After the Crisis: Revisiting the "Banks Are Special" and "Safety Net" Doctrines

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ABSTRACT

The idea that banks are special was most succinctly summarized by Gerald Corrigan more than 30 years ago in an analysis prepared for the Federal Reserve Bank of Minneapolis, where Corrigan was president at the time. With the help of his mentor, then Federal Reserve Chairman Paul Volcker, his analysis pondered the characteristics of banks that make them special; justified the provision of a supporting safety net for banks based on financial stability concerns; and detailed the costs and restrictions that banks must subject themselves to. But the years since Corrigan's analysis have seen two severe financial crises, and as the crisis of 2007–2009 clearly revealed, banks are not special, as the safety net was applied to a wide range of nonbank institutions. The Dodd-Frank Act was intended to cut back on the safety net by giving financial authorities wide discretion, but the right approach to rein in the safety net would be to cut back its beneficiaries.

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The financial turbulence of 2007 to 2009 and the response by the financial authorities have brought to the fore the topic that has been examined again and again during the last 35 years: Are banks special? How this question is answered is tied closely to the breadth of the safety net. As the crisis unfolded and the safety net was expanded to cover a broad range of financial institutions, much of the analysis of the specialness of rescued institutions was done on an ad hoc basis, literally in the middle of the night and on the fly, without full consideration of the long-term policy consequences for each individual institution or broad-based program intervention.

The legislative process for the Dodd-Frank Act[1] afforded an opportunity to apply a more measured and coherent approach to the question of the place of banks, insurance companies, investment banks, and other types of financial institutions in the financial system, as well as the contours of the safety net. However, the final Dodd-Frank legislation gave a mixed response to the question of whether banks remain special, and the weak analytical basis for the new statutory provisions was perpetuated forward from the days of the crisis. Most provisions codified a legal infrastructure that applied a similar regime across the range of financial institutions. By contrast, one major provision of the legislation, the Volcker Rule, continued to apply a bright-line rule between banks and other financial institutions, narrowly perpetuating the idea that banks are still special. More recently, the reconsideration of banks and the safety net has led a handful of senators to revisit the related question of the separation of commercial banking and investment banking and to call for a return to the Glass-Steagall construct that was initiated during the 1930s.[2]

The policy history shows that the justifications for the notion that banks are special and the ensuing government support have been arbitrary in nature,

1. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 11-203, 124 Stat. 1379 (2010).
2. Banking Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (1933).

both post hoc and ad hoc, and have not led to promised financial stability. A better approach would dispense with the investment-based debate about whether banks are special and instead narrowly shape the safety net to protect only small, individual, demand creditors.[3]

1. THE ORIGINAL CORRIGAN FORMULATION

Legend has it that Gerald Corrigan, then president of the Federal Reserve Bank of Minneapolis, and Paul Volcker, then chairman of the Federal Reserve, were in a late-night brainstorming session, and Volcker convinced Corrigan to write a "think piece" on the characteristics of banks, including the scope of activities banks should be allowed to offer and whether banking and commerce should continue to be separated.[4] The analysis on the state of banks was ultimately published in an essay in the 1982 annual report of the Federal Reserve Bank of Minneapolis, entitled "Are Banks Special?"[5] Normally, a commentary from an annual report of one of the Federal Reserve Banks would not attract much attention. However, given the secretive nature of the Federal Reserve, this analysis raised a great many eyebrows almost immediately, as noted in the *Wall Street Journal*, which called Corrigan's analysis "the most thorough statement in recent months of Federal Reserve views on major banking controversies."[6]

That statement has had staying power. Even though it was published more than 30 years ago, it has had a pervasive impact on the thinking of the staff and senior management of the Federal Reserve Board in Washington, the Reserve Banks, and the banking industry as a benchmark in discussions on the parameters of banking powers, constraints, and the safety net. Just months

3. There is a vast literature on the effects of monetary policy on the real economy via the credit channel. See Chairman Ben Bernanke, "The Financial Accelerator and the Credit Channel," speech at the Credit Channel of Monetary Policy in the Twenty-First Century Conference, June 15, 2007, http://www.federalreserve.gov/newsevents/speech/bernanke20070615a.htm. The discussion about credit channels in part gives rise to the view that banks are special and that failure of connected institutions can lead to deflationary pressures on the economy. This paper does not delve into those specific arguments. Rather, it tracks the history of how the view that banks are special came to be incorporated into public policy.
4. E. Gerald Corrigan, "Are Banks Special? A Revisitation," *Region*, Federal Reserve Bank of Minneapolis website, March 1, 2000, http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=3527.
5. E. Gerald Corrigan, "Are Banks Special?," *Annual Report: Federal Reserve Bank of Minneapolis*, January 1982, https://www.minneapolisfed.org/publications/annual-reports/ar/annual-report-1982-complete-text.
6. As quoted in Golembe Associates, "Are Banks Special?," no. 3 (1983): 2.

before the turmoil that began in 2007 and continued through 2009, Federal Reserve Governor Mark W. Olson revisited the Corrigan analysis in a speech before the Institute of International Bankers and concluded that "a strong case can be made that banks continue to be special. And because they are special, we, as regulators, will continue to apply high standards to companies seeking a bank charter."[7]

1.1. Corrigan's Three Traits That Make Banks Special

The precise meaning of "special" is obvious upon a quick reading of the first page of Corrigan's article, which starts out with a contrast between (1) those who see one big "financial services industry" that should be looked upon as a single entity, with little or no distinction between the various types of institutions (banks are not special), and (2) those associated with the "separation of banking from commerce and investment banking" who believe that specialization has worked well (banks are indeed special). In particular, the Corrigan analysis focuses on three traits of banks that make them special:

- They offer transaction accounts. They incur liabilities payable on demand at par that are readily transferable by the owner to third parties.
- They are the backup source of liquidity for all other institutions. This is the case for all other classes and sizes of institutions, both financial and nonfinancial, particularly when the financial system is under stress.
- They are the transmission belt for monetary policy. This is evidenced by a direct link between banks and the central bank's lender of last resort function and by the fact that banks are subject to reserve requirements.

The concept of a bank under Corrigan's construct included "commercial banks, thrifts, and credit unions" as well as some "nonbank" banks, which are not considered full-scale banks because they do not offer both lending and deposit services.[8]

7. Mark W. Olson, member of the Board of Governors of the US Federal Reserve, "Are Banks Still Special?," remarks at the Annual Washington Conference of the Institute of International Bankers, Washington, DC, March 13, 2006. See also Brian Browdie, "Are Banks Special? Three Decades On, the Question Endures," *American Banker*, July 1, 2013.
8. Corrigan, "Are Banks Special?" (1982).

1.2. The Privilege and Price of Being Special: Access to the Safety Net and Regulatory Limitations

In his analysis, Corrigan also made a direct connection between these enumerated traits and access to the public safety net, which included government deposit insurance, direct access to the discount window for borrowings in the form of lender of last resort loans, and direct access to the Federal Reserve's payment services. But banks also had to accept the following as a quid pro quo: being subject to reserve requirements and mandates regarding community reinvestment, a regime of safety and soundness regulation and supervision, separation of banking from commerce and investment banking, and other operating restrictions, such as limits on the scope of banking services and interest rate ceilings imposed during the 1930s under Regulation Q, which have since been fully phased out.[9] Table 1 summarizes all the characteristics, benefits, and limitations of a financial institution that is labeled a bank. For Corrigan, banks are special to an extent that justifies this package of intertwined elements, with the public underwriting any costs that might flow from offering the safety net, offset by granting the Federal Reserve and other financial agencies the power to impose restrictions on risk.

TABLE 1. STATE OF SPECIAL CHARACTERISTICS, BENEFITS, AND LIMITATIONS OF BANKS, CIRCA 1982

Bank characteristics	• Take deposits through transaction accounts • Supply credit in role as backup supplier of liquidity • Integral to monetary policy
Benefits to banks: access to the public safety net, particularly during times of stress	• Deposit insurance combined with liquidation under bank-specific procedures • Access to the discount window (lender of last resort) • Access to the payment system • Solvency support (bailouts)
Restrictions on banks	• Safety and soundness regulation and supervision • Separation of banking from commerce and investment banking and other limits on scope of banking services • Reserve requirements • Regulation Q ceilings on payment of interest

Source: E. Gerald Corrigan, "Are Banks Special?," *Annual Report: Federal Reserve Bank of Minneapolis*, January 1982. Author's analysis (solvency support added).

9. Corrigan, "Are Banks Special?" (1982); Joshua Feinman, "Reserve Requirements: History, Current Practice, and Potential Reform," *Federal Reserve Bulletin* (June 1993): 570; R. Alton Gilbert, "Requiem for Regulation Q: What It Did and Why It Passed Away," *Federal Reserve Bank of St. Louis Review* (February 1986): 22–37.

Corrigan attributed this link to the safety net to the relationship between deposits, public confidence, and the economic activity being funded, because the safety net acts as a backstop, particularly in times of stress (deposit drains or bank runs):

> Banks and bank regulators have long since recognized the importance of banks acting in ways that preserve public confidence in banks' capacity to meet their deposit obligations, thereby minimizing the likelihood of large, sudden drains of bank deposits. Deposit insurance and direct access to the lender of last resort are uniquely available to banks to reinforce that public confidence. Indeed, deposit insurance and access to the lender of last resort constitute a public safety net under the deposit taking function of banks. The presence of this public safety net reflects a long-standing consensus that banking functions are essential to a healthy economy. . . . Thus, while deposit insurance and access to the lender of last resort may rightly be viewed as the public policy safety net under banks' deposit taking function, the integrity of the deposit taking process and therefore the strength of the public safety net process depend to a substantial degree on the prudent management and control of risks on the part of the banking system as a whole.[10]

Although it did not play as prominent a role in the public safety net in 1982 as it has since that time, solvency support (also known as bailouts) for insolvent institutions should be properly listed as a part of the safety net, and it is reflected in table 1, even though Corrigan did not broach the topic in 1982. As opposed to explicit and well-defined guarantee programs such as deposit insurance, solvency support is an implicit guarantee in that the decision about whether or not such support is granted and the extent of support is not precisely known until an institution approaches failure. This evolution of solvency support reveals the expansion of the methods for dealing with failing institutions beyond the mere option of fully secured discount window lending and coverage of insured deposits.

This structure of benefits and costs has slowly evolved, with most of the changes linked to various financial crises during the earlier part of the 20th century:

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10. Corrigan, "Are Banks Special?" (1982).

1. After the Panic of 1907, Congress created the Federal Reserve with powers to provide discount window lending, impose reserve requirements, and supervise and regulate institutions, although the National Bank Act of 1863 had imposed a prior system of reserve requirements and supervision. National payment systems (such as the Federal Reserve Wire Network, known as Fedwire) had their genesis shortly after the creation of the Federal Reserve.[11]
2. In the wake of the Great Depression of the 1930s, deposit insurance was codified on the federal level; commercial banking and investment banking were separated (Glass-Steagall); the power to provide solvency support to "individuals, partnerships, and corporations"[12] was granted to the Federal Reserve; and Regulation Q ceilings were introduced.
3. After the Great Depression ran its course, in the 1950s the Federal Deposit Insurance Corporation (FDIC) was granted the power to engage in solvency support of insolvent institutions—the so-called open bank assistance (OBA)—on a permanent basis.

2. CORRIGAN'S UPDATED CONSTRUCT

As the decades passed and Gerald Corrigan moved on from his post at the Federal Reserve Bank of Minneapolis to a stint as president of the Federal Reserve Bank of New York and then to managing director of Goldman Sachs & Co., he regularly provided updates on how his views on the nature of banks were evolving in order to keep up with ongoing changes in the financial industry. These updates primarily reflected reconsideration of Glass-Steagall restrictions and the ultimate passage in 1999 of the Gramm-Leach-Bliley Act (GLBA),[13] as well as the developing concept of systemic risk.

