SHEARMAN & STERLING LLP

FINANCIAL INSTITUTIONS ADVISORY & FINANCIAL REGULATORY

CLIENT PUBLICATION

May 28, 2013

# Too Early to Tell If Dodd-Frank Ends "Too Big To Fail"

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**The debate regarding "too big to fail" ("TBTF") has reemerged as a focus of regulators, legislators and the media. We review the regulatory activity since the Dodd-Frank Act was enacted and show that new proposals intended to address TBTF tend to put the policy cart before the regulatory implementation horse.**


By our count, regulators have amassed over 1,650 pages in proposed and final rules that seek to address TBTF, which we roughly define as proposals that seek to limit the size of financial institutions, the scope of their activities or otherwise seek to protect the Federal safety net (which we use as a term to refer to any Federal assistance, including deposit insurance). In addition, there are provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**DFA**") which address TBTF that do not require rulemaking.

Despite this volume of regulatory work to implement the DFA's reforms, which is mostly not yet complete, proposals for new measures are being put forward, including:

- legislation sponsored by Senators Sherrod Brown (D-Ohio) and David Vitter (R-Louisiana) that would impose new capital requirements that are significantly higher than those in place today, place limits on transactions banks can enter into with affiliates and place new restrictions on the use of the Federal safety net;[1]
- a proposal by Federal Reserve Governor Daniel Tarullo to place a cap on a bank's non-deposit liabilities as a fraction of US gross domestic product;[2]
- a proposal by Federal Reserve Governor Daniel Tarullo to implement additional capital surcharges for institutions reliant on short-term funding;[3] and

[1] S. 798, 113th Cong. (2013), available here.

[2] Daniel Tarullo, Governor of the Board of Governors of the Federal Reserve System, "Industry Structure and Systemic Risk Regulation" (Dec. 4, 2012), available here.

- a proposal by Richard Fisher, the President of the Federal Reserve Bank of Dallas, to limit access to deposit insurance and discount window loans to commercial banks.[4]

In addition to these proposals, additional reforms are being discussed in the United Kingdom and European Union, such as legislation to implement the "Vickers Report" in the United Kingdom and the "Liikanen Report" in various EU jurisdictions.

This note includes two parts. The first part is a diagram showing that the majority of the DFA's reforms that are most directly intended to address TBTF are aimed at limiting the scope of financial institution activities. These proposals also may limit size indirectly. Other proposals do not directly address size or scope (although they may indirectly), but are intended to limit risks to the Federal safety net. Our diagram shows these distinctions. Of course, to some degree, most of the DFA is intended to address TBTF, and so the proposals highlighted below are inherently under-inclusive and represent more of a "top ten" list than a comprehensive cataloguing. For example, derivatives reforms seek to bolster the stability of that market and its largest participants, and reforms to the mortgage and securitization markets are intended to address shortcomings that were exposed during the crisis and led to significant losses at financial institutions (but are not included on the diagram). But the proposals noted below are the ten aspects of the DFA that we judge to be most directly aimed at the size and activities of large banking organizations, and that should be completed before any new reform proposals are considered.

