

FINANCIAL REGULATORY REFORM: A NEW FOUNDATION OR MORE OF THE SAME?

*Michael W. Boyer**

I. Introduction

Recently, the Obama Administration and the Federal Reserve released a comprehensive regulatory reform proposal aimed at preventing future financial crises like what the country underwent in 2008.¹ At first pass, the plan looks like sweeping regulatory reform with a focus on protecting financial industry consumers from future financial crises.² The Administration's proposal is ambitious in scope and detail, but it is not flawless. In particular, two titles of the proposal, "Title II: Consolidated Supervision and Regulation of Large, Interconnected Financial Firms," and "Title X: Consumer Financial Protection Agency Act of 2009" appear to protect the financial industry consumer; however, these two titles end up serving divergent interests.

A. Scope

This note examines these two titles as parts of the whole proposal in relation to prior regulatory attempts to control the financial services industry. Before analyzing the specific provisions of the reform plan, Part II of this note offers a comprehensive background on the origins of the current financial crisis. In particular, I focus on the relatively recent history of consolidation in the financial industry, with specificity on the

* J.D. Candidate, May 2010, Loyola University Chicago School of Law.

¹ Fed. Reserve Bd., *Financial Regulatory Reform: A New Foundation*, available at <http://www.financialstability.gov/roadtostability/regulatoryreform.html>. (last modified Aug. 11, 2009) [hereinafter *Financial Regulatory Reform*].

² Eamonn K. Moran, *Wall Street Meets Main Street: Understanding the Financial Crisis*, 13 N.C. BANKING INST. 5, 8 – 9 (2009) (explaining that the crisis essentially began with the failure of Bear Stearns).

creation of too big to fail (“TBTF”) bank holding companies (“BHCs”) like Citigroup. TBTF BHCs accelerated financial industry consolidation in the late 1990s and early 2000s with Congressional passage of the Graham-Leach-Bliley Act of 1999 (“GLB”).³ GLB and the big bank lobby paved the way for abusive banking practices that completely disregarded consumers’ best interest and essentially destabilized the world economy in less than a decade. For the last twenty years, financial institutions have sold the idea of industry consolidation to consumers and regulators as a method to create economies of scale that would ultimately lead to more choices and lower costs for financial services consumers. Part II explains how the biggest players in the banking industry in actuality disregarded consumer interests. TBTF BHCs exploited faulty economic reasoning to promote largesse and inefficiency for the purpose of taking on excessive risk with the implicit knowledge that government bailouts would be available if the system collapsed.

Part III of this note analyzes the specific provisions of the reform proposal related to TBTF BHCs and consumers. I compare these provisions to existing legislation and regulatory agencies that failed to mitigate the risk and abuse that led to the current banking crisis. The goal is to determine if the reform proposal i) adequately addresses current weaknesses in the financial industry regulatory framework, ii) provides sufficient authority to enact change in an immensely powerful but inherently flawed industry, and iii) if the reform proposal does have the authority to change financial industry practices, will it promote consumer interests? The explicit goal of the reform proposal is to prevent future financial crises.⁴ To achieve this goal, Title II of the proposal identifies a specific set of financial institutions that likely constitute what today are considered TBTF BHCs and labels them Tier 1 financial holding companies (“T1FHCs”). The proposal seeks to hold T1FHCs to a unique set of regulations under a to-be-formed agency. Title II of the proposal seeks to promote the financial health of T1FHCs because the government has deemed them too big, important, and/or interconnected to fail without dire consequences to the overall stability of the United States economy. Moreover, Part III of this note concludes that Title II ignores the latent consequences

³ See Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 219-20 (2002).

⁴ See Financial Regulatory Reform, *supra* note 1.

consumers will bear as a result of focusing on the financial health of T1FHCs. Title II implicitly authorizes future abusive practices towards T1FHC customers to ensure their largesse and inefficiency does not crumble and fail.

Part IV of this note explains what provisions the drafters of the proposal got right, and what they got wrong. Part IV compares Title II of the proposal to Title X, which addresses consumer protection. This section of the note addresses whether there are sufficient provisions in place to protect the consumer under the Consumer Protection Act of 2009 to overpower the likely latent consequences of Title II. Ultimately, I conclude that neither Title II nor X has sufficient authority to adequately dismantle the current TBTF financial regime. Title II attempts to control it, but is likely to fail because it does not provide disincentives nor does it disallow TBTF status. The result of this will be a continued erosion of consumer banking conditions and an ever-present threat of financial calamity.

B. The Financial Services Consumer

The new financial regulations have the potential to impact consumers in two different ways. First, a new regulatory scheme will impact financial industry consumers directly due to changes financial institutions make to comply with new regulations. Second, there will be an impact to the consumer as a taxpayer because the reform plan calls for a great deal of government oversight that will require tax financing.⁵

This note defines a financial services consumer as anyone who has a bank account, credit card, insurance policy, mortgage, or any type of retirement or investment account. Because of the depth and breadth of the financial services industry, this list is not exhaustive. This definition includes most Americans. It is important to understand the many ways individuals are financial industry consumers because, when dealing with T1FHCs, an institution may offer services in all of these categories. A single

⁵ Title X calls for fees on ‘covered persons’—meaning financial institutions—to pay for the proposed Consumer Financial Protection Agency. However, it is unclear if fee revenue will be able to meet the burden of the agency’s costs. Additionally, Title II does not clearly address where funding will come from. *See* Consumer Financial Protection Agency Act of 2009, H.R. 3126, 111th Cong. § 1018 (2009) available at <http://www.financialstability.gov/docs/CFPA-Act.pdf> (last modified Aug. 11, 2009).

T1FHC may offer its services to a significant percentage of the entire U.S. population. With one financial institution affecting this many individuals, it is important to understand the goals of the institution. It is equally important to understand the government's ability to regulate a company that is so significant to the economy that it will not be allowed to fail.

II. History

Two decades of industry consolidation have resulted in a few massive TBTF financial holding companies controlling a disproportionate amount of the industry. The government first fostered the growth of TBTF companies by relaxing federal banking regulations in the 1990s. The government then provided bailout money on an unprecedented scale during the 2008 financial crisis, which promoted more consolidation as smaller banks failed and got absorbed by TBTF financial companies. In fact, during the height of the financial crisis, Henry Paulson, then Treasury Secretary, encouraged TBTF bailout recipients to pair up with one another, which ultimately created some of the largest banks the country has known.⁶ This section begins with a brief history of financial industry consolidation during the 1990s, which was a period of relaxed regulatory standards that promoted consolidation at historic levels leading to Citigroup's creation. I then discuss how financial industry consolidation produces diseconomies of scale for TBTF banks, which creates a host of problems for consumers. Next, I explain the banks' motivations for achieving TBTF status, despite the substantial evidence indicating efficiencies are not achieved through consolidation. Finally, I briefly address the consolidation frenzy that occurred during and immediately after the 2008 TARP bailout.

A. Financial Industry Consolidation

Financial industry consolidation accelerated rapidly in the

⁶ James B. Stewart, *Eight Days: The Battle to Save the American Financial System*, THE NEW YORKER Sept. 21, 2009, at 74. (at the apex of the financial crisis, consolidation accelerated at the Fed's encouragement, which was something of a knee-jerk response to a problem that the Fed's leaders did not fully understand. John Mack, CEO of Morgan Stanley was instructed by Timothy Geithner and Henry Paulson to "follow the lead of Merrill Lynch and find a partner." Three days earlier, Merrill Lynch and Bank of America agreed to merge).