2.1. Developments That Prompted Corrigan's Revisitation

One of the most dramatic developments after 1982 was the reconsideration of the separation of commercial banking and investment banking. Because the

11. Feinman, "Reserve Requirements"; Board of Governors of the Federal Reserve, "The Federal Reserve Discount Window," July 21, 2010; Federal Reserve Bank of New York, "Fedwire and National Settlement Services," June 2009, http://www.newyorkfed.org/aboutthefed/fedpoint/fed43.html.
12. Federal Reserve Act § 13(3), 12 U.S.C. 343 (added as part of the Emergency Relief and Construction Act of 1932).
13. Gramm-Leach-Bliley Act of November 12, 1999, Pub. L. No. 106-102, 113 Stat. 1338.

securities activities of commercial banks were thought to have contributed to the stock market crash and the thousands of bank failures during the 1920s and early 1930s,[14] Congress included the Glass-Steagall provisions in the Banking Act of 1933. Commercial banks (under section 16) and their holding companies and affiliates (under sections 20 and 32) were forbidden from undertaking investment banking activities. Additionally, section 21 prevented investment banking companies from accepting deposits. During the 1970s the Glass-Steagall restrictions began to erode, with commercial banks offering securities and corporate finance services (primarily flowing from directives from the Federal Reserve), with investment banks assisting corporations with funding through bond issuances, and with money market mutual funds offering a deposit-like instrument with higher interest yields than offered by banks restricted by Regulation Q. The erosion continued in the 1980s and early 1990s with commercial banks offering discount brokerage services and limited underwriting of corporate securities. Developments in securitization moved assets such as mortgages, credit card receivables, and auto and consumer loans from bank balance sheets into the securities market.[15]

Before 1982, solvency support for banks had primarily taken the form of lending and investments through the Reconstruction Finance Corporation, which was a temporary program during the Depression. The power to provide solvency support became a permanent, standing power of open bank assistance through the FDIC, which was approved as part of the Federal Deposit Insurance Act of 1950 and used intermittently through 2009. At the time of Corrigan's analysis in 1982, there had been eight

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14. Much of the impetus for the legislation was from the Pecora Investigation (an inquiry initiated by the US Senate in 1932 to investigate the causes of the Wall Street Crash of 1929), which was highly critical of the financial industry.
15. Lawrence J. White, "The Gramm-Leach-Bliley Act of 1999: A Bridge Too Far? Or Not Far Enough?," *Suffolk University Law Review* 43, no. 4 (2010).

(mostly small) OBA bailouts, the largest of which was First Pennsylvania Bank of Philadelphia in 1980. Ultimately, as the financial crisis of the 1980s and early 1990s unfolded, the OBA power evolved to primarily address so-called systemic or too-big-to-fail institutions because of concern over the interconnections at these institutions and the potential secondary impact if one of these institutions failed. The support of Continental Illinois, First City Texas, First Republic Bank, and Bank of New England in 1984, 1988, 1988, and 1991, respectively, demonstrated the use of this power.[16]

In September 1998 the Federal Reserve Board approved the Citicorp-Travelers merger, which created Citigroup, the first US banking organization that was allowed to offer comprehensive banking, securities, and insurance services. The board approved the merger despite the fact that it was not entirely clear—based on a plain reading of the law—that these diverse businesses could coexist under Glass-Steagall. Nonetheless, the board gave Citigroup a five-year charter to operate as a universal bank. Within that five-year window, GLBA was approved, which swept away the prior legal restraints on affiliations among banks, securities firms, and insurance companies. It did so by repealing articles 20 and 32 of the Banking Act of 1933, but it did not repeal sections 16 (commercial banks underwriting or dealing in securities) and 21 (securities underwriters and dealers barred from accepting deposits).[17]

2.2. Corrigan's Revisitation and Reformulation of Banks' Specialness

During 1991 in his capacity as president of the Federal Reserve Bank of New York, Corrigan testified before the US House of Representatives' Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce in response to a Treasury Department analysis on modernization of the financial system.[18] He did not focus on the topic of the special attributes of banks as outlined in his 1982 analysis, so much as his thoughts

16. The power reached its height with the multiple individual institution bailouts during the most recent crisis that the FDIC approved for Wachovia, Citibank, and Bank of America in 2008 and 2009. Vern McKinley, *Financing Failure: A Century of Bailouts* (Oakland, CA: Independent Institute, 2012), 81–94 (Continental), 94–95, 104 (First City, Bank of New England, First Republic Bank), 237–47 (Wachovia), 251–55 (Citibank), and 256 (Bank of America).
17. Arthur Wilmarth, "How Should We Respond to the Growing Risks of Financial Conglomerates?" (Public Law and Legal Theory Working Paper No. 034, 2001), 1–4; Peter J. Wallison, "Five Myths about Glass-Steagall," *American* (American Enterprise Institute), August 16, 2012.
18. Treasury Department, "Modernizing the Financial System: Recommendations for Safer, More Competitive Banks," February 1991.

on the potential combination of banking and securities firms and the resulting impact on the safety net. He endorsed the Treasury's proposed partial repeal of Glass-Steagall, arguing that combinations of commercial and investment banking would not raise the same concerns as combinations of banking and commerce. This would be the case given their "congeneric" nature and as long as securities activities were conducted in separate holding company subsidiaries and the Federal Reserve was given consolidated supervision over the holding company for financial conglomerates.[19] Corrigan's stance signaled movement away from a strict interpretation of what he called the "separation doctrine" back in 1982.[20] Additionally, Corrigan elaborated on the concept of the transmission of "systemic risk" as the primary rationale for the safety net, presumably in line with developing intervention in this regard:

> The missing link [that justifies the creation of a safety net] is, of course, what central bankers and others call "systemic risk." By systemic risk I mean the clear and present danger that problems in financial institutions can quickly be transmitted to other institutions or markets, thereby inflicting damage on those other institutions, their customers, and ultimately, to the economy at large. More than anything else, it is the systemic risk phenomenon associated with banking and financial institutions that makes them different from gas stations and furniture stores. It is this factor—more than any other—that constitutes the fundamental rationale for the safety net arrangements that have evolved in this and other countries.[21]

Shortly after the Federal Reserve Board's approval of the Citicorp-Travelers merger, in 2000 (and after he had joined Goldman Sachs), Corrigan formally revisited his analysis, noting that "a great deal has changed since 1982." The primary changes Corrigan considered were the GLBA and "the severe banking sector problems that have been witnessed in so many countries—

19. E. Gerald Corrigan, president of the Federal Reserve Bank of New York, Statement before the Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce, US House of Representatives, April 11, 1991.
20. "This view is associated with the historical separation of banking from commerce and from investment banking. In general, this separation doctrine in banking grew out of concerns about concentration of financial power, possible conflicts of interest and the appropriate scope of risks banks should incur in the face of the special trusteeship falling on institutions that engage in the lending of depositors' money." Corrigan, "Banks are Special" (1982).
21. Corrigan 1991 testimony.

including the United States—over the past two decades." One of the major reasons for revisiting all these issues was to take on "the question of whether so much has changed since 1982 as to either narrow or broaden the class of institutions having access to the safety net, or to redesign certain aspects of the safety net, or both."[22]

Corrigan cited a number of changes in the landscape for the three traits of banks that make them special, but he remained committed to the idea that banks are still special:

- Transaction accounts: The "checkable money market mutual fund" continues to be popular as a potential substitute for bank deposits, but it still fails "the test of being payable on demand at par."
- Backup source of liquidity: "It remains highly unlikely that nonbanks . . . can provide very large amounts of liquidity on short notice, such as the surge in bank funding of the securities industry which occurred at the time of the 1987 stock market crash."
- Transmission belt for monetary policy: "Nonbank financial institutions specifically, play a much larger role than they once did in the transmission of monetary policy changes to the economy," but "it remains largely true that most monetary policy targets and indicators . . . [remain] uniquely associated with banking institutions."

In his revisitation, Corrigan emphasized that "the provisions of GLBA [were] sweeping" and that it resolved many of the issues that he grappled with as part of his "Are Banks Special" analysis:

> First, whether expanded activities for banks should be conducted through operating subsidiaries of banks or through subsidiaries of a bank holding company; second, whether or to what extent, to alter the doctrine regarding separation of banking and commerce; and third whether to preserve the narrow linkage between "banks" and full scale access to the so-called safety net as defined earlier. The 1982 essay answered these questions by: (1) favoring the bank holding company model; (2) strongly opposing the breakdown of the separation of banking and commerce; and (3) preserving the narrow link of extending the full-scale safety net only to banks.

22. Corrigan, "A Revisitation" (2000).

> Relative to these three central issues, [GLBA] stacks up rather well. It preserves the narrow link between banks and the safety net, and it rejects the blending of banking and commerce while providing some added flexibility for merchant banking. With regard to the bank subsidiary v. bank holding company question . . . GLB permits certain activities . . . to be housed in bank subsidiaries while other activities (including merchant banking) would be housed in subsidiaries of the bank holding company.[23]

Corrigan noted that the jury was still out on the question of undertaking activities in a bank subsidiary as opposed to the bank holding company, but the key issue was which one is "superior to the other in insulating the safety net from problems that might arise outside the bank, but within the group as a whole," and he remained "firmly of the view that the holding company provides the greater assurance." Corrigan's overall conclusion in his revisitation was that GLBA "seems to acknowledge that banks are special. Indeed, the Act is both powerful and progressive in providing a coherent framework to guide the next phase of the evolution of banking and finance in the United States." Within a decade, the crisis during 2008 and 2009 would clearly test this framework, and the efficacy of the GLBA changes would be at the center of the debate over the causes of the crisis and the needed legislative changes in its aftermath.

3. ALTERNATIVE VIEWS ON THE IDEA THAT BANKS ARE SPECIAL

Corrigan's policy piece was not met with universal praise within the banking industry or by academics specializing in banking policy. Both contemporary and more recent critiques have directly questioned Corrigan's analysis of banks being special.

3.1. Golembe's Critique of Corrigan

One of the pioneering consulting firms in finance and policy, Golembe Associates Inc., published an early critique of the idea that banks are special. The initial Golembe analysis in April 1983 harshly restated Corrigan's analysis as banks are "too 'special' to allow continued deterioration in the distinctions between them and other types of financial institutions" and as an effort by the

23. Corrigan, "A Revisitation" (2000).

“Unlike Corrigan, Kaufman makes a clear distinction between a drain on a single institution . . . and a drain on the entire system.”

“Federal Reserve, and presumably many sympathizers in the Congress and elsewhere . . . [to] turn back the clock to a simpler, more familiar and comfortable financial regime, simply by re-insulating banking from other forms of enterprise.” It openly questioned Corrigan’s hypothesis that “specialization of financial institutions has worked well” and belittled his policy model as being based on “faith and unstated assumption.” It also highlighted the confidence of those in the Federal Reserve Board and Reserve Banks to take on additional powers, a comment that could just as easily apply to the aftermath of the 2007–2009 financial crisis and their efforts to attain expanded powers: “The Federal Reserve seems to have enormous confidence in its ability to solve a wide array of economic problems, if only it is granted the necessary regulatory authority. That hurdle is easily overcome simply by calling everything in sight a ‘bank.’”[24]

Later comments by the firm’s principal, Carter Golembe, in a 1998 interview, went further: “In a sense, the ‘specialness’ [Corrigan] was talking about was one largely created by government, whose rules could not really keep pace with the market. Banks were probably special then but not nearly as special as Corrigan said they were, and today they are not nearly as special as they were in 1982, because of the changes that have taken place. With each passing year, they become less special.”[25]

3.2. Federal Reserve Bank of Dallas Economists’ Critique of Corrigan

A trio of economic analysts from the Federal Reserve Bank of Dallas questioned the need for a regime of regulation as described by Corrigan by focusing on the cost of bank failures. They refer to Corrigan’s work as “famous” and note that it is “exceptional for clearly making the case for

24. Golembe, “Are Banks Special?,” 2, 4–6. The commentary was actually penned by Bruce Morgan.
25. “Interview with Carter H. Golembe,” *Region*, Federal Reserve Bank of Minneapolis website, June 1998.

regulating banks" and that it is worthy of being a "benchmark" for purposes of formulating a theory of regulation. However, they then present the case, based on an analysis of nearly 600 bank failures in Texas from 1981 to 1991, that bank closures had no significant negative effects on employment and relatively little effect on economic conditions. As a result, they question the argument that a regime of regulation is justified in order to maintain and protect the institution of banking.[26]

3.3. Kaufman's Critique of Corrigan

Related research by George Kaufman also undermines the argument that the threat of runs on banks triggers the need for an expansive safety net by highlighting the positive aspects of bank runs combined with the timely resolution of bank failure.[27] Unlike Corrigan, Kaufman makes a clear distinction between a drain on a single institution—which does not necessarily have implications for contagion and systemic risk—and a drain on the entire system.