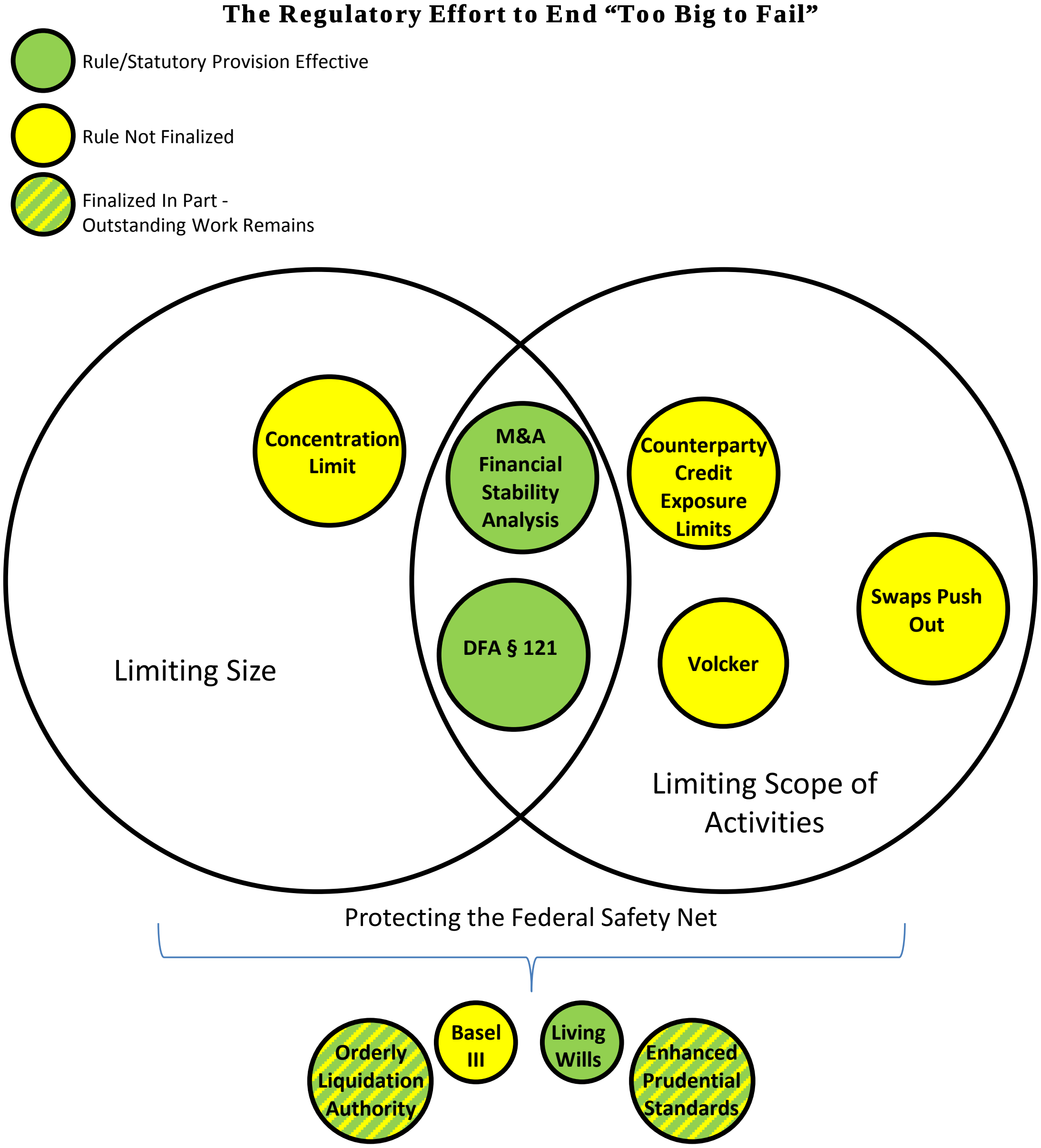
The second part is a chart that accompanies (and, in a soft copy of this note, is clickable from) the diagram and provides summary explanations of the ways in which the proposals noted in the diagram affect size and scope.  This chart provides links to the relevant primary source materials and Shearman & Sterling client publications on these issues.

While categorizing these reforms in this way cannot be scientifically precise, we seek to demonstrate that the DFA includes significant new regulatory tools to address TBTF, and most of these tools are not yet fully developed. Before new reforms are introduced, policymakers should take stock of the reforms in the DFA, not even three years old, and wait until these reforms are implemented by regulators and absorbed and understood by the market before initiating further action.

[3] Daniel Tarullo, Governor of the Board of Governors of the Federal Reserve System, "Evaluating Progress in Regulatory Reforms to Promote Financial Stability" (May 3, 2013), available here.

[4] Richard Fisher, President, Federal Reserve Bank of Dallas, "Ending 'Too Big to Fail': A Proposal for Reform Before It's Too Late (With Reference to Patrick Henry, Complexity and Reality)" (Jan. 16, 2013), available here.