1990s.⁷ The culmination of financial industry consolidation was the creation of Citigroup, the largest financial holding company to that point.⁸ Shortly after the Citigroup merger, Congress passed the GLB, which permitted financial holding companies like Citigroup to acquire both banking and non-banking financial institutions.⁹ The GLB's passage effectively represented the repeal of the Glass-Steagall Act of 1933, which was instituted to separate financial institutions by service type.¹⁰ The Glass-Steagall Act was a response to the financial crisis that brought about the Great Depression.¹¹ Its goal was to break apart financial conglomerates and force separate companies for commercial banking, investment banking, and insurance businesses.¹² However, decades later new legislation slowly began to erode the barriers set forth in Glass-Steagall and clever attorneys for banks exploited loopholes that led to preliminary consolidation within the industry.¹³ In the late-1990s a powerful bank lobby convinced Congress that permitting cross-sector financial holding company consolidation would produce economies of scale that would benefit both banks and

⁷ See Wilmarth, *supra* note 3, at 219-20.

⁸ Mitchell Martin, *Citicorp and Travelers Plan to Merge in Record 70 Billion Deal: A New No. 1: Financial Giants Unite*, N.Y. TIMES, April 7, 1998, available at <http://www.nytimes.com/1998/04/07/news/07iht-citi.t.html>.

⁹ Wilmarth, *supra* note 3, at 219-20 ("The GLB Act removed legal restrictions on affiliations between banks and securities firms by repealing two provisions of . . . the "Glass-Steagall Act." The GLB Act also eliminated legal barriers to affiliations between banks and insurance companies. As a result of the GLB Act, banks can combine with securities firms and insurance companies to organize financial conglomerates under the structure of a "financial holding company").

¹⁰ *Id.*

¹¹ Jonathan Zubrow Cohen, *The Mellon Bank Order: An Unjustifiable Expansion of Banking Powers*, 8 ADMIN. L.J. AM.U 335, 337 (1994) (explaining the origins of the Glass-Steagall Act: "Congress enacted four sections of the . . . Glass-Steagall Act to deal with its concern that banks, prior to the Great Depression, had invested customer deposits heavily in securities activities leading to many subsequent bank failures. The Act's primary purpose was to separate commercial and investment banking to ensure that these types of failures would not happen again").

¹² *Id.* See also, Eric Hsu, *Downsizing Citigroup: End of an Era or Bump in the Road for Graham-Leach-Bliley?*, 28 REV. BANKING & FIN. L. 404, 405-06 (2009) (a general discussion on the Glass-Steagall Act's intended goals).

¹³ Wilmarth, *supra* note 3, at 437-38 (discussing how even before the GLB Act was passed, banks created a "substantial presence" in non-depository financial services by "exploiting regulatory loopholes in the Glass-Steagall Act").

consumers.¹⁴ Scholars conclude that the GLB merely legitimized the consolidation that was already ongoing in the financial industry.¹⁵ With GLB's passage, financial institution consolidation began in earnest.

Banks argue that consolidation creates market efficiencies and economies of scale that ultimately benefit consumers through better service and lower fees.¹⁶ Based on legislative trends, the government seems to agree with the big banks' consolidation argument.¹⁷ After 1980, the Justice Department significantly relaxed merger standards, and since then has rarely denied banks' requests to merge.¹⁸ Between 1990 and 2002 there were thirty mergers among very large financial institutions.¹⁹ In 1998 alone, there were three mergers announced between six of the nation's twelve largest banks.²⁰ This consolidation resulted in decreased competition and a disproportionate increase in market share dominance by the largest financial institutions.²¹ Despite this decrease in competition and increased market share control, big bank champions claimed consumers would reap a wide variety of benefits from financial industry consolidation.²²

B. Diseconomies of Scale

The financial industry's goals over the last two decades

¹⁴ Discussing the powerful bank lobby, *Id.* at 307 ("During 1997-99, the financial services industry, led by the largest banks, securities firms and insurance companies, reportedly spent more than \$300 million on lobbying expenses and political contributions to secure passage of the GLB Act"); Discussing arguments made by banking consolidation advocates about the purported benefits of consolidation, *Id.* at 282 ("Advocates for big banks content that large diversified financial institutions can generate economies of scale and scope by selling a variety of consumer financial products").

¹⁵ *Id.* at 475.

¹⁶ *Id.* at 223.

¹⁷ Wilmarth, *supra* note 3.

¹⁸ *Id.* at 250-51.

¹⁹ *Id.* at 252.

²⁰ *Id.*

²¹ *Id.* at 252-54 (mergers resulted in the "fifty largest banks increase[ing] their share of the banking industry's assets from 55% in 1989 to 74% in 1999 . . . all of this growth occurred among the ten largest banks, as their combined market share rose from 26% to 49% of total industry assets during the 1990s" and "[b]y 2000, 50% or more of the deposits in each of twenty-five states and the District of Columbia were controlled by the five largest banks in the jurisdiction").

²² Wilmarth, *supra* note 3, at 282.

have been clear: consolidation is king. To further consolidation, banks lobbied for new legislation relaxing standards previously established as a response to the Great Depression.²³ To justify consolidation practices, big bank proponents argued that larger banks would create financial supermarkets where consumers would reap the benefits of maximum economies of scale.²⁴ However, while financial industry consolidation did create super-sized financial holding companies, these institutions, in turn, produced *diseconomies* of scale.²⁵ Consumers paid higher fees for worse customer service and had fewer choices of where to bank in many markets.²⁶ Further, these super-sized financial holding companies did not realize market efficiencies.²⁷ Instead, acquisition costs and other ancillary charges associated with managing behemoth corporations actually resulted in smaller profits for these institutions.²⁸ Even as consolidation ramped up

²³ Cohen, *supra* note 11, at 337.

²⁴ Wilmarth, *supra* note 3, at 283.

²⁵ *Id.* at 279-80 (“most economic studies have concluded that U.S. banks stop producing increasing returns to scale as they grow beyond the \$10-\$25 billion size range . . . FDIC data show that banks in the \$1-\$10 billion size range operate with better efficiency ratios than those registered by bigger banks.” To put this into perspective, the largest bailout recipients in 2008 received more money from the government than the high-end figure used in this Wilmarth article to demonstrate the point at which banks no longer yield efficiencies).

²⁶ *Id.* at 275-76 (when First Union merged with CoreStates it implemented a plan to push consumers towards electronic services and away from in-person banking. Customers responded by leaving: “First Union ultimately lost a fifth of CoreStates’ former depositors.” Similarly, After Wells Fargo’s hostile takeover of First Interstate Bank, it pushed customers out of traditional bank branches in an effort to cut costs. The “impersonal treatment offended many patrons, resulting in a loss of one-eighth of its retail deposit based and a sharp decline in its revenues”); Discussing market share dominance to over charge consumers, “numerous studies have found that banks in highly concentrated local markets pay below-average interest rates on consumer deposits and charge above-average interest rates on loans to consumers and small businesses. Another study concluded . . . competition from small local banks . . . had only a minor restraining effect on the dominant banks” and “[n]ational surveys have shown that the largest banks pay interest rates on deposits that are substantially lower than the rates paid by smaller banks. Studies have also found that large, multistate banks charge fees on deposit accounts that are significantly higher than fees assessed by small community banks”. *Id.* at 294-95.