3.4. England's Critique of Corrigan

Another critical analysis that uses the same title as Corrigan's analysis was penned by Catherine England, who was at the time director of regulatory studies at the Cato Institute. Although she does not mention Corrigan or his analysis by name, England concluded that banks are special, but "they are special primarily because of government policies" and "U.S. banks in particular have been made special by the web of intervention that surrounds them." Her analysis was prescient in that it identified a then developing political trend that would apply to today's nonbank institutions: "Banks and their customers have become increasingly dependent on continuing subsidies and protections provided by the government" and "attempts to protect banks through federal deposit insurance, discount window loans, and government-directed closure systems have largely removed U.S. banks from the realm of market discipline."[28]

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26. Robert T. Clair, Gerald P. O'Driscoll Jr., and Kevin J. Yeats, "Is Banking Different? A Reexamination of the Case for Regulation," *Cato Journal* 13, no. 3 (Winter 1994). During that crisis, 590 banks failed, but no examples of contagion (systemic risk per Corrigan) were evident.
27. George G. Kaufman, "Bank Runs: Causes, Benefits, and Costs," *Cato Journal* 7, no. 3 (Winter 1988): 559–87. Kaufman cites Corrigan in note 33, p. 579, but he does not otherwise directly address Corrigan's work in the body of the analysis.
28. Catherine England, "Are Banks Special?," *Regulation* (Spring 1991): 25, 33.

4. HOW LARGE WAS THE PRECRISIS SAFETY NET?

Even after the GLBA changes, Corrigan emphasized the "narrow link" between banks and the safety net, but he did not make much effort to measure the size of that safety net. Although there are methodological challenges in estimating the size of the safety net, doing so is essential in determining how the safety net has changed over time, and in particular, over the course of the most recent crisis. John Walter and John Weinberg attempted to estimate the size of the financial safety net using data from before the 2007–2009 financial crisis. Their results are detailed in table 2.[29]

TABLE 2. ESTIMATE OF THE SIZE OF THE SAFETY NET, PRECRISIS, CIRCA 1999 (IN BILLIONS)

	Explicitly guaranteed liabilities	Implicitly guaranteed liabilities	Total guaranteed liabilities	Total liabilities
Commercial banks, savings institutions, credit unions	3,176 (50%)	820 (13%)	3,996 (63%)	6,338
Government-sponsored enterprises	0	2,620 (100%)	2,620 (100%)	2,620
Other financial firms	0	0	0	7,723
TOTAL	3,176 (19%)	3,440 (21%)	6,616 (40%)	16,681

Source: John R. Walter and John A. Weinberg, "How Large Is the Federal Financial Safety Net?," *Cato Journal* 21, no. 3 (Winter 2002).

Note: Private employer pension funds excluded from the analysis; percentage is of total liabilities.

For "banks" the estimate included the explicit coverage of deposit insurance, but it also covered the potential implicit coverage through solvency support. Walter and Weinberg's estimate differs from Corrigan's definition of the safety net in that it includes government-sponsored enterprises (GSEs) as part of the safety net, notwithstanding the fact that these institutions are not special under Corrigan's formulation. The guarantee for GSEs was implied, mostly due to prior interventions of the government in bailing out GSEs (Fannie Mae and the Farm Credit System, for example) during the 1980s. As Walter and Weinberg stated, historical examples "could well create a public perception that similarly situated borrowers will be assisted if problems arise in the future."[30] That turned out to be the case with Fannie Mae and Freddie Mac.

29. John R. Walter and John A. Weinberg, "How Large Is the Federal Financial Safety Net?," *Cato Journal* 21, no. 3 (Winter 2002).
30. Ibid.

Guaranteed liabilities for financial institutions equaled $6.6 trillion, or 40 percent of all liabilities as of 1999. Of the total, $3.2 trillion consisted of explicit guarantees and $3.4 trillion consisted of implicit guarantees.

5. THE 2007–2009 FINANCIAL CRISIS AND THE "SPECIAL" QUESTIONS IT RAISED

The Corrigan analysis now needs to be reconsidered further in light of the financial crisis of 2007–2009. Based on the historical evidence, during a financial crisis there is a pullback in the willingness to extend credit to select large financial institutions in trouble. Each time such institutions are in trouble, the financial authorities expand the safety net to fill the funding gap. Consistent with the history, there was such a pullback during 2008 and 2009, and in response the safety net was extended through various forms of support and extended guarantees. As Treasury Secretary Timothy Geithner rationalized it, "The diversity of programs was necessary to extend a safety net against panic broad enough to cover the institutions and markets most critical to economic growth."[31] Expanding the safety net so far beyond banks has undermined the notion that banks are special.

5.1. Was Bear Stearns Special?

One of the earliest and most dramatic expansions of the safety net was the backstopping of the liabilities of the Bear Stearns Companies Inc. in March 2008. As an initial matter, the facts presented to support the intervention did not even meet Corrigan's three specific characteristics that justify extension of the financial safety net:

- Bear Stearns did not supply credit as a backup source of liquidity. The concerns for a commercial bank are that, if it has a run, it will not be able to fulfill its role in providing credit. Thus, the backstopping provisions of the safety net are made available to assure that there is continuity in fulfilling this role. Bear Stearns's balance sheet did not reveal an institution that was primarily involved in supplying credit for the purpose of supporting the liquidity needs of businesses; rather it was an institution whose primary investments were concentrated in financial instruments owned, such as futures, forwards, options, interest rate

31. Timothy F. Geithner, *Stress Test: Reflections on Financial Crises* (New York: Crown Publishers, 2014), 363.

swaps, and other derivatives, as well as collateralized financing, such as repurchase agreements.[32]

- Bear Stearns did not take deposits through transaction accounts. As Corrigan summarizes, “Only banks issue transaction accounts; that is, they incur liabilities payable on demand at par and are readily transferable by the owner to third parties. The owner of a transaction account can demand and receive currency in the face amount deposited in the account; write a check in the full amount of the account; or perhaps most importantly, the owner of the account can transfer the full amount of the account to a third party, almost instantly by wire transfer.”[33]
- Whether or not Bear Stearns was integral to monetary policy is debatable, as Bear Stearns was a member of the group of primary dealers that act as trading partners with the Federal Reserve Bank of New York in implementing monetary policy.[34] Bear Stearns collapsed before the implementation of the primary dealer credit facility, which was a special borrowing facility specifically for primary dealers.[35] However, Bear Stearns was never subjected to a regime of reserve requirements, as banks are.[36]

So, rather than addressing these criteria or some other existing means to assess inclusion under the safety net, the goal of those supporting intervention was to make Bear Stearns appear bank-like in order to justify this unprecedented support for a nonbank institution. Then a convincing case could be made for a bank-like intervention of solvency support (a bailout) rather than the typical historical response for an investment bank, that is, placement into bankruptcy (as happened in the case of the standing precedent of Drexel Burnham Lambert in 1990).[37] Bear Stearns was then used as a precedent to support other nonbank institutions, such as the American International Group (AIG).

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32. Bear Stearns Companies Inc., Condensed Consolidated Statements of Financial Condition, Form 10-Q, for quarterly period ending February 29, 2008.
33. Corrigan, “Are Banks Special?” (1982).
34. Federal Reserve Bank of New York, Primary Dealers List, accessed January 2, 2014, http://www.newyorkfed.org/markets/pridealers_current.html.
35. See Tobias Adrian, Christopher R. Burke, and James J. McAndrews, “The Federal Reserve’s Primary Dealer Credit Facility,” *Current Issues in Economics and Finance* 15, no. 4 (August 2009), Federal Reserve Bank of New York website, http://www.newyorkfed.org/research/current_issues/ci15-4.pdf.
36. Corrigan, “Are Banks Special?” (1982).
37. For a discussion of the Securities and Exchange Commission’s approach during that time, see Richard C. Breeden, former chairman of the Securities and Exchange Commission, written statement before the Senate Committee on Banking, Housing, and Urban Affairs, March 26, 2009, p. 17.

One bank-like characteristic presented in the case of Bear Stearns was the rapid run that led to its downfall.[38] The counterparties in the repurchase agreement (repo) and derivatives market refused to extend existing lending facilities with Bear Stearns. The rapidness of the run off in available credit was referred to by some as a "good old-fashioned run on the bank"[39] because of its similarities to a case of depositors withdrawing funds from a commercial bank during previous crises. One popular and more precise descriptor of the response of the counterparties was that a "run on repo" was triggered.[40]

Another bank-like characteristic presented in the case of Bear Stearns was the interconnectedness of its relationships with its counterparties.[41] Not unlike a classic too-big-to-fail correspondent bank that provides services to many smaller downstream banks and is thus at the center of a web of thousands of financial transactions and relationships, Bear Stearns was in the midst of a tangled web of transactions. This was the argument made to justify solvency support in the case of Continental Illinois during an earlier crisis,[42] and it was also the justification for intervention in the case of Bear Stearns, although the lack of actual evidence of interconnections as Bear collapsed is clearly based on the comments of Secretary Geithner:

> "Too big to fail" has become the catchphrase of the crisis, but that night our fear was that Bear was "too interconnected to fail" without causing catastrophic damage. And it was *impossible to guess the magnitude of that damage*. There were too many other firms that looked like Bear in terms of their leverage, their dependence on short-term funding, and their exposure to devastating losses as the housing market dropped and recession fears mounted.[43]

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38. McKinley, *Financing Failure*, 9–16.
39. William Ryback, "Case Study on Bear Stearns," Toronto Leadership Center, http://siteresources.worldbank.org/FINANCIALSECTOR/Resources/02BearStearnsCaseStudy.pdf; Kate Kelly, "Fear, Rumors Touched Off Fatal Run on Bear Stearns," *Wall Street Journal*, May 28, 2008, January 2, 2014, http://online.wsj.com/article/SB121193290927324603.html.
40. Gary Gorton and Andrew Metrick, "Securitized Banking and the Run on Repo," *Journal of Financial Economics* 104 (2012).
41. McKinley, *Financing Failure*, 131–32.
42. Ibid., 81–88. The case of Long-Term Capital Management's collapse was an in-between example, both historically and in the sense that there was no direct intervention in that case, although the Federal Reserve Bank of New York was involved in structuring a supporting facility by a number of large financial institutions.
43. Geithner, *Stress Test*, 151. Italics added.

The view that investment banks possess bank-like characteristics is also exemplified in the comments of Thomas Hoenig, currently the vice chairman of the FDIC and former president of the Federal Reserve Bank of Kansas City. His comments were actually regarding Lehman Brothers, which did not receive solvency support, but the important point is that he was describing an investment bank situated similarly to Bear Stearns:

> I suggest Lehman was a commercial bank in every sense. It had very-short-term liabilities, such as repos, that were used to fund longer-term assets, just as banks use demand deposits. Many repos were overnight instruments and were not subject to the same rules as other liabilities should the firm fail. Furthermore, major investors in repos were money market mutual funds, which do not mark the net asset values of their shares to market. As a result, they were understood by most consumers to be deposits and were treated as deposits.[44]

Do these two similarities between investment banks and commercial banks bolster the argument that the safety net should have been extended to cover the liabilities of investment banks because investment banks are indeed also special? Unfortunately in the panic of March 2008 and the bailout of Bear Stearns, the policy arguments cited were not made in a measured and analytical way; they were more indicative of a superficial and seat-of-the-pants argument.