**The Regulatory Effort to End "Too Big to Fail"**



## The Regulatory Effort to End "Too Big to Fail"

| RULE / PROPOSAL | OVERVIEW | LIMITATIONS ON SIZE AND SCOPE | PROTECTING THE FEDERAL SAFETY NET |
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| The Volcker Rule<br>(Section 619 of DFA) | Status:<br>Study by the Financial Stability Oversight Council ("**FSOC**") released in January 2011 (available here).<br>Proposal issued in October 2011 (Federal Reserve, OCC, FDIC, SEC, available here) and February 2012 (CFTC, available here). Not yet finalized.<br>In June 2012, the Federal Reserve issued a statement of policy (available here) regarding its February 2011 final rule on the Volcker Rule conformance period (available here).<br>You may refer to Shearman & Sterling's client publication regarding the proposed regulation here.<br>Description:<br>The "Volcker Rule" prohibits proprietary trading and certain investments in hedge and private equity funds. | Restrictions on proprietary trading may result in a reduction in underwriting and market making activities by large banks. In addition, restrictions on making investments in hedge and private equity funds will limit balance sheet growth in this area. | It is unclear whether the Volcker Rule ultimately will reduce risks to the Federal safety net. On the one hand, the Volcker Rule limits some categories of activities that may be "risky." On the other hand, the Volcker Rule may restrict diversification benefits by unduly limiting banks' ability to hedge risk and operate diverse businesses. |
| Single Counterparty Credit Exposure Limit ("SCCL")<br>(Section 165(e) of DFA) | Status:<br>Proposal issued in January 2012 by the Federal Reserve for domestic banks (available here) and December 2012 for foreign banking organizations (available here).<br>You may refer to Shearman & Sterling's client publications for the domestic and foreign proposals here and here, respectively.<br>Description:<br>The proposed SCCL would require "covered companies"[5] to limit their aggregate net credit exposure on a consolidated basis to any unaffiliated company to 25% of such covered company's capital stock and surplus. A more stringent 10% limit applies to covered companies with $500 billion in total consolidated assets for exposures | The imposition of an SCCL could result in a reduction in certain activities and size by limiting the capacity of the largest banks to engage in transactions with certain counterparties. | The SCCL is intended to address the issue of certain institutions being "too interconnected to fail." However, if adopted as proposed, the SCCL could push certain derivatives and other activities away from extensively regulated, prudently managed institutions to less regulated "shadow" firms with potentially lower-risk management standards, which in turn could increase risk to the Federal safety net through knock-on effects. |

[5] For the domestic proposal, "**covered company**" means any company organized under the laws of the United States or any State that the FSOC has determined shall be supervised by the Federal Reserve and for which such determination is still in effect (nonbank covered company), and any bank holding company (other than a foreign banking organization) that has $50 billion or more in total consolidated assets. The foreign proposal applies to foreign banking organizations with total consolidated assets of $50 billion or greater, with a more stringent limit for a foreign banking organization or US intermediate holding company with total consolidated assets of $500 billion or more. The foreign proposal applies to credit exposures at a number of levels, including the level of the intermediate holding company required under the proposal and combined US operations.