²⁷ *Id.* at 279-80.

²⁸ *Id.* at 272 (discussing profitability issues for the largest banks: “Economic studies have generally shown that large bank mergers in the United States during the 1980s and 1990s did not improve overall efficiency or

in the 1990s and continued to increase even through the 2008 financial crisis, big banks never realized their much-lauded economies of scale. This has also meant that consumers never experienced the purported benefits used to justify consolidation in the first place. However, as the next section details, large banks were consolidating for other, less altruistic motives in spite of inefficiencies they realized from their mergers.

C. TBTF's Allure

Despite significant data proving diseconomies of scale for extremely large financial institutions, banks continued to pursue a consolidation policy because they were motivated in part by attaining TBTF status. TBTF status offers the protection of an implicit government guarantee because a financial institution's failure poses such a risk to the overall health of the economy that it cannot be allowed to fail.²⁹ As a matter of survival in competitive markets, banks have a strong incentive to pursue TBTF status even though such a pursuit creates inefficiencies, largesse, and suboptimal banking conditions for the average consumer.³⁰

Perhaps unwittingly, the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") codified TBTF status and offered guidelines for acquiring federal bailout money.³¹ The FDICIA did two things: i) it encouraged financial institutions to consolidate in an effort to reach TBTF status, and ii) it encouraged excessive leveraging and risk-taking for financial institutions that achieved TBTF status. Essentially, by acknowledging that some financial firms were deemed so necessary to the economy's functioning that the government

profitability of the resulting banks. . . . In thirteen of the fifteen largest bank mergers of 1997-98, the resulting banks failed to meet their profit targets for 1999. . . . As with bank merger studies, corporate acquisition reviews have concluded that most acquiring firms paid takeover premiums that exceeded the value of any performance improvements that could be realized from expected postmerger 'synergies').

²⁹ Wilmarth, *supra* note 3, at 353.

³⁰ *Id.* at 296.

³¹ *Id.* at 300 ("Section 141 of FDICIA authorizes the FDIC to protect uninsured depositors and other creditors in a large failing bank if such action is needed to prevent "serious adverse effects on economic conditions or financial stability." This is in stark contrast to the general FDIC policy that places failing banks into receivership where assets are sold off and management is fired).

would be required to bail them out, the government offered a type of free implicit insurance to a select group of institutions while at the same time authorized them to act carelessly in balancing risk.³² The result of this was an increased market share by very large banks and more importantly, a dramatic increase in the amount of risk the largest banks were willing to assume.³³

Throughout the late 1990s and increasingly into the 2000s, large financial institutions assumed a disproportionate amount of risk when compared to small ones.³⁴ Large financial institutions had both the power and the incentive to dive deeper into risk than their predecessors and smaller counterparts. Large banking institutions have a huge incentive to achieve TBTF status because an implicit bailout guarantee by the government helps TBTF banks subsidize their risk.³⁵ TBTF status equals a government subsidy because certain banks are able to build an implied bailout into the cost of their risky actions.³⁶ Therefore, TBTF banks are able to leverage themselves more than traditional banks because they need not build the same risk premium into their asset cushion.³⁷ Generally accepted banking

³² *Id.* at 316.

³³ *Id.*; See also David Cho, *Banks 'Too Big to Fail' Have Grown Even Bigger*, THE WASH. POST Aug. 28, 2009 at A01.

³⁴ Wilmarth, *supra* note 3, at 316, 373-74. (“[B]ig banks have pursued risky business strategies since 1993” and “big banks have relied on proprietary trading and portfolio investments to produce a growing share of their revenues. Much of this trading and investing has occurred in high-risk areas . . . Chase, Citigroup, and Bank of America derived a significant and growing percentage of their revenues from [such trading]”).

³⁵ *Id.* at 301-02 (“TBTF policy also subsidizes the cost of uninsured deposits for the largest banks, because market participants expect the FDIC to use its “systemic risk” authority to protect all deposits held by big banks”).

³⁶ *Id.* at 300-01 (“TBTF status confers significant benefits on big banks. Studies have shown that, compared to smaller banks, the largest banks operate with lower capital ratios, higher percentages of uninsured deposits, lower levels of core deposits, higher percentages of loans, and lower levels of cash and marketable securities”).

³⁷ *Id.* at 353. Instead, TBTF banks take advantage of their implied government safety net and commit to riskier investments that during good times return higher profits for investors and shareholders. Wilmarth’s article, published in 2002 would turn out to be eerily prophetic: “The major U.S. dealers in [over the counter] derivatives are the nation’s largest banks, securities firms, and insurance companies. . . . Federal regulators would probably intervene to prevent the failure of any major derivatives dealer due to concerns that such an event would trigger a systemic crisis in the financial markets. . . . [The nation’s largest banks] have a strong temptation to exploit the federal safety net’s implicit subsidy by engaging in speculative trading.” *Id.*

standards call for leveraging of ten to one or less, which means for every one hundred dollars a bank loans out, it has at least ten dollars on hand to cover the debt. By the time the market collapsed in 2008, large financial institutions had leveraged themselves by a ratio of thirty to one, meaning that for every dollar the bank had on hand, it held thirty more in debt.³⁸ This risk level proved unsustainable.

Banks also seek TBTF status to control market share and decrease competition. Instead of creating all-out monopolies, large, interconnected financial institutions have succeeded in creating oligopolies that serve common interests to these financial institutions at inflated costs to consumers.³⁹ Further, research has shown that big banks engage in “mutual forbearance” in setting prices in markets in which they compete against each other.⁴⁰ Mutual forbearance results in small banks being unable to compete against big banks in specific markets because large banks artificially maintain lower fee structures until smaller banks are forced to bow out of a given market.⁴¹ Additionally, the government has made it easier for large banks to hang on to the customers they lure away from smaller banks by “permitting discounts that reward customers for purchasing multiple products from a single bank.”⁴² On top of that, TBTF banks utilize their technical advantage to dissuade consumers from switching banks by using discount incentives to get customers to enroll in bundled financial services and direct deposit which, “make[s] it more difficult for the customer to transfer a deposit relationship to another institution.”⁴³ In short, these government incentives promote largesse and inefficiency in the financial industry. These regulatory policies have driven banks to achieve TBTF status. Historically, the cost to the consumer for TBTF status seems to be similar to that of monopolies: increased cost,

³⁸ Stewart, *supra* note 6, at 60.

³⁹ Wilmarth, *supra* note 3, at 299 (“[M]ergers enable large universal banks to capture long-term oligopoly pricing power in retail markets, consolidation will significantly harm the interests of consumer”).

⁴⁰ *Id.* at 296 (discussing large bank pricing motives: “preliminary evidence indicating that large, multistate banks increase their profits by forbearing from aggressive price competition in markets that they share with other banks. This tentative evidence of “mutual forbearance” suggests that major banks may exercise joint price leadership in local or regional areas where they hold significant market positions”).

⁴¹ *Id.*

⁴² *Id.* at 298.

⁴³ *Id.*

decreased choices, and bad service. Clearly, for banks, there is a strong allure to TBTF status.

D. 2008 Banking Crisis Further Accelerates Consolidation

A full discussion of the events that led up to last year's banking crisis exceeds the scope of this note. Here, I focus on the consolidation that occurred within the financial industry as a result of the crisis. Below is a brief synopsis of the unprecedented consolidation that occurred within the financial industry during and immediately following the height of the banking crisis.