For example, the Corrigan analysis does raise the issue of runs, or what he also calls "deposit drains."[45] But, similar to Corrigan's incomplete analysis regarding runs on an individual institution versus a systemic run, those arguing for intervention in the case of Bear Stearns did not make the case that a run on Bear further implied a run on the entire system.

One of the component parts of the safety net, deposit insurance, was implemented in the wake of the Great Depression because small depositors not only ran and withdrew funds from banks but also completely withdrew them from the financial system.[46] There was a concern during 2008 and 2009 that a series of runs could bring about a collapse of the financial system, but during the 1930s this idea became a reality, as evidenced by a plunge in the ratio of deposits

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44. Thomas M. Hoenig, "The Case for Simple Rules and Limiting the Safety Net," in *Money Markets and Government: The Next 30 Years*, ed. James A. Dorn (Washington: Cato Institute, 2013), 167.
45. Corrigan, "Are Banks Special?" (1982).
46. For a discussion of depositor response in the case of a run, see George G. Kaufman, "Bank Runs: Causes, Benefits, and Costs," *Cato Journal* 7, no. 3 (Winter 1988): 559, 563.

to currency during that period.[47] Although Bear Stearns did experience an event akin to a run, the evidence is lacking that those withdrawing funds from Bear Stearns pulled their funds completely out of the financial system.

As for interconnectedness, there was no coherent argument advanced to explain what is systemically harmful about a run of this kind on a nonbank financial institution and how a nonbank financial firm would cause a systemic breakdown if it were to fail.[48] The extent of interconnectedness in the case of Bear Stearns has never been publicly detailed.[49] Chairman Sheila Bair of the FDIC (the agency responsible for a large part of the safety net) put it well in describing her response when told of the concern over the possible failure of Bear Stearns:

> I received an early morning call from one of our senior examiners advising me that Bear Stearns would be declaring bankruptcy that day. "Investment banks fail," I told him and went back to sleep. . . . What I did think was remarkable was why the NY Fed was even getting involved. Among the five major securities firms, Bear was the smallest. It was one of the weaker firms that had fed on the subprime mortgage craze in the extreme. Why didn't the NY Fed just let it go down? . . . Securities firms [were] outside the safety net of deposit insurance and Fed discount window lending. In the past when securities firms had gotten in trouble, they had been acquired or recapitalized by private-sector entities, or they were placed into bankruptcy. Yet here the NY Fed was putting government money at risk to protect Bear's counterparties and creditors; even Bear's shareholders would get a little something out of the deal. . . . It was very curious to me, and I was concerned about the precedent the NY Fed was setting.[50]

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47. Milton Friedman and Anna Jacobson Schwartz, *A Monetary History of the United States, 1867–1960* (Princeton, NJ: Princeton University Press / National Bureau of Economic Research, 1963), 801–4.
48. Jean Helwege and Gaiyan Zhang, "Financial Firm Bankruptcy and Contagion," paper presented at Midwest Finance Association Annual Meeting, May 28, 2013, available through SSRN at http://ssrn.com/abstract=2136246 or http://dx.doi.org/10.2139/ssrn.2136246; Peter J. Wallison, "TARP Baby: The Administration's Resolution Authority for Nonbank Financial Firms," American Enterprise Institute, September 2009, p. 5.
49. Vern McKinley, "Run, Run, Run: Was the Financial Crisis Panic over Institution Runs Justified?" (Policy Analysis No. 747, Cato Institute, Washington, DC, April 10, 2014), 24–25.
50. Sheila Bair, *Bull by the Horns: Fighting to Save Main Street from Wall Street and Wall Street from Itself* (New York: Free Press, 2012), 74–75.

5.2. Was Crisis Coverage of Nondeposit Accounts under the Financial Safety Net a Repudiation of Corrigan's Special Traits?

The Bear Stearns intervention involved extending the safety net to a different type of financial institution than had previously been covered. Yet another expansion of the financial safety net during 2008 not only involved a different type of institution, but also involved expanding the coverage to a new type of liability under the FDIC. This approach called for coverage of nondeposit accounts in the form of a Debt Guarantee Program (DGP) and large transaction accounts over the FDIC limit in a Transaction Account Guarantee Program (TAGP), both as part of the FDIC Temporary Liquidity Guarantee Program. The DGP provided a guarantee by the FDIC for newly issued unsecured and unsubordinated debt of financial institutions and their holding companies.

Before the FDIC board's approval of the DGP, the FDIC had only explicitly backed deposit accounts, not debt instruments. The board approved the DGP in October 2008 after a number of institutions, such as Washington Mutual and Wachovia Bank, experienced a run by their depositors and other creditors in September. In an internal memo, the FDIC staff referred to these runs as "rapid and substantial outflows of uninsured deposits from institutions that are perceived to be under stress."[51] DGP and TAGP were wound down during 2012 well after the period of financial distress.[52]

The FDIC board based its decision to guarantee debt on the vague notion of "systemic risk," which it argued was being heightened by ongoing bank runs. It cited a blend of reasons to support the systemic risk argument, including overall market conditions, the state of the interbank market and commercial paper market, and the state of private asset-backed securitization. The only detailed analysis specific to banks that the board cited was an FDIC internal staff study for the board indicating that a 5 percent run on uninsured deposits would reduce GDP growth by 1.16 percent in a normal economy and 1.96 percent in a stressed economy. Unfortunately, it is not clear, based on the underlying study, whether this analysis took into account a net bank run.[53]

This is another case of using weak underlying analysis to justify a policy decision. An analysis based on a net bank run would have netted out any

51. Mitchell L. Glassman, "FDIC Guarantee of Bank Debt," memo to the FDIC Board of Directors, October 13, 2008, p. 4.
52. FDIC, "Temporary Liquidity Guarantee Program," last modified February 27, 2013, http://www.fdic.gov/regulations/resources/tlgp/index.html.
53. FDIC, "Modeling Systemic Risk to the Economy," undated (acquired through Freedom of Information Act request).

instances where deposits simply moved from a troubled institution to a strong institution. While these troubled institutions were experiencing such runs, other institutions that were seen as stronger and safer—such as JPMorgan Chase—were the beneficiaries of an increased flow of depositor funds.[54] The Government Accountability Office undertook a review of the Debt Guarantee Program and was skeptical of the basis for these conclusions on runs. It noted that the FDIC did not track the detailed underlying outflows at all. In fact, its conclusions were simply based on "anecdotal reports from institutions and the regulators serving as their primary supervisors."[55]

This intervention by the FDIC implied that Corrigan's focus on extending the safety net to bank transaction accounts was too narrow and needed to be broadened to allow the FDIC to guarantee a wider range of liabilities to include debt. Such a dramatic expansion of the safety net should have triggered a debate regarding the justifications for such a major policy change, what FDIC Director Thomas Curry rightly referred to during FDIC board deliberations on the program as "a major expansion of the FDIC's business beyond deposit insurance and beyond depository institutions." That debate never materialized.[56]

5.3. Was Implicit Financial Safety Net Support for the 19 Largest Banking Organizations a Repudiation of Banks' Specialness?

In 1982 Gerald Corrigan did not even mention any form of solvency support as part of the then-existing financial safety net. Although solvency support had at that point become a permanent power of the FDIC, the idea of bailing out financial institutions was in its nascent phase of development. However, the prolific use of open bank assistance and other means of bailing out uninsured depositors during the 1980s and 1990s made bailouts a more permanent feature of the safety net. Owing to the response of the authorities during 2008 and 2009 in backstopping the largest financial institutions through a range of programs—such as the Troubled Asset Relief Program (TARP) and FDIC open bank assistance, which included the FDIC Debt Guarantee Program, the Transaction Account Guarantee Program, and the Federal Reserve's power to

54. JPMorgan Chase, *Annual Report 2009* (2010), p. 28, http://files.shareholder.com/downloads/ONE/179535640x0x362439/a51db960-bda2-4e30-aacd-3c761b81ba75/2009_AR.pdf.
55. Government Accountability Office, "Federal Deposit Insurance Act: Regulators' Use of Systemic Risk Exception Raises Moral Hazard Concerns and Opportunities Exist to Clarify the Provision," GAO-10–100 (April 2010), pp. 16–17.
56. FDIC, Minutes of the Board of Directors Meeting, October 13, 2008, p. 56477.

intervene under "unusual and exigent circumstances"[57]—bailouts became an even more entrenched part of the safety net.

Nowhere is this deep entrenchment of financial support made clearer than in the 2009 Supervisory Capital Assessment Program (SCAP), the stress testing of the 19 largest banking organizations to assess their financial standing, and the companion Capital Assistance Program (CAP). The CAP provided any necessary capital support and was jointly organized by the Treasury Department and the Federal Reserve.[58] The following statement summarizes how the SCAP and CAP worked in tandem: "Should that assessment indicate that an additional capital buffer is warranted, institutions will have an opportunity to turn first to private sources of capital. Otherwise, the temporary capital buffer will be made available from the government."[59] Despite the fact that the CAP has closed, the liabilities of the 19 firms are implicitly considered within the confines of the safety net.[60]

5.4. The Size of the Newly Expanded Safety Net and Its Implications for Banks' Specialness

The cumulative effect of these piecemeal additions to the safety net has been substantial. The estimated guaranteed liabilities, both explicit and implicit, for the financial sector grew from a nominal value of $6.6 trillion or 40 percent of all financial firm liabilities in 1999 to $22.1 trillion or 57 percent of all financial firm liabilities in 2009. Of the total as of 2009, $7.3 trillion consisted of explicit guarantees and $14.9 trillion consisted of the more ill-defined implicit guarantees (which nearly equal 100 percent of US GDP). Now the implicitly guaranteed segment is actually double the size of the explicitly guaranteed segment.[61] The fact that the guarantees have shifted from explicit to implicit also reveals the ultimate beneficiaries of the shift. An explicit guarantee such as deposit insurance, which predominated as a share of the safety net back before

57. Federal Reserve Bank of Minneapolis, "The History of a Powerful Paragraph: Section 13(3) Enacted Fed Business Loans 76 Years Ago," June 2008, https://www.minneapolisfed.org/publications/the-region/the-history-of-a-powerful-paragraph.
58. US Department of the Treasury, "Supervisory Capital Assessment Program & Capital Assistance Program," last modified December 9, 2013, http://www.treasury.gov/initiatives/financial-stability/TARP-Programs/bank-investment-programs/scap-and-cap/Pages/default.aspx.
59. Joint Statement by the Treasury, FDIC, OCC, OTS, and the Federal Reserve, February 23, 2009, http://www.federalreserve.gov/newsevents/press/bcreg/20090223a.htm.
60. Nadezhda Malysheva and John R. Walter, "How Large Has the Federal Financial Safety Net Become?," Federal Reserve Bank of Richmond's *Economic Quarterly* 96, no. 3 (2010): 273–90.
61. Ibid., 276. The 1991 calculation is from Walter and Weinberg, "How Large is the Federal Financial Safety Net?" In 2014 Secretary Geithner estimated the safety net at $30 trillion (*Stress Test*, 363).

the 1980s, provided a government benefit primarily for individual retail depositors. An implicit guarantee for large, uninsured depositors and nondeposit creditors, which predominates as a share of the safety net currently, provides a government benefit primarily for wholesale institutional depositors and creditors who are fully capable of monitoring the condition of individual financial institutions.