| RULE / PROPOSAL | OVERVIEW | LIMITATIONS ON SIZE AND SCOPE | PROTECTING THE FEDERAL SAFETY NET |
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| | to similarly sized covered companies, foreign banking organizations or nonbank financial companies designated by the FSOC for Federal Reserve supervision. | | |
| Other Enhanced Prudential Standards<br>(Sections 165 & 166 of DFA) | Proposal issued in January 2012 by the Federal Reserve for domestic banks (available here) and December 2012 for foreign banking organizations (available here).<br>Credit exposure reporting requirements were proposed along with the proposal for living will rules. Final rules for living wills were adopted (see below), but the credit exposure reporting rules are not yet finalized (Federal Reserve and FDIC's April 2011 proposal available here).<br>You may refer to Shearman & Sterling's client publications for the domestic and foreign proposals here and here, respectively.<br>Description:<br>Pursuant to Sections 165 and 166 of the DFA, the Federal Reserve has proposed enhanced prudential standards and early remediation requirements for domestic and foreign banking organizations. The proposed enhanced prudential standards include risk-based capital and leverage requirements, liquidity requirements, early remediation requirements, risk management and risk committee requirements, and a debt-to-equity limit. The standards also include stress testing requirements, which have been finalized for domestic banks (available here and here), but remain in the proposal stage for foreign banking organizations. In addition, the proposal for foreign banking organizations includes a requirement for an intermediate holding company for foreign banking organizations with $10 billion or greater of US assets (not including branches and agencies). | The proposed enhanced prudential standards do not directly limit the size of financial institutions or the scope of their activities. However, as heightened capital and liquidity requirements are implemented, financial institutions may limit certain activities due to the attendant regulatory costs. | In proposing enhanced prudential standards, the Federal Reserve stated that the proposal "would provide incentives for covered companies to reduce their systemic footprint and encourage covered companies to consider the external costs that their failure or distress would impose on the broader financial system, thus helping to offset any implicit subsidy they may have enjoyed as a result of market perceptions of implicit government support." This statement shows that the Federal Reserve intends for the enhanced prudential standards to lower the risk that the specter of failure of a large financial institution would result in Federal assistance to the institution.<br>To bolster this outcome, Federal Reserve Governor Tarullo has stated that there "is a clear need for a requirement that large financial institutions have minimum amounts of long-term unsecured debt that could be converted to equity and thereby be available to absorb losses in the event of insolvency" (see remarks available here). |
| Basel III | Status:<br>Proposal issued in June 2012 by the US Federal banking regulators (available here).[6] | New capital requirements could pressure banks to avoid businesses that involve assets with relatively high risk-weights, thus inhibiting balance sheet growth in | Capital requirements are intended to provide a buffer against losses and thereby avoid the need for banks to rely on the Federal safety net. However, capital also has attendant social costs, |

6 At the same time that the banking agencies proposed rules to implement Basel III, they also proposed rules for "advanced approaches" (available here) and "standardized approach" (available here) capital requirements, and finalized rules regarding market risk capital (available here).

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| | You may refer to Shearman & Sterling's client publication comparing US and EU efforts to implement Basel III here.<br>Description:<br>Basel III establishes a new set of global standards for capital adequacy (available here) and liquidity (available here, as revised in January 2013; original document available here) for banking organizations. The Basel Committee on Banking Supervision (the "**Basel Committee**") developed Basel III to supplement and, in certain respects replace, the existing Basel II standards, the composite version of which was issued in 2006 as an update to Basel I. The core elements of Basel III were finalized at the international level in 2010. | such areas. | such as reducing lending. |
| Credible Living Wills<br>(Section 165(d) of DFA) | Status:<br>Final rule adopted in November 2011 by the Federal Reserve and FDIC (available here); first round submissions were made in July and October 2012. Additional submissions are scheduled to be made later this year.<br>You may refer to Shearman & Sterling's client publication regarding the final living wills rule here.<br>Description:<br>Section 165(d) of the Dodd-Frank Act requires certain large financial institutions to prepare and periodically revise plans for their rapid and orderly resolution under the US bankruptcy code in the event of their material financial distress or failure. | Living wills alone do not directly affect the size of financial institutions and the scope of their activities. However, the DFA provides regulators with the authority to determine that a living will submission is "not credible," in which case the regulators, subject to certain conditions, are authorized to impose more stringent capital, leverage or liquidity requirements, or restrictions on the growth, activities or operations of the company. Eventually, under the statutory framework, the regulators could use the living wills process to force a firm to divest assets or operations. | Federal Reserve and FDIC officials have argued that living wills are a core element of reforms designed to mitigate risks to the US financial system and to contribute to the end of TBTF status for large financial institutions (see, for example, Federal Reserve Governor Tarullo's remarks available here, and FDIC Chairman Gruenberg's remarks available here). Recently issued guidance (available here) on the second submissions by last year's first-round filers indicates that the regulators may be willing to use the living wills process as a catalyst to reduce the size and complexity of large firms. |
| Orderly Liquidation Authority ("OLA")<br>(Title II of DFA) | Status:<br>The FDIC has adopted a number of rules to implement the OLA,[7] and has undertaken planning to develop a resolution strategy (the so-called "single point of entry" strategy; see here). For an overview of the FDIC's efforts, see here. | The OLA itself does not place limits on the size of financial institutions and scope of their activities. In fact, the OLA is intended to allow large, complex financial institutions to exist and fail without systemic consequences. However, if the FDIC determines that | The OLA is directly aimed at protecting the Federal safety net by allowing large, complex financial institutions to fail without the need for government assistance to avoid systemic consequences.[8] |