Even though TBTF financial institutions are largely responsible for the 2008 banking crisis, these institutions were bailed out by the federal government at unprecedented levels. In September 2008, Congress authorized a \$700 billion bailout program that was used primarily to make direct capital injections into TBTF financial institutions.⁴⁴ Access to these funds prevented TBTF banks like Citigroup and Bank of America from going into FDIC receivership like comparatively smaller banks such as Washington Mutual, Wachovia, and IndyMac.⁴⁵ In fact, Citigroup and Bank of America received capital injections above and beyond what was initially distributed to them under TARP.⁴⁶ Both banks received an additional \$20 billion in government preferred stock purchase investments.⁴⁷ Bank of America's need for additional bailout funds resulted from its consolidation efforts at the height of the crisis. Bank of America absorbed the highly troubled bank Countrywide, and then brokered a deal to merge with Merrill Lynch with the government's blessing.⁴⁸ Bank of America merged their comparatively good assets with the highly toxic ones of Countrywide and Merrill Lynch and suddenly found itself in a perilous position where extraordinary bailout funds were necessary to keep it from failing.⁴⁹ Government action in 2008

⁴⁴ DANIEL GROSS, *DUMB MONEY: HOW OUR GREATEST FINANCIAL MINDS BANKRUPTED THE NATION* 3 (2009) ("Congress approved a \$700 billion bailout of the nation's financial system. But Treasury Secretary Henry M. Paulson's plan to deploy that cash to buy toxic mortgages was quickly abandoned in favor of injecting funds directly into large banks").

⁴⁵ *Id.*

⁴⁶ Lissa L. Broome, *Extraordinary Government Intervention to Bolster Bank Balance Sheets*, 13 N.C. BANKING INST. 137, 141-42 (2009).

⁴⁷ *Id.*

⁴⁸ GROSS, *supra* note 44, at 88.

⁴⁹ *Id.* at 89 ("By January 2009, it was clear that Bank of America buying

quickly defined which financial institutions were TBTF, and these institutions used their power to create favorable outcomes for themselves.

TBTF bailout recipients used their privileged positions to swallow comparatively smaller banks reeling from the credit collapse. This resulted in even fewer banking options for consumers, and further entrenchment of the TBTF ideology in the financial industry. When the dust settled from the stock market panic in early 2009, the new financial landscape revealed clear winners. J.P. Morgan Chase, Bank of America, and Wells Fargo together controlled three of every ten dollars on deposit in United States bank accounts.⁵⁰ Further, when including Citigroup with the aforementioned, these four TBTF financial institutions issued half of all mortgages and roughly two thirds of all credit cards in the U.S.⁵¹ Two of the largest depository institutions acquired investment banks on the cheap because of the crisis: Bank of America purchased Merrill Lynch,⁵² and J.P. Morgan Chase absorbed Bear Stearns' remaining good assets for ten dollars per share.⁵³ TBTF financial institutions took advantage of market conditions and used taxpayer bailout dollars to fund even more industry consolidation.

The 2008 financial crisis worsened the banking environment for consumers. First, federal regulators relaxed anti-trust standards for large banks as a result of the crisis, allowing some banks "to hold more than 10 percent of the nation's deposits" even though this is prohibited by law.⁵⁴ Additionally, J.P. Morgan Chase and Bank of America were permitted to exceed Department of Justice antitrust guidelines for market share domination in several metropolitan regions.⁵⁵ Large banks can now use relaxed regulatory standards to saturate select markets, which has resulted in consumers now having fewer banking options.⁵⁶ Relaxed regulatory standards also results in

Merrill was like a boat taking on water believing it could save itself by lashing to another ship that was filling up with concrete").

⁵⁰ Cho, *supra* note 33, at A01.

⁵¹ *Id.*

⁵² GROSS, *supra* note 44, at 89.

⁵³ *Id.* at 84. ("Henry Paulson hammered out a deal for JPMorgan Chase to access credit from the Federal Reserve to buy [Bear Stearns] at a bargain-basement price of \$2 per share (later revised upward to \$10 a share)").

⁵⁴ Cho, *supra* note 33, at A01.

⁵⁵ *Id.*

⁵⁶ *Id.* ("In Santa Cruz, Calif., Wells Fargo, Bank of America and J.P. Morgan Chase hold three-quarters of the deposit market").

suboptimal banking conditions for consumers, especially when it comes to account fees.⁵⁷

In sum, four TBTF financial institutions emerged from the 2008 crisis with a clear advantage over non-TBTF banks. These banks received extraordinary bailout support from the government. They used their privileged status and bailout money to increase their market share in the industry, and the government largely ratified these bank's actions by relaxing antitrust standards. Consumers are already experiencing the negative consequences from post-crisis consolidation.

E. Historical Summary

Banking industry consolidation produced suboptimal results for the consumer. To afford costly mergers, giant banks began cutting services at branches in an attempt to force customers into electronic banking.⁵⁸ More consolidation also meant fewer choices for consumers, particularly in urban areas.⁵⁹ Ultimately, large banks caught on to their dominant market positions and responded by abusing consumers. Large banks with less competition in urban markets charged their customers more fees, higher interest rates on loans, and paid a lower interest yield on consumer savings and checking accounts.⁶⁰

Despite taking advantage of their market dominance, large banks did not perform as well as small and midsized banks in the early 2000s.⁶¹ However, the stability provided by TBTF status compelled additional consolidation, and for those banks that had achieved such status, there was what seemed to be an unquenchable thirst for leverage and investment in unregulated financial products.

III. Reform Proposal

The Obama Administration and the U.S. Department of the Treasury introduced an ambitious plan to prevent future financial crises in a white paper called "Financial Regulatory

⁵⁷ *Id.* ("In the last quarter, the top four banks raised fees related to deposits by an average of 8 percent, according to research from the Federal Reserve Bank of Dallas. Striving to stay competitive, smaller banks lowered their fees by an average of 12 percent").

⁵⁸ Wilmarth, *supra* note 3, at 274-76.

⁵⁹ *Id.* at 239.

⁶⁰ *Id.* at 293-96.

⁶¹ *Id.* at 272-79.

Reform, A New Foundation.”⁶² This white paper outlines the goals of an extensive set of new regulations released at the same time.⁶³ In broad terms, the administration plans to consolidate financial regulatory power under the Federal Reserve and expand its reach and authority beyond its current reach of BHCs.⁶⁴ This note examines the plan within this white paper and corresponding regulations to create a Financial Services Oversight Council to regulate TBTF financial entities, which the administration has renamed T1FHCs.⁶⁵ Additionally, this note examines the white paper section and corresponding regulatory proposal for creating a new consumer financial protection agency under the Consumer Financial Protection Agency Act of 2009.

This section examines interactions between these two areas of the Proposal. First, I identify the specific language in Title II that deals with defining T1FHCs and explain why this is a mere extension of previous TBTF policy and a further implicit guarantee of government intervention. Second, I examine the prudential standard requirements set forth in Title II. These prudential standards are crafted to attempt to prevent the need for future government bailouts by promoting greater transparency and requiring T1FHCs to be well managed and well capitalized.⁶⁶ Third, this section compares these provisions to existing legislation and regulatory agencies that failed to mitigate risk and abuse, which led to the current banking crisis. The goal is to determine if the reform proposal i) adequately addresses current weaknesses in the financial industry regulatory framework, ii) provides sufficient authority to enact change in an immensely powerful, but inherently flawed industry, and iii) promotes consumer interests.