Some might argue that the safety net has since 2009 been reduced to the degree that explicit programs have been allowed to lapse over the past few years. However, to the extent these explicit liabilities have rolled off, it is more likely that they have simply migrated from being explicit liabilities to being implicit liabilities and thus have remained in the safety net. Additionally, the category of "other financial firms" has seen an increase in firms covered under the safety net. As of the 2009 analysis, the only institution in this category was the insurer AIG. Since that time, the Financial Stability Oversight Council (FSOC) has designated a number of other nonbank systemic institutions, which would now be included within the parameters of the safety net in a process that is discussed further in section 6.3.[62]

6. DODD-FRANK, THE SAFETY NET, AND ERODING NOTIONS OF BANKS' SPECIALNESS

At the core of Dodd-Frank's provisions regarding financial support for financial institutions was the idea that the safety net had grown too large as a result of the interventions during 2008 and 2009. But rather than repealing the multiple, ad hoc bailout provisions the authorities leveraged during the crisis, Dodd-Frank instead codified their structure, with what the authors of the act believed were tightened, stricter limitations than the open-ended commitments to individual institutions made during 2008 and 2009.

As argued in summary materials produced by the Senate Banking Committee, the authors of the Dodd-Frank Act modified safety net support, hoping that in so doing the act

> ends the possibility that taxpayers will be asked to write a check to bail out financial firms that threaten the economy by creating a safe way to liquidate failed financial firms; by imposing tough new capital and leverage requirements that make it undesirable to get too big; by updating the Fed's authority to

62. The designated institutions include Prudential Financial, AIG, GE Capital, and MetLife.

allow system-wide support but no longer prop up individual firms; and by establishing rigorous standards and supervision to protect the economy and American consumers, investors, and businesses.[63]

Similar "never again" promises were made regarding too-big-to-fail institutions during the deliberation for and passage of the Federal Deposit Insurance Corporation Improvement Act reforms in 1991, but those assurances did not prevent the bailouts of 2008 and 2009.[64] The jury is still out on whether the Dodd-Frank provisions will actually accomplish these lofty goals, and it will be difficult to fully assess how successful they are until the next financial crisis. Only then will we know the extent to which the authorities at that future time will either (1) calmly shutter insolvent institutions with their newfound authorities (see table 3 and individual discussions in the sections that follow) or (2) panic—as they did in 2008 and 2009—and greatly expand the safety net again, in the hope that the problems will, at least in the short run, go away.

TABLE 3. INSTITUTIONS AND CORRESPONDING PROVISIONS IN DODD-FRANK

Institutions and crisis response programs	Permanent Dodd-Frank codification
Bear Stearns, AIG, Lehman Brothers Various Federal Reserve emergency-lending facilities[(a)]	Broad-based eligibility program Orderly Liquidation Authority Regulation and supervision of designated institutions
FDIC Debt Guarantee Program participants	Widely available support program
Wachovia, Citigroup, Bank of America[(b)]	Placement in receivership and Orderly Liquidation Authority
Fannie Mae Freddie Mac Money market fund insurance	Not addressed

(a) For a good summary of these institutions, see table 1 in *Dodd-Frank: What It Does and Why It's Flawed*, ed. Hester Peirce and James Broughel (Arlington, VA: Mercatus Center at George Mason University, 2012), 122.
(b) Bank of America includes Merrill Lynch.

63. Senate Banking Committee, "Brief Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act," p. 1, July 1, 2010, http://www.banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf.
64. McKinley, *Financing Failure*, 111–14. During 2008 to 2009, provisions regarding prompt corrective action in particular were regularly applied to small institutions, but they were not applied to any of the largest banks, notwithstanding their weakened capital position.

6.1. Broad-Based and Widely Available Support Programs Imply That Banks Are Not Special

The traditional central bank response to sharp increases in the demand for money is an announcement of lending to sound institutions on good collateral at a penalty rate.[65] The Federal Reserve has done a poor job of documenting and describing underlying analyses of soundness and collateral quality; in particular, it has refused to disclose documents that would shed more light on whether supported institutions were indeed solvent.[66] Although the borrowings were paid back in full, it appears that the availability of an open-ended funding source from the Federal Reserve turned insolvent entities into solvent entities by leveraging the credit standing of the US government. AIG is one clear example of a nonbank institution where this was the case.

As a result of these questions raised during the crisis about the efficacy of lending to financial institutions of questionable solvency, in Dodd-Frank the individual institution bailouts were transformed into programs similar to the Federal Reserve's Primary Dealer Credit Facility and the FDIC Debt Guarantee Program. The new programs were more in keeping with traditional

65. McKinley, "Run, Run, Run," 3; Thomas M. Humphrey, "Lender of Last Resort: What It Is, Whence It Came, and Why the Fed Isn't It," *Cato Journal* 30, no. 2 (Spring/Summer 2010): 345–51. Soundness of institutions is more recently referred to as solvency.

66. It is not clear at all whether there was any analysis done of Bear Stearns's insolvency. Later in the crisis during the AIG meltdown, some analysis on this question was undertaken, but the Federal Reserve has refused to release its analysis. McKinley, *Financing Failure*, 201. Federal Reserve Board economist William Nelson also raised a related point about insolvency analysis early on in the ongoing assessment of AIG: "What should we do? If AIG doesn't have collateral they can pledge to us, I just don't think we can lend. It seems like it would have to be the Treasury. If we think the entity is insolvent, can you think of anyway [*sic*] to make the failure more orderly?" Ibid. Later, the analysis of whether AIG was insolvent became even clearer as stated by Vice Chairman Don Kohn in his brief conversation with Jacob Frenkel of AIG when he told Frenkel that AIG was "'very reluctant' to open up another 13-3 facility for an entity not even an investment bank. And that the market thought it was not only a liquidity problem but also a capital problem." Ibid. The Fed was not forthcoming in its disclosures of documents to shed light on the issue of solvency of supported institutions, and "in the case of Bear Stearns, it was very clear that documents existed that might shed light on some of the last-minute decision-making, and that is clearly also the case with regard to AIG. The Board of Governors has acknowledged the existence of documents, but thus far they have been unwilling to disclose the content of those documents. One set of emails directly addresses the issue of the solvency of AIG." Ibid. With regard to Lehman Brothers, see follow-up questioning from Commissioner Peter Wallison of the Financial Crisis Inquiry Commission about a "study of the collateral that was available," to which Chairman Bernanke responded, "I don't have any—to my knowledge, I don't have a study to hand you. But it was the judgment made by the leadership of the New York Fed and the people who were charged with reviewing the books of Lehman that they were far short of what was needed to get the cash to meet the run. And that was the judgment that was given to me." Transcript of a Hearing of the Financial Crisis Inquiry Commission, "Too Big to Fail: Expectations and Impact of Extraordinary Government Intervention and the Role of Systemic Risk in the Financial Crisis," September 2, 2010, p. 84.

safety net–based lender of last resort facilities: a program of broad-based eligibility (in the case of the Federal Reserve) and widely available support (in the case of the FDIC) that inures to the benefit of a broader population of institutions than the one-off, single-institution interventions of 2008 and 2009. Additionally, requirements were imposed that the recipient institutions must be solvent and, in the case of the Federal Reserve borrowings, be appropriately secured.[67]

Although these Dodd-Frank limitations could conceivably prevent lending to insolvent institutions, history is replete with examples of financial agencies using their discretion to avoid limitations on their ability to intervene.[68] In the aftermath of the financial turmoil of the 1980s and 1990s, there was a backlash against providing failing banks with discount window funding to prop them up and, in the process, bail out uninsured depositors. Three cases in particular illustrate this phenomenon well: Franklin National Bank in 1974, Continental Illinois in 1984, and Bank of New England in 1991. As a result of this backlash, changes were made in the Federal Deposit Insurance Improvement Act of 1991 to restrict Federal Reserve lending to troubled institutions.[69]

During 2008, Citibank clearly displayed the characteristics of a problem bank (a four- or five-rated institution under the CAMELS system for rating banks). Notwithstanding its difficulties, Citibank was approved to purchase Wachovia Bank, a privilege that is limited to sound institutions. To get around this regulatory restriction, Citibank was proclaimed a "healthy" institution in order to receive funding under the TARP. It was also allowed to access the various Federal Reserve lending facilities, as it had outstanding borrowings from the Federal Reserve continuously from January 2008 through August 2009, peaking at a level of $99.5 billion.[70] This indicated that the authorities have ignored information that should have prevented them from providing solvency support. It would not be surprising if during the next crisis, the authorities became creative in their interpretation of what is meant by "solvent" under the Dodd-Frank mandates in order to extend credit to a problem institution.

67. Dodd-Frank, §§ 1101–5.

68. Anna J. Schwartz, "The Misuse of the Fed's Discount Window," *Federal Reserve Bank of St. Louis Review* 74, no. 5 (September/October 1992): 58–69.

69. McKinley, "Run, Run, Run," 9–10.

70. Ibid., 18–22. One study has estimated that, if each Federal Reserve loan to Citigroup is counted as a separate transaction, then Citigroup was the recipient of $2.65 trillion of total emergency lending. James Felkerson, "$29,000,000,000,000: A Detailed Look at the Fed's Bailout by Funding Facility and Recipient" (Working Paper No. 698, Levy Economics Institute of Bard College, December 2011), available through SSRN at http://ssrn.com/abstract=1970414.

6.2. Orderly Liquidation Authority for Nonbanks Implies Banks Are Not Special

Another safety net–related provision inserted into Dodd-Frank was the creation of the Orderly Liquidation Authority (OLA) administered by the FDIC. OLA was meant to be an alternative to the bankruptcy process administered through the courts for systemic, nonbank financial institutions that require liquidation. Under the Corrigan formulation, banks needed their own "special" liquidation procedure as part and parcel of the deposit insurance component of the safety net. The creation of a special regime implies that select nonbank financial institutions have become so bank-like that they need their own bank-like process of liquidation.

The imposition of OLA was intended to be a trimming back of the safety net and provision of solvency support as displayed during the interventions of 2008 and 2009, providing "a third option between the choices of bankruptcy and bailout," in the words of Federal Reserve Chairman Bernanke. "A new resolution regime for nonbanks, analogous to the regime currently used by the [FDIC] for banks, would provide the government the tools to restructure or wind down a failing systemically important firm in a way that mitigates the risks to financial stability and the economy and thus protects the public interest."[71]

In securing this expanded power, the FDIC undertook a lobbying effort based on the idea that it could address the wind down of an institution like Lehman Brothers in a more effective manner than through the courts.[72]

71. Chairman Ben S. Bernanke, "Regulatory Reform," testimony before the Committee on Financial Services, US House of Representatives, October 1, 2009, http://www.federalreserve.gov/newsevents/testimony/bernanke20091001a.htm.

72. FDIC, "FDIC Rebuts Inaccurate Op-Ed," last modified April 28, 2010, http://www.fdic.gov/news/letters/rebuttal_04072010.html. See also "The Orderly Liquidation of Lehman Brothers Holdings Inc. under the Dodd-Frank Act," *FDIC Quarterly* 5, no. 2 (2011). This was a direct criticism of the current bankruptcy system and the courts' administration of it, but indirectly, it was also a criticism of the bankruptcy of Lehman. These criticisms were largely baseless. The FDIC's criticism of the Lehman liquidation included comments such as the following: (1) "Huge fees and expenses. As of January 2010, fees paid to debtor's counsel and experts in the Lehman bankruptcy exceeded $588 million without a plan of reorganization having been proposed by that date." (2) "Drawn out resolution (WAMU was resolved in 24 hours on a Thursday). Lehman has offered a 'blueprint' for its reorganization 18 months after filing Chapter 11." These criticisms by the FDIC that led to the legislative changes were actually highly flawed and misleading. The Lehman transaction involved the meticulous liquidation of a $600 billion entity, with thousands of claimants and 1.2 million derivatives contracts. Alternatively, the Washington Mutual case (which the FDIC compared to the Lehman case) was essentially a whole-bank purchase organized by the FDIC, which involved minimal actual input other than reaching out to JPMorgan Chase and putting together the legal documentation for the transaction. It should be noted that, although this agreement was largely boilerplate in that it was a type of agreement historically used by the FDIC, the agreement between JPMorgan Chase and the FDIC has triggered litigation. See Dan Fitzpatrick, "J.P. Morgan Chase Sues FDIC over Washington Mutual Claims," *Wall Street Journal*, December 17, 2013.