[7] The FDIC has adopted rules regarding the enforcement of subsidiary and affiliate contracts (see here); the treatment of mutual insurance holding companies (see here); priority of payments and determination of claims under OLA (see here); treatment of similarly situated creditors, personal services agreements, contingent obligations, and certain other matters (see here); and calculation of the "maximum obligation limit" (see here).

[8] Section 214(a) of the DFA provides that "[n]o taxpayer funds shall be used to prevent the liquidation of any financial company" under the OLA, and Section 214(c) provides that "[t]axpayers shall bear no losses from the exercise of any authority under" Title II.

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| | In addition, market participants conducted a simulation exercise of the OLA (see here).<br>Description:<br>The OLA provides the FDIC new authorities to resolve systemically important financial institutions. This new framework is intended to allow the FDIC to resolve a SIFI without risking significant cascading losses across the financial system and broader economy. | size or complexity are likely to inhibit an orderly resolution under the OLA, the FDIC may seek to use other regulatory authorities to limit size and scope (such as the living wills process). | |
| Concentration Limit<br>(Section 622 of DFA) | Status:<br>Not yet proposed.[9]<br>Description:<br>Section 622 of the DFA, which was proposed by President Obama along with the Volcker Rule (see here), prohibits certain financial companies from acquiring or merging with another company if the total consolidated liabilities of the acquiring company would exceed 10% of aggregate consolidated liabilities of all financial companies at the end of the calendar year preceding the transactions, subject to certain exceptions for acquisitions: (i) of failing banks, (ii) with respect to which the FDIC is providing assistance under Section 13(c) of the Federal Deposit Insurance Act, and (iii) that would result only in a *de minimis* increase in the liabilities of the financial company. | Section 622 directly limits size by restricting the growth of financial companies through mergers and acquisitions. | The concentration limit is intended to prevent banks from becoming TBTF by growing through mergers and acquisitions. However, in the absence of implementing regulations by the Federal Reserve, key details of the application of this provision remain uncertain. For example, it is not clear how the Federal Reserve will measure the aggregate consolidated liabilities of all financial companies or whether such measurement will be publicly available. |
| Swaps Push-Out<br>(Section 716 of DFA) | Status:<br>Rules not proposed (rulemaking is discretionary). In May 2012, the Federal banking regulators issued guidance on the effective date of the swaps pushout provision (available here). In January 2013, the OCC issued guidance on its intent to favorably consider requests for a transition period under the swaps push out provisions (available here).<br>Description:<br>Section 716 of the DFA prohibits the provision of "Federal assistance"[10] to | The swaps push-out provision could limit the size of swaps entities' balance sheets by limiting the scope of swaps activities that such entities can conduct. Separately capitalized affiliates can indirectly limit bank lending, assuming no additional capital is raised at the group level. | On the one hand, the swaps push-out provision limits the "risky" swaps activities that swaps entities can undertake and therefore reduces the risk that these activities could lead to the need for a bail out. On the other hand, the provision limits the flexibility swaps entities will have to manage risk, which could be counterproductive to the goal of protecting the Federal safety net. |

9 Pursuant to Section 622(e) of the DFA, in January 2011 the FSOC issued recommendations regarding the implementation of the concentration limit, including recommendations regarding the definition of "liabilities" for certain companies, the collection, aggregation, and public dissemination of concentration limit data, and the acquisition of failing insured depository institutions. Financial Stability Oversight Council, Study and Recommendations Regarding Concentration Limits on Large Financial Companies (Jan. 2011), available here.