A. Definitions

The reform proposal introduces a new term: Tier 1 Financial Holding Company. I assert that this term is a less

⁶² DEP'T OF THE TREAS., FINANCIAL REGULATORY REFORM, A NEW FOUNDATION: REBUILDING SUPERVISION AND REGULATION, 21 (2009) *available at* http://www.financialstability.gov/docs/regs/final_report_web.pdf.

⁶³ *Id.*

⁶⁴ DEP'T OF THE TREAS., BANK HOLDING COMPANY MODERNIZATION ACT OF 2009 *available at* <http://www.financialstability.gov/docs/regulatoryreform/07222009/titleII.pdf> [hereinafter BHC Act 2009].

⁶⁵ *Id.* at § 203(t).

⁶⁶ BHC Act 2009, *supra* note 64, at § 202.

politically charged way of saying too big to fail financial institution. The white paper proposes heightened consolidated supervision and regulation by the Federal Reserve and the to-be-created Financial Services Oversight Council (“FSOC”) of “all large, interconnected financial firms.”⁶⁷ Title II—Consolidated Supervision and Regulation of Large, Interconnected Financial Firms of the proposal (“Title II”) offers a general definition of T1FHCs at Section 6(a)(1)(A) where it gives the FSOC authority to designate a financial institution as a T1FHC when it “determines that material financial distress at the company could pose a threat to global or United States financial stability . . . during times of economic stress.”⁶⁸

Title II further enumerates criteria the FSOC may consider in determining whether a financial institution meets criteria for T1FHC status during times of economic stress. Sections 6(a)(1)(A)(i) through (vii) are a non-exhaustive list of criteria the FSOC can use to make a T1FHC determination such as: the amount of a company’s holdings and liabilities, reliance on short term funding, the company’s interaction and transactions with other companies, and the company’s importance to the financial system.⁶⁹

Additionally, Title II includes a set of standards for classifying a financial institution as a T1FHC at any point based on data collected by the FSOC. Generally, if a financial institution has at least \$10 billion in assets, at least \$100 billion in assets under management, or at least \$2 billion in gross annual revenue, the FSOC can designate the institution a T1FHC.⁷⁰ Per Title II, the FSOC will collect a variety of data on financial

⁶⁷ DEPT OF THE TREAS., FINANCIAL REGULATORY REFORM, A NEW FOUNDATION: REBUILDING SUPERVISION AND REGULATION 21 (2009) available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

⁶⁸ BHC Act 2009, *supra* note 64, at §6(a)(1)(A).

⁶⁹ *Id.* §6(a)(1)(A)(i)-(vii) (specifically, the FSOC is permitted to consider the following criteria to designate T1FHC status during times of economic stress: “(i) the amount and nature of the company’s financial assets; (ii) the amount and types of the company’s liabilities, including the degree of reliance on short-term funding; (iii) the extent of the company’s off-balance sheet exposures; (iv) the extent of the company’s transactions and relationships with other major financial companies; (v) the company’s importance as a source of credit for households, business and State and local governments and as a source of liquidity for the financial system; (vi) the recommendation, if any, of the Financial Services Oversight Council; and (vii) any other factors that the Board deems appropriate”).

⁷⁰ *Id.* at § 6(a)(2)(A)

institutions to determine whether they fit the profile of a T1FHC.⁷¹

B. Prudential Standards

In an attempt to prevent the need for future taxpayer bailouts of T1FHCs, Title II sets a series of heightened prudential standards that are stricter than the standards ordinary financial institutions will have to comply with under these new regulations.⁷² After being deemed a T1FHC by the Board, the financial institution has 180 days to comply with the prudential standards set forth in this proposal.⁷³ The prudential standards set forth include, but are not limited to: minimum capital requirements, leverage limits, liquidity requirements, and risk management requirements.⁷⁴ These prudential standards represent a response to a lack of cohesive regulatory authority over TBTF financial institutions prior to the 2008 crisis. By implementing such standards and giving regulatory agencies the requisite authority to monitor and enforce compliance, these standards attempt to mitigate future bailout needs for T1FHCs. However, as discussed in part IV of this note, these requirements will produce a suboptimal banking environment for the average consumer because prudential requirements detailed in Section 6A of Title II encourage consumer abuse.

Title II, Section 6A defines minimal capital requirements, leverage limits, liquidity requirements, and risk management requirements for T1FHCs. The FSOC Board shall determine capital requirements for each T1FHC.⁷⁵ Additionally, the Board will be responsible for setting leverage limits and monitoring T1FHCs to ensure compliance.⁷⁶ Section 6A also restricts all

⁷¹ *Id.* at § 6(d).

⁷² *Id.* at § 6(c)(1) (explaining: “prudential standards shall be more stringent than the standards applicable to bank holding companies to reflect the potential risk posed to financial stability by United States Tier 1 financial holding companies”).

⁷³ *Id.* at § 6(b).

⁷⁴ *Id.* at § 6(c)(1)(A)-(D).

⁷⁵ BHC Act 2009, *supra* note 64, at § 6A(c)(2) (explaining: “The Board shall, by regulation, specify for each relevant capital measure the levels at which a Tier 1 financial holding company is well capitalized, undercapitalized, and significantly undercapitalized”).

⁷⁶ *Id.* at §6A(c)(3) (here, the Proposal sets a floor for the Board in determining leverage limits when a T1FHC reaches an undercapitalized stage: “The Board shall, by regulation, specify the ratio of tangible equity to total

capital distributions by T1FHCs that are not in compliance with minimum capital requirements, but provides an exception where such a distribution would improve the T1FHC's financial health.⁷⁷ This suggests a policy of permitting a TBTF organization to save itself despite regulations implemented to punish bad behavior, and suggests that preserving the T1FHC is the priority of this Act.

Additionally, Title II requires T1FHCs to be "well capitalized and well managed."⁷⁸ Title II defines a T1FHC as well capitalized "if it exceeds the required minimum level for each relevant capital measure."⁷⁹ While this definition is vague, it maintains that T1FHCs are well capitalized if they meet the capital standards set forth in subsection 'c' of Section 6A of Title II.⁸⁰ However, the majority of these capital standards are to be set by the to-be-formed FSOC Board, so there is no way to fully assess their effectiveness until after the reform package is signed into law. Title II lacks an adequate definition of what it means for a T1FHC to be well capitalized.

If the Board determines that a T1FHC is undercapitalized and a capital restoration plan is needed, the T1FHC's management is responsible for submitting the plan and, if they fail to do so, they can be removed by the FSOC.⁸¹ This seems to be the only section in Title II that specifically holds management responsible for their actions and it only permits removal if, after running the T1FHC poorly, the management team fails to submit an appropriate plan to correct the institution's capital issues. The way Title II treats these requirements as a whole indicates a strong status-quo bias by the Proposal's drafters. This is bad for the consumer because it suggests that it will take a fairly high degree of negligence by corporate officers at T1FHCs before the regulatory agencies will intervene, which is not all that different than what consumers have now.

assets at which a Tier 1 financial holding company is critically undercapitalized . . . Leverage Limit Range . . . shall require tangible equity in the amount—(i) not less than 2 percent of total assets; and . . . not more than 65 percent of the required minimum level of capital under the leverage limit").

⁷⁷ *Id.* at § 6A(d).