Notwithstanding the questionable basis for bestowing these powers upon the FDIC, the OLA provisions grant the FDIC a large degree of discretion regarding the treatment of similarly situated creditors for a variety of possible justifications.[73] This expanded power could leave the door open to selectively provide a safety net in the form of guarantees similar to those the FDIC provided on an ad hoc basis during 2008.[74] It has led Federal Reserve Bank of Richmond President Jeffrey Lacker to question whether the OLA provisions realistically accomplish any significant change to current too-big-to-fail policy and a trimming back of the safety net:

> Title II gives the FDIC the ability to borrow funds from the Treasury (specifically, the Orderly Liquidation Fund at the Treasury) to make payments to creditors of the failed firm. The funds are to be repaid from recoveries on the assets of the failed firm or from assessments against the largest, most complex financial companies. While the FDIC is to pay creditors no more than they would have received in a liquidation of the firm, the Act provides the FDIC with broad discretion to pay more. This encourages short-term creditors to believe they would benefit from such treatment and therefore continue to pay insufficient attention to risk and invest in fragile funding arrangements. Given widespread expectations of support for financially distressed institutions in orderly liquidations, regulators will likely feel forced to provide support simply to avoid the turbulence of disappointing expectations.

73. Dodd-Frank, §§ 210(b)(4) and 210(d)(4). Some sample justifications are as follows: to maximize the value of the assets of the covered financial company; to initiate and continue operations essential to implementation of the receivership or any bridge financial company; to maximize the present value return from the sale or other disposition of the assets of the covered financial company; or to minimize the amount of any loss realized upon the sale or other disposition of the assets of the covered financial company.

74. This point is made in Hester Peirce, "Title II: Resolution," in *Dodd-Frank: What It Does and Why It's Flawed*, ed. Hester Peirce and James Broughel (Arlington, VA: Mercatus Center at George Mason University, 2012), 36. See also Martin J. Gruenberg, acting chairman of FDIC, remarks to the Federal Reserve Bank of Chicago Bank Structure Conference, Chicago, IL, May 10, 2012, http://www.fdic.gov/news/news/speeches/chairman/spmay1012.html. The Orderly Liquidation Fund can be a source of direct funding for resolution, and can also be used to provide guarantees similar to the debt guarantee that was provided through the DGP, which was part of the FDIC's Temporary Liquidity Guarantee Program.

> We appear to have replicated the two mutually reinforcing expectations that define "too big to fail."[75]

The existence of OLA as a rescue mechanism for nonbank financial institutions and its potential to be used to provide nonbank creditors of these institutions with government support again blurs the distinction between banks and nonbanks. OLA suggests that banks are not special after all.

6.3. Extending a Bank-Like Oversight Regime to Select Nonbanks Implies Banks Are Not Special

As Corrigan pointed out and as illustrated in his table 1, there was a form of quid pro quo at work in the regime of 30 years ago: "banks" received coverage under the safety net, but in turn they were subjected to all manner of safety and soundness regulation and supervision. More recently, under sections 165 and 171, Dodd-Frank imposes extended oversight, including prudential standards regarding risk-based capital and leverage, on nonbank financial institutions designated as systemically important. The initial designation of systemically important is determined by the FSOC. This oversight is justified as explained in an FSOC rulemaking:

> In the recent financial crisis, financial distress at certain nonbank financial companies contributed to a broad seizing up of financial markets and stress at other financial firms. Many of these nonbank financial companies were not subject to the type of regulation and consolidated supervision applied to bank holding companies, nor were there effective mechanisms in place to resolve the largest and most interconnected of these nonbank financial companies without causing further instability. To address any potential risks to U.S. financial stability posed by these companies, the Dodd-Frank Act authorizes the Council to determine that certain nonbank financial companies

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75. Jeffrey M. Lacker, testimony before the Committee on Financial Services, US House of Representatives, June 26, 2013. For a similar sentiment, see Arthur E. Wilmarth Jr., "The Dodd-Frank Act: Flawed and Inadequate Response to the Too-Big-to-Fail Problem," *Oregon Law Review* 89 (2011): 951, in particular the section entitled "Dodd-Frank's Orderly Liquidation Authority Does Not Preclude Full Protection of Favored Creditors of SIFIs," pp. 993–1000.

will be subject to supervision by the Board of Governors and prudential standards.[76]

One source for the bank-like regulation and supervision regime was the Collins Amendment, which was ultimately included in Dodd-Frank, named after the senator who offered up the amendment. However, the thrust of the amendment was the brainchild of then FDIC Chairman Bair, and it was reportedly drafted by her staff at the FDIC. The primary intent of the amendment was to ensure that minimum capital requirements for large banks were at least as stringent as those applicable to smaller banks. Bair argued that, under prior capital standards consistent with international standards under the Basel Accord (or Basel II), large banks were perversely allowed to follow less stringent capital requirements than smaller banks through discretionary development of capital parameters. Under Bair's logic, the same standards should also be imposed at the holding company level and further to systemically important financial institutions in order to assure a cross-cutting level playing field for capital standards. According to Bair, the Federal Reserve and Treasury had argued against codifying such standards in legislation and argued for giving the discretion to the Federal Reserve in setting capital standards working within the international system of Basel (which—in response to the crisis—was being updated under Basel III). Not surprisingly, the large banks also supported the discretionary approach.[77]

Although, in developing the Collins Amendment, Bair focused on the distinction between large banks (and their holding companies) and small banks with regard to capital requirements, the distinction between banking institutions and nonbanking institutions, such as insurers, was not a primary concern of hers.[78] Given that the FSOC has designated insurers as systemic, this application of the Collins Amendment is certainly not theoretical.[79] Within the parameters of that amendment, the Federal Reserve is responsible for coming up with

76. Financial Stability Oversight Council, "Authority to Require Supervision and Regulation of Certain Non-bank Financial Companies," Final Rule and Interpretive Guidance, April 11, 2012.
77. For further details on Bair's perspective and her rationale on the Collins Amendment, see Bair, *Bull by the Horns*, 219–38, 264, 325–26. For background on her views on Basel II, see "Chapter 2: The Fight over Basel II," ibid. See also Davis Polk, "Collins Amendment: Minimum Capital and Risk-Based Capital Requirements," Client Memorandum, June 28, 2010. This memo notes that the Collins Amendment was originally drafted by FDIC staff and reflected views held by Chairman Bair.
78. See Bair, *Bull by the Horns*. Bair does not focus in her book on this distinction; she makes only a passing reference to the applicability of the leverage ratio to nonbanks, on p. 326.
79. Rob Cox, "MetLife's Low Profile May Work to Its Advantage," *New York Times DealBook*, July 29, 2014.

prudential standards that apply to these insurers. The potential difficulties with the Federal Reserve's effort to extend its current oversight framework for banks to a broader population of financial institutions were highlighted in a colloquy between Congressman Dennis Ross of Florida and Chairman Bernanke:

> Congressman Ross: I look at the Collins Amendment and what concerns me is that I'm afraid your hands may be tied, in that we have two different types of financial institutions here. We have the short-term funding of the banks and we have the long-term funding of insurance companies and yet we're going to give risk-based capital requirements, expanded requirements, based on general accepted accounting principles which don't apply to insurance companies. We're going to increase the cost of insurance . . . and more importantly we're going to probably result in a conflict between the McCarran-Ferguson Act and the implementation of a Basel III capital requirement for insurance companies. How do you feel we can resolve that? Can we resolve that?
>
> Chairman Bernanke: On insurance companies, we're going to do our best to tailor our consolidated supervision to insurance companies, but I agree with you that the Collins Amendment does put some tough restrictions that we're going to have . . .
>
> Congressman Ross: The insurance companies that are now going to be held to a higher capital standard, build more short-term debt, and then all of a sudden they enter the banking business which is counterproductive to where we want to go. . . . If we impose these bank-centric capital requirements on insurance companies, would that have done anything to have saved AIG from its financial collapse of five years ago?
>
> Chairman Bernanke: On the Collins Amendment, it does make it more difficult for us because it imposes as you say "bank-style capital requirements" on insurance companies.[80]

But to bring this back to the issue of the Corrigan construct, the safety net, and its justifications, it is not clear that the enhanced regulatory regime is

80. "FOX Business Network: Ross and Bernanke Talk about the Need to Address the Debt Ceiling," YouTube video, 3:08, from a Fox Business Network broadcast, posted by "Rep. Dennis Ross," July 17, 2013, http://www.youtube.com/watch?v=sAAxn6EeomQ.

appropriate, given that there is nothing inherent in the structure of insurance companies that would dictate the concern that they are regularly susceptible to bank-like runs that would give rise to an ensuing system-wide panic.[81] The basis for designating and applying such a regime to nonbanks such as insurance companies is at the core of a recent lawsuit by MetLife, which brought suit against the FSOC on these issues during early 2015.[82]

7. CURRENT REGULATORY EFFORTS ROOTED IN A BELIEF THAT BANKS ARE SPECIAL

The postcrisis regulatory actions—including the codification of support programs, the procedures for OLA, and the expansion of oversight to a wide range of financial institutions—imply that banks are not particularly special. These provisions have now been extended to other institutions that do not possess the Corrigan bank-like features. Meanwhile, other newly codified and proposed reforms continue to preserve the view that banks are special.

7.1. The Volcker Rule Clings to a Belief That Banks Are Special

The backstop for the lending activities that commercial banks undertake is at the core of the safety net as described by Corrigan. The Volcker Rule, which is part of Dodd-Frank, advances the argument that relying on the safety net as a backstop for so-called risky activities such as proprietary trading or related speculative activities distant from bank lending (so-called safety-net creep)[83] should be prohibited. It embodies the perspective that banks are special.

Dodd-Frank addresses these concerns of Volcker under section 619, which sets forth a seemingly straightforward prohibition at its outset: "Unless otherwise provided in this section, a banking entity shall not—(A) engage in proprietary trading; or (B) acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund." It then grants broad authority to the Federal Reserve to apply the provision.

In an opinion piece in the *New York Times*, Volcker laid out the reasoning behind these limits:

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81. Richard G. Liskov, Holland & Knight, "Washington's Unprecedented Bid to Supplant State Insurance Regulators," news release, November 21, 2013.
82. Compl., MetLife, Inc. v. Financial Stability Oversight Council, No. 15-CV-45 (D.D.C. January 13, 2015), available at http://online.wsj.com/public/resources/documents/011315metlife.pdf.
83. Hester Peirce, "Title VI: New Authority for the Fed," in *Dodd-Frank*, ed. Peirce and Broughel, 67–69.

> Governments have long provided commercial banks with the public "safety net." The implied moral hazard has been balanced by close regulation and supervision. Improved capital requirements and leverage restrictions are now under consideration in international forums as a key element of reform. The further proposal set out by the president recently to limit proprietary activities of banks approaches the problem from a complementary direction. The point of departure is that adding further layers of risk to the inherent risks of essential commercial bank functions doesn't make sense, not when those risks arise from more speculative activities far better suited for other areas of the financial markets. The specific points at issue are ownership or sponsorship of hedge funds and private equity funds, and proprietary trading—that is, placing bank capital at risk in the search of speculative profit rather than in response to customer needs.[84]

The legislative changes in Dodd-Frank regarding financial institution support, regulation, and supervision, as well as the establishment of OLA, were based on the perceived failings of the response during the financial crisis. For example, OLA was intended to address problems with a so-called disorderly liquidation of Lehman Brothers. Supervisory and regulatory changes were intended to address regulatory gaps in the oversight of nonbank institutions like AIG. However, changes resulting in the Volcker Rule did not have their genesis in the particular weaknesses identified during the crisis, as illustrated by this colloquy between Senator Mike Johanns and Paul Volcker, who begrudgingly admits this fact during a hearing on the Volcker Rule:

> Senator Johanns: Tell me the evil you are trying to wrestle out of the system with this rule . . .
>
> Mr. Volcker: What I want to get out of the system is taxpayer support for speculative activity. . . . I do not want my taxpayer money going to support somebody's proprietary trading . . .
>
> Senator Johanns: But here is the problem. . . . AIG, how would this have prevented all the taxpayer money going to AIG? If this rule had been in place, what would have been different?

