this would mean that as little as one-sixth of the bonus from any given year would be withheld for the full three years. In addition, §954 of Dodd-Frank requires the SEC to make rules mandating the recovery of erroneously-awarded compensation. Dodd-Frank required that a claw-back rule be finalized in 2012. This would require executives to return up to three years of compensation if their corporation has issued inaccurate financial statements and their pay was awarded based on those errors. The SEC has not yet proposed one.

6. Political Spending Disclosure Requirements

Now, seven years after the crisis began, it may be time for Congress to step in where regulators have either left gaps due to inaction or identified gaps in their authority. Such action in the public interest, however, would require a sufficient number of legislators who truly serve the public and are not influenced by both overt and hidden political spending by financial firms. After the 2010 Supreme Court decision in *Citizens United*, corporations can spend unlimited amounts to influence elections. Upon opening the floodgates, the five-member Court majority anticipated that such political spending would be promptly and fully disclosed to the public. However, presently, there is no general legal requirement that corporations disclose their political spending. Numerous large corporations have stated they will limit or disclose certain types of political spending. These actions suggest that an SEC disclosure requirement is in keeping with a growing practice and would not be overly burdensome. However, it is still necessary as current political spending disclosure policies and practices are entirely voluntary and could be reversed.

The SEC should use its authority to respond to a 2011 petition by a committee of ten corporate and securities law experts (the "Political Disclosure Petition"). The committee asked the agency to engage in a rulemaking that would require public companies to disclose their political spending. The petitioners expressed concern about the use of corporate resources for political activities. Among other reasons, they contended that "disclosure of information on corporate political spending is important for the operation of corporate accountability mechanisms, including those that the courts have relied upon in their analysis of corporate political speech." They noted that:

"The Supreme Court has . . . relied upon, these

"Upon opening the floodgates, the five-member Court majority anticipated that such political spending would be promptly and fully disclosed to the public. However, presently, there is no general legal requirement that corporations disclose their political spending."

> accountability mechanisms, particularly when corporations use shareholder resources for political purposes. In particular, in its recent decision in *Citizens United* . . . Court relied upon “[s]hareholder objections raised through the procedures of corporate democracy” as a means through which investors could monitor the use of corporate resources on political activities. “Shareholders,” the Court hoped, could “determine whether their corporation’s political speech advances the corporation’s interest in making profits,” and discipline directors and executives who use corporate resources for speech that is inconsistent with shareholder interests.

Shareholders without access to information cannot discipline directors and executives. The SEC has received more than 1.2 million comment letters concerning the Political Disclosure Petition. There were more than 8,000 different types of letters in this group. The vast majority expressed support. Supporters included institutional and retail investors, state treasurers and members of Congress.

According to two committee members, Professors Lucian Bebchuk and Robert J. Jackson, Jr., “To our knowledge, the petition has attracted far more comments than any other SEC rulemaking petition—or, indeed, than any other issue on which the Commission has accepted public comment—in the history of the SEC.” While this was on the SEC’s regulatory agenda for 2013, it no longer appears.

Conclusion

At the Dodd-Frank signing ceremony, President Barack Obama said the new law would deliver "transparency" and would "rein in the abuse and excess that nearly brought down our financial system."

He also promised that it would end taxpayer-funded bailouts and that we would "never again be asked to foot the bill for Wall Street's mistakes." He cautioned, however, that, "For these new rules to be effective, regulators will have to be vigilant." Vigilance is more than a skill: it is a mindset. Care and attention toward finishing the work of financial reform, and in asking Congress for additional support where necessary depends upon rooting out regulatory capture. Some agencies are admirably working toward the goal of helping staff and leadership avoid such pitfalls. With the public interest in mind, they will be able to turn the discussed six reform opportunities (which are also detailed on the chart below) into accomplishments.

Crisis/Bailout Contributor	Dodd-Frank Tool or Mandate	Status Today	Opportunities for Regulatory Action
Top banks were too big and too complex to be allowed to fail	§ 165d: Credible Resolution Plan ("living will" — plan for rapid and orderly resolution if material financial distress or failure) §1101 (to ensure that any Fed emergency lending program or facility is used to provide liquidity to the financial system, and not to rescue an individual company)	The top six bank holding companies had about $9.9 trillion in assets at the beginning of 2015. Before the crisis the top six had approximately $7 trillion. Eleven of the largest banks have failed to provide the Fed and FDIC with a credible resolutions plan ("living will"). Fed proposed rule tracks statutory language without sufficient accountability.	(1) The Fed and the FDIC should require top banks to provide credible "living wills" that show how each can file for bankruptcy without triggering a financial crisis (2) The Fed should create a rule that provides more accountability regarding the use of its emergency lending authority
Banks borrow too much relative to their assets	§165 (enhanced prudential standards) §171 (generally applicable leverage ratio)	For the largest banks, permitted leverage is still too high, even with the new supplemental leverage ratio that will go into effect in 2018. And, there is still high dependence on short-term wholesale funding, as noted below.	Fed should implement a strong capital buffer proposal for the eight US banks designated as G-SIBs, but with substantial more equity capital, in the double digits.
Dangerous interconnections and run risk through short-term wholesale funding and securities lending markets	§165 (enhanced prudential standards) 984(b) (SEC required to make rules "designed to increase the transparency of information available to brokers, dealers, and investors, with respect to the loan or borrowing of securities." Also, pre-existing authority to regulate short-term wholesale lending	According to the Office of Financial Research "[T]he risk of fire sales and runs in short-term wholesale funding markets remains unresolved." Boston Fed President: "The funding model, the core of the problem, hasn't changed at all. It is a model that is designed for government intervention." Fed has recently proposed a rule to help address this problem. SEC securities lending rule under 984(b) has not been proposed, but was supposed to be finalized in 2012.	(1) The Fed and SEC should limit the use by banks and broker-dealers of overnight and other short-term lending backed by non-Treasury collateral. (2) Fed should increase capital and margin requirements for these and other securities funding transactions (and include short-term funding in capital buffer). (3) SEC should make rule regarding transparency of securities lending
US banks using foreign subsidiaries to engage in risky derivatives transactions that result in US government bailout	§722(d) (CFTC can regulate swaps activity outside the US that have a "direct and significant connection with activities in, or effect on, commerce of the United States.")	London Whale and MF Global swaps managed abroad but losses absorbed in US. SEC and CFTC have loopholes in final rules that allow foreign subsidiaries to avoid regulatory oversight.	The CFTC should not allow US Banks to avoid regulatory oversight of swaps conducted by their foreign subsidiaries simply by having the parent "deguarantee" them. And the SEC should close loophole that exempts from regulation even parent guaranteed security-based swaps.
Perverse incentives and absence of accountability and transparency of executive pay and corporate political spending	§ 956(b) (Prohibits pay arrangements that encourage "inappropriate risks by covered financial institutions"). §954 (Recovery of erroneously-awarded compensation — requiring SEC to make rules requiring clawback policy). Pre-existing authority for mandating political spending disclosure.	Incentive pay proposal has stagnated. Clawback rule has not been proposed. SEC has apparently taken political spending disclosure rule off agenda notwithstanding one million comment letters.	Agencies should promulgate incentive pay rule and SEC should issue clawback rule and propose a rule mandating disclosure of corporate political spending.

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