⁷⁸ *Id.* at § 6(c)(5).

⁷⁹ *Id.* at § 6A(b)(1)(A).

⁸⁰ *Id.* at § 6(c).

⁸¹ *Id.* at § 6A(f)(2)(E).

C. Accountability

The regulatory reform proposal includes heightened corrective action measures for T1FHCs, but its focus is reactive when it should be preventative. Section 6A of Title II governs corrective action for T1FHCs. Essentially, the reform proposal requires the FSOC Board to take prompt action to motivate a failing T1FHC to recapitalize itself. Section 6A sets forth a variety of standards T1FHCs must comply with and the consequences for failing to comply. Pertinent elements of Section 6A are detailed below because they demonstrate how the regulatory reform proposal insufficiently addresses the root problems of too big to fail in the financial industry. Further, Section 6A lays groundwork for encouraging T1FHCs to turn to abusive banking practices in an effort to comply with the regulatory standards proposed.

Section 6A requires the FSOC Board take “prompt corrective action” against problematic T1FHCs.⁸² Section 6A then goes on to outline minimum capital requirements that T1FHCs must maintain to avoid corrective action from the FSOC. Specifically, the reform proposal cites the capital requirements established in the BHC along with leverage limits and risk-based capital requirements.⁸³ Additionally, the FSOC Board is permitted to craft additional measures that further the goals of Section 6A.⁸⁴ Basically, the majority of the progressive standards the reform plan seeks to establish will not be known until the proposal becomes law and the FSOC Board determines what the standards should be.

Additionally, Section 6A mandates that troubled T1FHCs create “capital restoration plans.”⁸⁵ Generally, Title II calls for an undercapitalized T1FHC to submit a capital restoration plan to the FSOC Board.⁸⁶ The proposal is not overly forthcoming in what constitutes an undercapitalized T1FHC. It defines a T1FHC as undercapitalized when it “fails to meet the required minimum level for any relevant capital measure.”⁸⁷ The capital measures that this definition refers to are to be set by the FSOC Board. An adequate capital restoration plan will contain steps the

⁸² BHC Act 2009, *supra* note 64, at § 6A(a).

⁸³ *Id.* at § 6A(c)(1)(A).

⁸⁴ *Id.* at § 6A(c)(1)(B).

⁸⁵ *Id.* at § 6A(e)(2).

⁸⁶ *Id.* at § 6A(e)(2)(A).

⁸⁷ BHC Act 2009, *supra* note 64, at § 6A(b)(1)(B).

undercapitalized T1FHC will take to regain well-capitalized status, specific annual goals the undercapitalized T1FHC will meet to recapitalize, and how the T1FHC will comply with the Board's requirements.⁸⁸ It is only when an undercapitalized T1FHC fails to submit a sufficient capital restoration plan that the Board will take additional corrective measures. These potential additional measures include removing management or requiring divestiture.⁸⁹

Section 6A also contains a mandatory bankruptcy provision, but only if the T1FHC is 'critically under capitalized.'⁹⁰ The Proposal defines critically undercapitalized as failing to meet an FSOC Board-determined leverage threshold for a ratio of tangible equity to total assets.⁹¹ If the Board determines a T1FHC has become critically undercapitalized, it shall require the T1FHC to file for Chapter 11 bankruptcy.⁹² This is perhaps the strongest corrective provision in the reform plan for T1FHCs. However, it still falls short because it fails to define what the threshold is for 'critically undercapitalized.' It also fails because there is nothing in the reform plan indicating the government will not intervene before a T1FHC reaches critically undercapitalized status as long as the company submits an adequate capital restoration plan. In sum, accountability measures enumerated in Title II lack the strength to effectively discipline T1FHCs.

D. Consumer Financial Protection Agency Act of 2009

The Obama Administration has also proposed creating a

⁸⁸ *Id.* at § 6A(e)(2)(B).

⁸⁹ For removing management, *see* Bank Holding Company Modernization Act of 2009 § 6A(f)(2)(E) ("Improving Management.—Doing one or more of the following—(i) New election of directors.—Ordering a new election for the Tier 1 financial holding company's board of directors. (ii) Dismissing directors or senior executive officers. Requiring the Tier 1 financial holding company to dismiss from office any director or senior executive officer who had held office for more than 180 days immediately before the Tier 1 financial holding company became undercapitalized."). For requiring divestiture, *see* Bank Holding Company Modernization Act of 2009 § 6A(f)(2)(F) ("Requiring the Tier 1 financial holding company to divest itself of or liquidate any subsidiary if the Board determines that the subsidiary is in danger of becoming insolvent, poses a significant risk to the Tier 1 financial holding company, or is likely to cause a significant dissipation of the Tier 1 financial holding company's assets or earnings").

⁹⁰ *Id.* at § 6A(h).

⁹¹ *Id.* at § 6A(c)(3)(A).

⁹² *Id.* at § 6A(h)(1).

new consumer protection agency under Title X of the administration's regulatory reform proposal. While well-intentioned, the Consumer Financial Protection Agency Act of 2009 inadequately addresses the threat TBTF financial institutions present to the consumer. Title X's goal is to prevent future credit crises like the one born from the housing market collapse of 2007-08. It seeks to accomplish this through rigorous federal regulation that promotes increased "transparency, simplicity, fairness, accountability, and access in the market for consumer financial products or services."⁹³ Title X has a clear regulatory objective of ensuring consumers understand information about financial products and services so they can make responsible decisions while being protected from unfair or deceptive practices.⁹⁴ However, Title X does not include any specific protection for consumers against oligopolistic tendencies of TBTF financial institutions.

The reform plan attempts to manage the risk that any one T1FHC can pose to the overall health of the economy by mandating a set of elevated prudential standards and imposing various corrective actions for violators. Such a system will not benefit the consumer. T1FHCs will need to work hard to meet the proposed prudential standards, which will lead to poor banking conditions at these institutions. Further, Title II does not contain a plan to eliminate TBTF status for these companies. Instead, Title II ratifies T1FHCs' largesse and implicitly agrees to support it so long as a set of vaguely-defined requirements are met. Title X adequately addresses credit transparency and predatory lending practices, but completely fails to protect the consumer from the TBTF dangers outlined in the history section of this note. The bottom line is that this proposal fails to cure the underlying issues presented by TBTF financial institutions that were occurring long before the 2008 financial crisis.

IV. Analysis

The regulatory reform proposal contains many strengths. Particularly, it makes a genuine effort to consolidate regulatory power in the financial industry to eliminate legal loopholes, increase transparency, and reduce inefficiencies. The proposal also contains impressive consumer protections, which are tailored to prevent future abusive lending practices and promote

⁹³ H.R. 3126, at § 1021(a).

⁹⁴ *Id.* at § 1021(b).

transparency in the financial industry. However, there is a logical flaw between the goals asserted under regulating T1FHCs and protecting consumers as set forth in the reform proposal. That flaw is the implicit authorization by the government to implement abusive consumer practices by T1FHCs. The prudential standards summarized in the white paper and detailed in Title II are troublesome in that they will encourage large banks to innovate new ways of meeting capital requirements. On its face, this may not seem like a bad idea, but it potentially has grave impacts for consumers.