84. Paul Volcker, "How to Reform Our Financial System," *New York Times*, January 31, 2010.

> Anything? Let's say the Volcker rule had been in effect, would that have stopped AIG from doing this?
>
> Mr. Volcker: If it had been in effect on an insurance company . . . and you had a particularly effective capital requirement alongside the complementary approach, I believe we would not have had a trouble with AIG.
>
> Senator Johanns: Well, see, I think you are losing me again . . .
>
> Mr. Volcker: The Volcker rule, much as I would like to say it solved all problems, does not solve all problems. It is part of a, I think, coherent reform of the financial system. . . . It certainly would not have solved the problem at AIG or solved the problem with Lehman, alone. It was not designed to solve those particular problems.
>
> Senator Johanns: Exactly. That is the point. You know. This kind of reminds me of what the chief of staff [Rahm Emanuel] said, never let a good crisis go to waste. What we are doing here is we are taking this financial reform, and we are expanding it beyond where we should be. And I just question the wisdom of that, unless somebody can make the case to me that had this been in place the world would have been differently . . .
>
> Mr. Volcker: The chairman made the point that I would emphasize, that the problem today is look ahead and try to anticipate the problems that may arise, that will give rise to the next crisis. And I tell you, sure as I am sitting here, that if banking institutions are protected by the taxpayer and they are given free rein to speculate . . . my soul is going to come back and haunt you.[85]

Interestingly, Chairman Volcker and Gerald Corrigan, who collaborated on the concept of banks being special, ended up on opposite sides of the argument on the Volcker Rule. The codification of the rule is an outgrowth of Corrigan's early formulation, but it is in conflict with Corrigan's updated view, expressed in his 1991 testimony, that banks could affiliate with securities firms,

85. *Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies*, Hearing before the Committee on Banking, Housing, and Urban Affairs, US Senate, 111th Congress, Second Session, February 2, 2010.

insurance companies, and other capital market institutions without compromising the safety net. In 2010, two days after Volcker, Corrigan testified in his capacity as managing director at Goldman Sachs, and in so doing, he undermined many of the arguments used to justify the Volcker Rule:

> Client-driven market making and the hedging and risk management activities growing out of such market making are natural activities of banks and Bank Holding Companies. As such, these activities are subject to official supervision, including on-site inspections, capital and liquidity standards and various forms of risk related stress tests.
>
> The Volcker plan would also prohibit "banks" and Bank and Financial Services Holding Companies from owning or sponsoring hedge funds and private equity funds. I believe that the financial risks associated with such ownership or sponsorship can be effectively managed and limited by means short of outright prohibition. . . .
>
> More generally, it should be noted that hedge funds and private equity funds are providing both equity and debt financing to small and medium sized businesses in such vital areas as alternative energy and technology ventures. Given the long-term benefits of these activities, I also believe there is something to be said for the proposition that, subject to appropriate safeguards, regulated Bank Holding Company presence in the hedge fund and private equity fund space can help to better promote best industry practice.[86]

Corrigan's testimony does contain a passing reference to banks still being special.[87]

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86. E. Gerald Corrigan, managing director, Goldman, Sachs & Co., statement before the Committee on Banking, Housing, and Urban Affairs, US Senate, February 4, 2010, pp. 11–13. A recent biography of Chairman Volcker describes this interesting set of circumstances as follows: "Volcker had mentored Corrigan, teaching him fly-fishing and recommending him as president of the Federal Reserve Bank of New York, the powerful branch of the central bank located in the heart of Wall Street, where Corrigan grew the Rolodex that nurtured his new career. Corrigan had served Volcker as a loyal knight, protecting his back and defending his honor. But now their interests diverged, and Corrigan served a new master." William L. Silber, *Volcker: The Triumph of Persistence* (New York: Bloomsbury, 2012), 273–74.

87. "I have always believed that banks [whether stand-alone or part of a Bank Holding Company] are special." Corrigan, 2010 testimony, p. 5.

Volcker's comments targeting Goldman Sachs's transformation into a bank holding company in September 2008 show a further rift between the former colleagues: "The lines differentiating financial institutions had been blurred, but if Goldman wanted the commercial banking safety net it should look more like a bank, specializing in taking deposits and making loans, rather than like a hedge fund, geared to speculating on mispriced securities."[88]

During the same testimony as the back-and-forth between Paul Volcker and Senator Johanns, Senator Michael Crapo raised a question regarding the difficulty in actually carrying out this broad authority: "Drawing bright lines between the permissible and impermissible activities on market making or customer facilitation or proprietary trading is going to be very difficult, and some people say impossible or unworkable. If the Government makes it too difficult for banks to take positions, then there will be less liquidity in the market."[89] Volcker responded with the assurance that "bankers know what proprietary trading is and what it is not, and do not let them tell you anything different."[90]

However, the follow-through on implementation of the rule has revealed more validity in Senator Crapo's concerns than in Volcker's assurances. The final rule was issued by the financial authorities in December 2013, more than three years after the passage of Dodd-Frank; it was an extraordinarily complex 963-page directive.[91] This is yet another case of a restriction imposed on "banks" in return for the provision of the safety net, one that it is not at all clear will ultimately reduce risk, as it may in fact cause banks to cut back on legitimate risk reduction activities in order to avoid regulatory scrutiny.[92] It perpetuates the idea that granting the financial agencies a wide swath of authority to develop and implement complex regulations is the best path to a safer and more stable financial system.[93] The effort has been called a "fool's errand," whose

88. Silber, *Volcker*, 277. Source is an interview with the author, William L. Silber.
89. Volcker, 2010 testimony, p. 36.
90. Ibid.
91. Department of the Treasury, Office of the Comptroller, 12 C.F.R. Part 44; Board of Governors of the Federal Reserve System, 12 C.F.R. Part 248; Federal Deposit Insurance Corporation, 12 C.F.R. Part 251; and Securities and Exchange Commission, 17 C.F.R. Part 255; "Prohibitions and Restrictions on Proprietary Trading and Certain Instruments in and Relationships with Hedge Funds and Private Equity Funds," Effective Date April 1, 2014. For a summary, see Justin Baer and Julie Steinberg, "Volcker Rule Challenges Wall Street," *Wall Street Journal*, December 10, 2013.
92. Proprietary trading or covered fund activities of nonbank financial companies supervised by the Federal Reserve are subject to so-called Volcker Lite (i.e., a less stringent version of the Volcker Rule).
93. "The Volcker Ambiguity," *Wall Street Journal*, December 11, 2013.

primary result has been massive spending by banks on an "army of lawyers, accountants, compliance consultants and IT vendors."[94]

As the process of implementation of this seemingly simple provision has played out, the Volcker Rule is indicative of the 30-year struggle to clearly define and link the characteristics of "banks" with the benefits of the safety net and also with the underlying institutions subject to the various costs and restrictions of the regulatory regime. In many ways, the effort is an anachronism, an attempt to bring bright lines or delineations to a financial industry that has long since left behind the approach of placing the various federal financial sector components into convenient boxes that dictate supervisory and crisis management policy. The various agencies issuing the rule give assurances that they can micromanage the process of hedging and draw the rather arbitrary line between hedging and proprietary trading. This displayed confidence is simply another example illustrating the Golembe comment regarding the Federal Reserve's ability to solve a wide array of economic problems, if only it is granted the necessary regulatory authority to keep banks isolated from risky financial activities.

7.2. Glass-Steagall and the Nostalgia of "Banks Are Special"

Senator Elizabeth Warren led an effort in the 113th Congress that would have gone further than the Volcker Rule to revitalize the notion that banks are special by narrowing the types of activities that are supported by the safety net. During her campaign for the senate seat she now holds, Warren argued that "banking should be boring."[95] Upon taking a place on the Senate Banking Committee, she offered the 21st Century Glass-Steagall Act of 2013, with Senator McCain among the cosponsors. Proponents of the new Glass-Steagall want banks to be special because of what they do not do. The primary aims of the legislation are

> (1) to reduce risks to the financial system by limiting banks' ability to engage in activities other than socially valuable core banking activities;

94. Mayra Rodriguez Valladares, "Is Outsourcing the Volcker Rule's Achilles Heel?," *American Banker*, November 4, 2014; Mayra Rodriguez Valladares, "Why Volcker Rule Is a Fool's Errand," *American Banker*, October 1, 2014.
95. Elizabeth Warren for Senate, "Banking Should Be Boring," May 22, 2012, http://elizabethwarren.com/blog/banking-should-be-boring.

(2) to protect taxpayers and reduce moral hazard by removing explicit and implicit government guarantees for high-risk activities outside of the core business of banking; and

(3) to eliminate conflicts of interest that arise from banks engaging in activities from which their profits are earned at the expense of their customers or clients.

Under the provisions of the act, financial institutions must make the necessary adjustments to comply with the act within a five-year phase-in period.[96]

Senator Warren relies primarily on historical evidence to support her proposed bill and her stated contention that, when Glass-Steagall was fully in force for 50 years from the early 1930s through the early 1980s, the banking system was sound and stable: The "boom and bust cycle went away" as evidenced by the overall "tiny number of bank failures" and, with regard to "the big [banks]" there were "zero" failures. Under her narrative, deregulation kicked in during the early 1980s and the Reagan era with the "chipping away" of the pillars of Glass-Steagall and the "deregulation" of the industry; then the savings and loan crisis, Long-Term Capital Management's collapse, and other financial system stress ensued. Senator Warren contends that, based on this historical record, the solution is that, if financial institutions want access to FDIC-insured deposits, then "speculative trading" needs to be "walled off" from the funding source of FDIC deposits.[97]

Senator Warren appears to be describing a black-and-white sequencing of events where everything was tranquil during the 50 years from 1933 to 1983 because of the implementation of the Glass-Steagall restrictions, but a further examination of the underlying details reveals that this analysis is flawed. At the beginning of the noted 50-year period, it must be recognized that the banking system was in a state approaching pristine. The period from 1919 to 1933 was wrenching, during which the banking system was cleansed of weak institutions as approximately 15,000 banks failed or had operations

96. "Any affiliation, common ownership or control, or activity of an insured depository institution with any securities entity, insurance company, or swaps entity, or any other person, as of the date of enactment of the 21st Century Glass-Steagall Act of 2013, which is prohibited under subparagraph (A) shall be terminated as soon as is practicable, and in no event later than the end of the 5-year period beginning on that date of enactment." 21st Century Glass-Steagall Act of 2013, §§ 2 and 3.
97. "Senator Elizabeth Warren—Reinstating Glass-Steagall—CNBC," YouTube video, 5:30, posted by "Marie Marr," July 12, 2013, http://www.youtube.com/watch?v=M6rnsLNvXzM; "Sen. Elizabeth Warren Pitches 21st Century Glass-Steagall Bill," Fox News website, July 12, 2013, http://video.foxbusiness.com/v/2542020700001/sen-elizabeth-warren-pitches-21st-century-glass-steagall-bill/#sp=show-clips.

suspended, and the number of banks went from more than 30,000 down to roughly 15,000.[98] Leading up to and during the Banking Holiday of 1933, the financial agencies undertook a diagnostic of the banking system that involved a triage-like process to weed out weak financial institutions. This process involved a review and recommendation by the district Federal Reserve Bank, the chief national bank examiner, and the comptroller of the currency.[99] Thus after this rigorous review and the closing of weaker institutions, the banks that were left in the system in 1933 at the start of this 50-year period were in a particularly strong financial position.