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| | any "swaps entity"[11] with respect to any swap, security-based swap or other activity of the swaps entity, subject to certain conditions and exceptions. | | |
| Federal Reserve Financial Stability Analysis in Evaluating Mergers & Acquisitions<br>(Sections 604(d) and (e)) | Status:<br>Effective (rulemaking not required).<br>Description:<br>Section 604(d) of the DFA amends the Bank Holding Company Act to require the Federal Reserve, when evaluating mergers and acquisitions, to take into consideration "the extent to which a proposed acquisition, merger or consolidation would result in greater or more concentrated risks to the financial stability of the United States banking or financial system." Similarly, Section 604(e) of the DFA requires the Federal Reserve to consider whether a proposed acquisition by a banking organization of a nonbank presents "risks to the stability of the United States banking or financial system."<br>The Federal Reserve has issued two orders approving transactions that include an analysis of this new "financial stability" factor: an order approving Capital One Financial Corporation's acquisition of ING Bank, fsb (available here) and an order approving the acquisition of RBC Bank (USA) by The PNC Financial Service Group, Inc (available here). | While the Federal Reserve has not yet denied an application based on this new "financial stability" factor, these provisions of the DFA provide the Federal Reserve with new authority to limit growth and consolidation by acquisitions. In addition, the orders that the Federal Reserve has issued that include a financial stability analysis provide the Federal Reserve with flexibility to determine that a proposed transaction presents risks to the stability of the US banking or financial system due to the size or complexity of the proposed combination. | It seems that these provisions of the DFA are intended to provide the Federal Reserve with a new tool that can be used to prevent financial institutions from becoming too big or too interconnected to fail. The Federal Reserve's interpretations of these new provisions to date provide the Federal Reserve with sufficient flexibility going forward to use this tool more aggressively if it determines to do so. |
| Mitigation of Risks to Financial Stability<br>(Section 121 of | Status:<br>Effective (rulemaking not required).<br>Description:<br>Section 121 of the DFA provides that, | Section 121 provides the Federal Reserve and the FSOC with direct authority to limit the scope of a financial institution's activities and require a | Section 121 theoretically allows the Federal Reserve and FSOC to limit the scope of a financial institution's activities and its size to prevent the firm from |

[10] "Federal assistance" is defined as the use of any advances from any Federal Reserve credit facility or discount window that is not part of a program with broad-based eligibility under section 13(3)(A) of the Federal Reserve Act and FDIC insurance or guarantees for the purpose of: (A) making any loan to, or purchasing any stock, equity interest, or debt obligation of any swaps entity; (B) purchasing the assets of any swaps entity; (C) guaranteeing any loan or debt issuance of any swaps entity; or (D) entering into any arrangement (including tax breaks), loss sharing, or profit sharing with any swaps entity.

[11] "Swaps entity" means any swap dealer, security-based swap dealer, major swap participant, major security-based swap participant that is registered under the Commodity Exchange Act or the Securities Exchange Act of 1934. The term "swaps entity" does not include any major swap participant or major security-based swap participant that is an insured depository institution. In addition, the term "swaps entity" does not include any insured depository institution under the Federal Deposit Insurance Act or a covered financial company under Title II of the DFA which is in conservatorship, receivership, or a bridge bank operated by the FDIC.

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| DFA) | upon an affirmative vote of not fewer than two-thirds of the FSOC, the Federal Reserve may require that a bank holding company with $50 billion in total consolidated assets or more or a nonbank financial company designated by the FSOC for Federal Reserve supervision: (i) be limited in its ability to offer a product or service, (ii) require such company to terminate one or more activities, (iii) conduct certain activities in accordance with conditions set by the Federal Reserve, or (iv) if the foregoing are "inadequate to mitigate a threat to financial stability of the US," sell or transfer assets or off-balance sheet items to unaffiliated entities.<br>To take these actions, the Federal Reserve must determine that the company "poses a grave threat to the financial stability of the United States." | financial institution to reduce its size by asset dispositions.<br>The "grave threat" standard is not defined, and it is not clear whether a financial institution must be in financial distress to pose a "grave threat" to financial stability. | taking actions that could threaten the Federal safety net. |