This note has already established that TBTF financial institutions, T1FHCs-to-be, have a track record of higher operating costs resulting from diseconomies of scale. Further, excessive debt leveraging drove profits posted by T1FHCs from 2002 to 2007.⁹⁵ Therefore, the profitable years leading up to the collapse of the credit and housing markets were illusory because these profits were attained through unsustainable banking practices.⁹⁶ Once ‘the music stopped,’ any sense that TBTF financial institutions achieved real profits eroded as banks assumed losses that exceeded all reasonable expectations.⁹⁷ It remains to be seen, but it is improbable, that compliance with the prudential standards set forth in the proposal would give banks the profit avenues they have previously enjoyed. Consequently, T1FHCs will have to raise capital by other methods. They will do so by charging consumers high fees and interest rates.⁹⁸

The financial crisis and recession of the last two years has shuttered many small banks.⁹⁹ Additionally, a latent consequence

⁹⁵ Louise Story & Eric Dash, *Banks Are Likely to Hold Tight to Bailout Money*, N.Y. TIMES, Oct. 17, 2008.

⁹⁶ Story & Dash, *supra* note 95 (“For every dollar the banks earned during the industry’s most prosperous years, they have now wiped out \$1.06”).

⁹⁷ Michivo Nakamoto & David Wighton, *Citigroup Chief Stays Bullish on Buy-outs*, FIN. TIMES, July 9, 2007, available at <http://www.ft.com/cms/s/0/80e2987a-2e50-11dc-821c-0000779fd2ac.html> (quoting Citigroup’s former CEO Chuck Prince regarding profits the bank was making due to over leveraging: “When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing”).

⁹⁸ Unfortunately, the regulatory reform proposal explicitly restricts the authority of the proposed Consumer Financial Protection Agency to regulate usurious lending. Consumer Financial Protection Agency Act of 2009, H.R. 3126 at § 1022(g) (“Nothing in this title shall be construed as conferring authority on the Agency to establish a usury limit applicable to an extension of credit offered or made by a covered person to a customer”).

⁹⁹ Stephen Bernard, *Regulators Take Over 2 Banks; 94 Failures This*

of comprehensive systemic failure in the financial industry, combined with an elite group of TBTF banks has led to even more industry-wide consolidation.¹⁰⁰ Before the crisis, investment banks were separated from commercial banks and while they were systemically interconnected, they were different institutions.¹⁰¹ Now, this relatively small number of investment and commercial institutions has largely partnered up to further reduce the number of big bank players in the market.¹⁰² The few T1FHCs share a disproportionate amount of the financial industry burden and their overall financial health is now essential not just to the U.S. economy, but the global economy.¹⁰³

The remaining T1FHCs will use their customers to subsidize the prudential standards of the reform plan that require T1FHCs to be especially well capitalized. Consumers will pay for T1FHC status through higher banking transaction fees, lower interest rate yields on accounts, and higher interest rates on loans of all varieties. Further, the consumers that will primarily finance these prudential standards will be the ones that can least afford them. These T1FHCs will impose hefty overdraft fees, late payment charges, minimal balance requirements, additional loan closing costs, and uncompetitive loan rates on their customers. In fact, even though the proposal is not yet law, banks are already doing this. In 2009, banks will collect over \$38 billion in special charges and overdraft fees paid by customers.¹⁰⁴ The largest banks are charging the highest fees.¹⁰⁵ In order to continue

Year, CHI. TRIB., Sept. 18, 2009, *available at* <http://www.chicagotribune.com/business/sns-ap-us-bank-closures,0,6099722.story> (as of September 18, ninety-four banks have failed in 2009, and the “number of banks on the FDIC’s confidential “problem list” jumped to 416 at the end of June from 305 in the first quarter [which is] the highest number since June 1994 . . . The [FDIC] insurance fund has been so depleted by the epidemic of collapsing financial institutions that some analysts have warned it could sink into the red by the end of this year”).

¹⁰⁰ Cho, *supra* note 33.

¹⁰¹ *Id.*

¹⁰² *Id.*

¹⁰³ *Id.*

¹⁰⁴ Saskia Scholtes & Francesco Guerra, *Banks Make \$38bn From Overdraft Fees*, FIN. TIMES, August 9, 2009, *available at* http://www.ft.com/cms/s/0/43d18c68-851d-11de-9a64-00144feabdc0.html?ncllick_check=1 (“US banks stand to collect a record \$38.5bn in fees for customer overdrafts this year, with the bulk of the revenue coming from the most financially stretched consumers . . . fees are nearly double those reported in 2000”).

¹⁰⁵ Scholtes & Guerra, *supra* note 104 (“[t]he highest overdraft fees were

recruiting and maintaining their most valued clients, large banks will have to immunize certain classes of clients from all of these extra fees and instead pass the burden along to the average financial industry consumer.¹⁰⁶ Consequently, the consumers that can least afford it will be financing TBTF financial institutions' new fee-based practices of raising capital.¹⁰⁷ This process is already underway as a natural byproduct of self-imposed repentant leveraging restrictions on TBTF companies that create diseconomies of scale. The only difference under the proposal is that the process will be implicitly codified through strict prudential standards.

As it currently stands, consumers have few options to avoid abuse by large financial institutions. By allowing smaller banks to fail and bailing out large banks, two things happen: i) the assets of small failed banks are ultimately sold off to larger institutions through the receivership process, and ii) the government reinforces the idea of safety for the consumer in choosing a large bank. When viewed together, these results necessarily lead to ever increasing industry consolidation because banks want to achieve T1FHC status and consumers want to keep their money in the safest places possible.

A. FDIC Receivership Fails the Consumer When Unevenly Applied

FDIC receivership encourages consolidation and creates larger banks automatically. When some banks are given the privilege of TBTF status and others are not, those with TBTF status will always prevail. Further, TBTF status banks are likely candidates to absorb the assets of failed smaller banks. While many banks were involved in subprime mortgages and

charged by the largest banks . . . banks with assets greater than \$50bn – a group including Citigroup, Bank of America, JPMorgan Chase and Wells Fargo;” these banks have a current median overdraft fee of \$33 compared to the current industry average of \$26, and Bank of American customers have it the worst, where customer overdrawn by \$6 could trigger a total penalty of \$350 in a single day).

¹⁰⁶ *Id.* (“[t]he most cash-strapped customers are the hardest hit by such fees, with 90 per cent of overdraft revenues coming from 10 per cent of [US checking accounts] . . . Regular use of overdrafts is most common among consumers with low credit scores”).

¹⁰⁷ *Id.* (“[b]anks are returning to a fee-driven model and overdraft fees are the mother lode . . . Overdraft fees accounted for more than three-quarters of service fees charged on consumer deposits”).

securitized risk investments over the last five years, it was the largest banks that received extraordinary government support in the form of direct capital injections,¹⁰⁸ while smaller banks were left to languish in FDIC receivership only to be dismantled and have their assets sold off to the same TBTF institutions receiving Troubled Asset Relief Program (“TARP”) capital injections. If FDIC receivership is to be taken seriously, it must apply to all banks, not just ones deemed small enough to fail. By maintaining a two-tiered banking system (TBTF and everyone else), the government stacks the deck in favor of the TBTF financial institution because they are the likely buyers of failed banks’ assets that have been scrubbed clean in FDIC receivership. The regulatory reform plan attempts to reconcile this inequity by maintaining that bankruptcy will be mandatory for critically undercapitalized T1FHCs.¹⁰⁹ However, Title II does not specifically bar future bailout resources, and in fact implies that if T1FHCs uphold the requirements of Title II, they will be protected from failure because of their unique attributes to the economy’s survival.