Additionally, the institutions in 1933 had the benefit of the newly granted safety net support of deposit insurance, which at least in the short term stabilized their funding.[100] Small depositors were largely behind the bank runs of the prior period; with the deposit guarantee, they did not have the same strong incentive to run on weak institutions. The institutions also enjoyed the benefit of hundreds of millions of dollars of capital funding from the Reconstruction Finance Corporation. So it is not surprising that the salutary effects of closing weak institutions outright, combined with recapitalization of the remaining institutions, had the effect of cleansing and shoring up the system and that, for the ensuing decades, there were a very small number of banking failures. The supporters of imposing Glass-Steagall once again do not advance the case that it was the elixir that brought the banking system to stability and kept it in that state for half a century.

"The supporters of imposing Glass-Steagall once again do not advance the case that it was the elixir that brought the banking system to stability."

On the other end of this 50-year period, Senator Warren does not get the history correct when she states that there were no large failures until deregulation kicked

98. John R. Walter, "Depression Era Bank Failures: The Great Contagion or the Great Shakeout?," Federal Reserve Bank of Richmond's *Economic Quarterly* 91, no. 1 (Winter 2005): 39, 41.

99. FDIC, "A Brief History of Deposit Insurance in the United States," Prepared for the International Conference on Deposit Insurance, September 1998, p. 24.

100. As discussed in the concluding section of this paper, there is extensive analysis of the destabilizing effects of deposit insurance.

in during the Reagan era. In fact, the banking system began what would become a two-decades-long period of stress during the macroeconomic volatility of the mid-1970s, as there were some large bank failures or near failures well in advance of the Reagan years. For example, Franklin National Bank of New York, which was at one time one of the 20 largest banks in the United States, was closed and select creditors were bailed out in 1974. First Pennsylvania Bank, the largest bank in the city of Philadelphia and also a top-tier bank, was on the brink of failure when it was bailed out by the FDIC in early 1980. Continental Illinois, which was even larger than Franklin or First Pennsylvania and broke into the top 10 banks, was on the brink of failure in 1984; however, it was weak many years before its failure.[101] It can hardly be said that the failure of any of these institutions had a deregulatory genesis during the Reagan years.

Citigroup epitomizes the type of institution that supporters of Glass-Steagall want to alter, given its long history of mixing banking and nonbanking activities, which accelerated with the Citicorp-Travelers merger in the 1990s.[102] Citigroup is a holding company, which has a great many commercial banks that draw insured deposits (through Citibank commercial banking franchises), and it also engages in investment banking, brokerage, and asset management services.[103] However, Senator Warren implies that the problems that led to the Citigroup bailout in 2008 were primarily driven by traditional investment banking activities, such as underwriting and dealing in corporate securities (so-called risky investments), as opposed to traditional commercial banking activities, such as mortgage and commercial lending and similar investments ("boring" banking). But the primary cause of losses for Citigroup was its portfolio of US mortgage-related assets in the form of collateralized debt obligations. Charles Prince, the chairman and CEO of Citigroup during the time of the initial announcement of major losses at Citigroup in November 2007 (which led to his resignation that same month), testified before the Financial Crisis Inquiry Commission that the cause of the losses at Citigroup were "the wholly unanticipated and dramatic collapse in residential real

101. McKinley, *Financing Failure*, 66–101.

102. "Sen. Elizabeth Warren Pitches 21st Century Glass-Steagall Bill," Fox News, 2:00.

103. For a good summary of the various business lines of Citigroup around the time of the multiple government bailouts as it was broken into two primary operating units (Citicorp and Citi Holdings), see Citigroup Inc., "Citi to Reorganize into Two Operating Units to Maximize Value of Core Franchise," Citigroup website, January 16, 2009, http://www.citigroup.com/citi/press/2009/090116b.htm.

estate values across the board, in every community and geographic location nationwide."[104]

Rationalizations provided by supporters of Glass-Steagall restrictions for the relative calm in the financial industry during the period after the Depression and the attribution of Citicorp's losses during the most recent crisis do not hold up under scrutiny. The goal that, through targeted legislation, "risky" investments will first be sufficiently defined and then be walled off from traditional banking is not achievable either in the context of the Volcker Rule or in the broader context of the proposed Glass-Steagall reinstatement. Both efforts are rooted in an anachronistic desire for banks to be special.

CONCLUSION

The idea that banks are special involves the application of a value judgment that certain financial service activities provide more social utility than others. As outlined by Gerald Corrigan, it means that "banks" play such a vital role in the economy and the financial system that they should be backstopped by the federal government through various elements of the financial safety net. The overarching goal of this safety net is to limit damaging drains of deposits (runs) and contribute to a stable financial system.

The Corrigan formulation further gives the impression that the safety net, combined with powers to engage in and restrictions on the risk-taking activities of banks, are a series of logical tradeoffs negotiated to an optimal level. The reality is that the parameters of the safety net and the activities of banks are the subject of political negotiations, what has been called the Game of Bank Bargains. This involves a partnership among those who influence banking policy: the group in control of the government, bankers, minority shareholders,

104. Charles Prince, former chairman and CEO of Citigroup Inc., testimony before the Financial Crisis Inquiry Commission, April 8, 2010, p. 4; Citigroup Inc., "Citi's Sub-prime Related Exposure in Securities and Banking," Citigroup website, November 4, 2007. Prince also noted in his testimony that the declines in the fair value of Citi's sub-prime related direct exposures occurred after a series of rating agency downgrades of sub-prime US mortgage-related assets. See also "2008 Financial Crisis and Citigroup Senior Management, Day 2, Panel 1," C-Span website, April 8, 2010, http://www.c-spanvideo.org/program/SeniorM; Bair, *Bull by the Horns*, 54–55. Bair also describes some of the financial institutions' exposures to the collateralized debt obligations market, particularly the incentives to sell off equity tranches to other firms, which led to lower capital requirements if they bought back the triple-A rated portion. See also Lawrence J. White, "The Gramm-Leach-Bliley Act of 1999: A Bridge Too Far? Or Not Far Enough?," *Suffolk University Law Review* 43, no. 4 (2010): 15.

debtors, and depositors.[105] As the critics of the Corrigan approach pointed out decades ago, this idea that banks are special is a mere creation of government policy. The Corrigan construct can best be summarized as a post hoc justification for the powers and restrictions on banks and the parameters of the safety net as they existed back in 1982.

Any significant vestige of the concept that banks are special existing in the eyes of the financial authorities before the 2007–2009 crisis was jettisoned in the response to the crisis. This attitude was best summarized by the Geithner comment that there was a need to "extend a safety net against panic broad enough to cover the institutions and markets most critical to economic growth."[106]

Although he gave an obligatory nod to the concept of the special nature of banks in his 2010 testimony, Gerald Corrigan himself has not weighed in to revisit whether banks are still special and he actually weighed in against the Volcker Rule, which was the major element of the Dodd-Frank Act that was in keeping with the spirit of the doctrine that banks are special. The reasons for the attractiveness of the Volcker Rule seem to reflect nostalgia driven by a strange cult of personality surrounding Chairman Volcker; they are not based on the lessons learned from the crisis or the logic of the underlying arguments.

What is also clear from an examination of the responses to the turbulence of 2008 and 2009 is that there never was a lucid examination of the justifications for expanding the safety net during the development of the ad hoc solutions as the crisis was ongoing in real time. Efforts were focused on reducing volatility in the short run with little consideration for the long-term consequences of the interventions. The deliberations during the development of the Dodd-Frank provisions afforded an opportunity to take a more measured analysis of the newly expanded safety net. The authors of that legislation argue that they cut back the safety net from the peak size of the crisis period, but these pronouncements have rightly been met with a great deal of skepticism.

Recent calls by advocates for a reinstatement of the Glass-Steagall Act would take the Volcker Rule a step further. Their arguments are in keeping with the concept that banks are special, as they euphemistically and approvingly characterize select financial services provided by banks as "socially valuable

105. Charles W. Calomiris and Stephen H. Haber, *Fragile by Design: The Political Origins of Banking Crises and Scarce Credit* (Princeton, NJ: Princeton University Press, 2014), 27–59 (bank bargains generally); 13, 36–37, 258–59, 453, 461–62, 483 (safety net).
106. Geithner, *Stress Test*, 363.

core banking activities."[107] In so doing, they also imply that extending credit through commercial banks is nearly riskless, an idea that a quick review of history reveals to be an absurd notion.[108]

The ultimate goal of the treatment of banks as special was financial stability. The system of imposing investment limitations and granting power to financial supervisors to monitor risk on the investment side while simultaneously allowing the discretion to apply a safety net to nearly every type of creditor on the liability side has not worked. Rather than leading to a more stable financial system, the United States continues to experience financial instability, as evidenced by two major financial crises since Corrigan penned his analysis that banks are special in 1982.[109] That system remains in place after the changes under Dodd-Frank, which ironically were meant to trim back the safety net from its breadth during the 2007–2009 crisis.

The safety net for banks has had both stabilizing and destabilizing effects.[110] Drains on funding have continued, and during each passing crisis, new demands have arisen for expanding the safety net further. The panicked concerns publicly expressed by the financial authorities about the potential damage from runs on financial institutions, based on narrow and flawed analysis of individual institutions, have contributed to even greater instability. Movement toward the safety net has been in an upward direction for decades since 1982 (see table 4), but that movement has to reverse back down to the lowest rungs on the ladder.

Narrowing the scope of the safety net in a more satisfactory manner than in Dodd-Frank is an achievable goal. The focus should not be on the investment side, but rather on narrowing the beneficiaries of the safety net. As an initial step, the safety net should be reduced to small, individual demand creditors, those who are most likely to run and withdraw entirely from the financial system. The current outsized level of deposit insurance coverage and availability of discretionary payments to large creditors based on financial stability concerns are well beyond this basic level. Meanwhile

107. This phrase is used in Thomas M. Hoenig and Charles S. Morris, "Restructuring the Banking System to Improve Safety and Soundness," Federal Reserve Bank of Kansas City, May 2011. The same phrase is used in Senator Warren's bill, the 21st Century Glass-Steagall Act of 2013.

108. Senator Warren advanced the idea that extending credit to commercial banks is nearly riskless by contrasting "boring" commercial banking such as extending loans with the activities of nonbanks, which she indicated by shaking her hand as if to roll dice. "Sen. Elizabeth Warren Pitches 21st Century Glass-Steagall Bill," Fox News.

109. Carmen M. Reinhart and Kenneth S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (Princeton, NJ: Princeton University Press, 2009), 203–22, 390.

110. Calomiris and Haber, *Fragile by Design*, 36–38, 190–95, 258–59, 461–62.

the wholesale, institutional depositors and creditors who are capable of monitoring the condition of individual financial institutions should fend for themselves. The latter investors have the resources to monitor the condition of banks on their own or to pay a third party to address the risk of losing deposited or loaned funds.[111]

TABLE 4. OPTIONS FOR BREADTH OF THE SAFETY NET

Full federal safety net	All creditors at all types of financial institutions are protected.
Extended safety net	Circa 2008 and 2009, banks are not special.
Limited safety net	Banks are special (Corrigan) and deserving of a safety net.
De minimis safety net	Level of coverage is focused on small, individual demand creditors.
No federal safety net	No creditors are protected; banks are not special because their failure poses no particular danger.

111. "Promontory International Network LLC . . . sells products to thousands of banking clients, including a method of spreading large deposits among several institutions to ensure they are covered by FDIC insurance that otherwise tops out at $250,000 per account." Jesse Hamilton and Cheyenne Hopkins, "Banking Consultant Promontory to Face U.S. Senate Panel," *Bloomberg*, April 10, 2013.

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The views expressed in this study are McKinley's own and do not represent the views of any of the organizations he has previously worked for.

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