B. TBTF Drives the Rational Consumer to Suboptimal but Safe Banks

The consumer will want to bank at T1FHCs because there is greater perceived safety. Despite the suboptimal banking conditions for the average consumer, through TBTF status, the government incentivizes consumers who put up with TBTF banks by impliedly insuring those banks against their own risk. A rational consumer would seek to house their savings with a bank that affords the greatest security against loss. While even small banks have FDIC deposit insurance, there is a general comfort in knowing that not only your money is safe with your bank, but also your bank is safe against failure. Actions by the federal government over the last year have taught the consumer that the largest financial institutions are protected through government intervention because of the risk they pose to the overall stability to the economy. Smaller banks, by contrast, are sent to FDIC receivership where larger banks swallow up the good assets of the failed small bank. While the consumer does not lose their

¹⁰⁸ Broome, *supra* note 46, at 142-43) (discussing the largest TARP fund recipients, in particular the secondary capital infusions to save Citibank and Bank of America).

¹⁰⁹ BHC Act 2009, *supra* note 64, at § 6A (h) (1).

personal funds when a bank fails, they may have to deal with branch closings as the purchaser of the failed bank's assets eliminates redundancies in specific markets. Additionally, the customer at the failed bank has no say in which larger financial institution purchases the right to their account. Here again, the planned regulatory reform fails to address the inequity between treatment of TBTF and small banking institutions, thereby creating a subconscious consumer bias towards TBTF financial institutions.

Finally, consumers will have fewer options of where to bank. T1FHCs will use their market share and power to dominate markets creating fewer options for consumers and greater incentive for T1FHCs to impose more fees. An already-demonstrated result of the 2008 financial crisis is an increase in consolidation within the banking industry. The largest TARP fund recipients essentially went on a merger frenzy immediately following distribution of the funds. Further, the government's response to the extraordinary collapse of the financial market was to not only permit more consolidation, but to encourage it.¹¹⁰ The result of the financial crisis was fewer small and mid-size banks, and increased market share for the surviving large banks. Title II in no way addresses this increasing inequity in the industry. Increasingly, consumers are left with fewer choices than ever of where to bank, and are forced to put up with inefficient and abusive banking practices as TARP fund recipients pull themselves out of their own mess by raising fees while decreasing service. It is difficult to argue how, in the long run, inefficiently run market-dominating oligopolies will benefit the consumer.

V. Conclusion

What does this mean for TBTF banks? This country's largest financial institutions may have to face the reality that they will be unable meet both the prudential standards set forth in Title II of the reform plan, and the regulatory standards proposed to protect consumers in Title X. If TBTF financial institutions are unable to capitalize themselves with consumer fees and the mortgage lending and investing practices of the past are shut off, they may not be able to overcome their diseconomies of scale and will be forced to fragment. Recently, we have already begun to see movement in Congress to reform banking fee practices.¹¹¹

¹¹⁰ Stewart, *supra* note 6, at 74.

¹¹¹ Stacy Kaper, *Dodd Preps Bill to Limit Fees on Overdrafts*, AM.

Empirical analyses indicate there is a great deal of public support for bank fee reform, and legislators may not have much trouble passing new restrictive legislation because their electorates want it.¹¹² Three large banks have already responded in anticipation of Congressional rebuke by easing some of their overdraft fees.¹¹³

However, the bottom line is that the big bank lobby is an undeniable force in politics. It is highly centralized, exceedingly organized, and extremely well-funded. This stands in stark contrast to the consumer, who is widely dispersed, poorly organized, and lacks funding resources. Where there is a will, there is a way, and the big bank lobby has a continued vested interest in promoting TBTF status in the financial industry. The regulatory reform proposal lacks the tenacity required to end the cycle of regulatory influence by financial elites in politics. Instead, it proposes a considerate but ultimately ill-equipped consumer protection agency. Further, it favors a strong status-quo bias by simply imposing a new set of regulations through a new government agency in Title II, which merely adds to the ineptitude of previous legislative acts that have already proved inadequate to prevent financial calamities created at the hands of TBTF companies.

Instead, the Administration should focus on ending TBTF privileges by forcing divestiture of financial institutions that pose systemic risk to the economy. Also, regulators should concentrate

BANKER, Sept. 18, 2009, available at http://www.americanbanker.com/issues/174_180/dodd_preps_bill_to_limit_fees_on_overdrafts-1002159-1.html (discussing how overdraft fee reform is “rapidly gaining momentum on Capitol Hill” where proposals to create an opt in policy with greater transparency and proportional fees could pass as early as this year. Bankers explain that “restricting overdraft fees would hit institutions . . . [because] it’s hard to make money in straight banking, so you have to have fee-based activities.” However, banks may have an uphill battle to fight as politicians such as Charles Schumer have publicly concluded that “debit cardholders are getting scammed by their banks”).

¹¹² *Id.*

¹¹³ Candace Choi, *As banks ease up on overdraft fees, customers could see new fees, products elsewhere*, S.F. EXAM’R, Sept. 23, 2009, available at <http://www.sfexaminer.com/economy/ap/60634867.html> (“Bank of America customers will no longer be charged overdraft fees when a customer’s account is overdrawn by less than \$10 a day. A \$35 fee will still be levied if the account isn’t brought into balance within five days . . . JPMorgan Chase says it won’t charge fees when accounts are overdrawn by \$5 or less. The maximum number of fees per day will be lowered to three from six . . . [Wells Fargo] will not charge a fee if a customer overdraws an account by \$5 or less, and will only charge that fee up to four times per day”).

on preventing new TBTF financial institutions from forming. Rather than codifying TBTF in the financial industry under the T1FHC label and imposing an enhanced set of prudential standards for creative banking attorneys to work around, the government should explicitly promise an end to taxpayer subsidies for negligently-managed financial institutions. TBTF banks show a continued flagrant disregard for consumer interests, and now is the time for real reform. There is an abundance of public outrage about how TARP fund recipients spent taxpayer dollars to overcharge their own customers in the wake of the worst financial crisis since the Great Depression. Lawmakers should capitalize on this outrage by passing meaningful legislation while they still have support in the court of public opinion.

Unfortunately, I fear that politicians lack the resolve and are too easily swayed by lobbyists. It is unlikely that the consumer will see an end to TBTF financial institutions. As demonstrated by the largely toothless proposed FSOC agency, even the Administration that ran on the idea of change is unable or unwilling to take the steps necessary to protect the consumer and the taxpayer from big banks. Title X of the reform proposal does not reconcile the implied authorization of Title II that impliedly permits T1FHCs to survive at all costs. Without sufficiently curbing the methods by which T1FHCs stay well-capitalized, the consumer can expect a variety of suboptimal banking conditions such as decreased or impersonal service, higher costs, more fees, and lower annual percentage yields on deposit accounts. Combine these disservices with additional consolidation and the result is markedly fewer banking options for consumers. Plus, since the government has already shown exceptional willingness to bail out large financial institutions while letting smaller ones fail, even those consumers with good alternative banking options may be inclined to put up with abusive practices at TBTF banks because of the subconscious security of government backing.

In sum, the regulatory reform proposal represents more of the status quo of banking policy of the last thirty years disguised as effective reform. Certainly, the consumer can count on some improvements as a result of this legislation, but ultimately this plan only works to forestall future economic calamities by TBTF financial institutions. In the meanwhile, the plan promotes a less-than-ideal banking environment for the average consumer.