

QUIXOTIC REGULATION: SECTION 23A OF THE FEDERAL RESERVE ACT AND CONTAINMENT OF THE FEDERAL SAFETY NET SUBSIDY

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Section 23A of the Federal Reserve Act imposes quantitative and qualitative limits on certain transactions between depository institutions and their non-depository affiliates. The Board of Governors of the Federal Reserve states that a purpose of Section 23A, along with Section 23B of the Federal Reserve Act, which mandates that depositories conduct affiliate transactions on arm's length terms, is to prevent any subsidy given to depositories by the federal safety net from leaking to their non-depository affiliates. Yet Section 23A does not stop subsidy from leaking to non-depository affiliates through mispriced transactions; Section 23B does this by mandating that depositories receive adequate compensation in affiliate transactions. Most importantly, neither Section 23A nor Section 23B can prevent subsidy from leaking through dividend transactions to non-depository affiliates or to shareholders. Thus, in this Note, I question the usefulness of restrictions on affiliate transactions and of restrictions on affiliations generally, concluding that the goal of containing subsidy should take a backseat to the goal of preventing subsidy from accruing to depository institutions in the first place.

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INTRODUCTION

Modern banking law is designed in part to prevent the government subsidy provided to depository banking institutions by the federal safety net¹ from subsidizing non-depository financial activity. In working toward this goal, policymakers have struggled to define the set of activities in which depositories can engage directly and the ways in which depositories can associate and transact with other types of financial companies. The proper scope of depository activity limitations underlies debates over high-profile banking laws from the Glass-Steagall Act, which prohibited a depository institution from dealing in or underwriting securities or affiliating with an institution that principally underwrites securities,² to the Volcker Rule, which prohibits a depository institution, one of its affiliates, or its holding company from proprietary trading.³ The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act” or “Dodd-Frank”) directs the Financial Stability Oversight Council to study and recommend possible implementations of the Volcker Rule that will “limit the inappropriate transfer of Federal subsidies from institutions that benefit from deposit insurance and liquidity facilities of the Federal Government to unregulated entities.”⁴

¹ I refer here to the subsidy which may be given to depositories through underpriced deposit insurance and discount window loans, *see infra* Part II.A.1., not the subsidy given to “too-big-to-fail” financial institutions—including those without depository subsidiaries—through implicit government backing, *see infra* text accompanying notes 82–88.

² *See* Banking Act of 1933, Pub. L. No. 73–66, §§ 16, 20, 21, 32 Stat. 162, 184–94 (codified as amended in scattered sections of 12 U.S.C.), *repealed in part* by Financial Services Modernization Act of 1999 (Gramm-Leach-Bliley Act), Pub. L. No. 106–102, 113 Stat. 1338 (codified as amended in 15 U.S.C. §§ 6801–6809 and §§ 6821–6827).

³ *See* Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111–203, § 619, 124 Stat. 1376, 1620–31 (2010). The Rule also imposes additional capital requirements on nonbank financial companies supervised by the Board of Governors of the Federal Reserve System that engage in proprietary trading. *Id.*

⁴ *Id.* at 1621 (to be codified at 12 U.S.C. § 1851(b)(1)(C)). In a floor debate of the conference report of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the chairman of the Financial Institution Subcommittee of the House Committee on Financial Services stated that “a strong Volcker rule” would “minimize a bank’s ability to use subsidized funds for risky trading practices.” 156 CONG. REC. H5244 (daily ed. Jun. 30, 2010) (statement of Rep. Gutierrez), 156 Cong Rec H 5233, at *H5,244 (LEXIS).

A less prominent law, Section 23A of the Federal Reserve Act (“Section 23A”),⁵ has lurked in the background of these debates. Section 23A imposes quantitative and qualitative limits on certain transactions between depository institutions and their non-depository affiliates. Along with Section 23B of the Federal Reserve Act (“Section 23B”), which mandates that depository institutions conduct affiliate transactions on market terms,⁶ Section 23A’s purposes are to prevent the subsidy given to depositories through the federal safety net from leaking to their non-depository affiliates, and to prevent depositories from incurring excessive credit exposure to their riskiest affiliates.⁷ Congress repealed the Glass-Steagall Act’s prohibition on the affiliation of depository institutions and investment banks at least partly because Section 23A remained as a firewall to contain the federal subsidy provided to depositories.⁸

In a recent article, Saule T. Omarova, assistant professor of law at the University of North Carolina, argues that certain regulatory exemptions of affiliate transactions from Section 23A’s quantitative and qualitative restrictions have undermined Section 23A’s purposes, creating moral hazard and financial instability.⁹ She further argues that amendments to Section 23A by the Dodd-Frank Act will likely fail to restrain regulators from issuing problematic exemptions from Section 23A.¹⁰ She concludes that the continued broad availability of regulatory exemptions means that Section 23A can no longer bear the weight of being the primary statutory firewall between depositories and their affiliates after Congress’s repeal of the Glass-Steagall Act’s prohibition on depository affiliations with firms principally engaged in securities underwriting.¹¹

In this Note, I first contend that Section 23A cannot prevent subsidy from escaping depositories. Unlike Omarova, I argue that Section 23A could never bear the weight of containing the federal safety net subsidy—insofar as it exists—*irrespective of* regulatory exemptions. I identify two forms of subsidy leakage: transactions between a depository and its non-depository

⁵ See generally 12 U.S.C. § 371c (2006) (amended 2010).

⁶ See 12 U.S.C. § 371c-1 (2006) (amended 2010). Section 23B requires affiliate transactions to be conducted on terms “that are substantially the same, or at least as favorable to such bank or its subsidiary, as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies.” 12 U.S.C. § 371c-1(a)(1)(A) (2006). When comparable transactions are not available in the marketplace for reference, the statute requires affiliate transactions to be conducted on terms that in good faith would be extended to nonaffiliated companies. See § 371c-1(a)(1)(B). Except where noted, I refer to terms meeting either of these requirements as “market” terms, and transactions done on market terms as “arm’s length” transactions.

⁷ See Transactions Between Member Banks and Their Affiliates, 67 Fed. Reg. 76,560, 76,560 (Dec. 12, 2002) (codified at 12 C.F.R. pt. 223).

⁸ See *infra* text accompanying notes 45–46.

⁹ See Saule T. Omarova, *From Gramm-Leach-Bliley to Dodd-Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act*, 89 N.C. L. REV. 1683, 1689 (2011).

¹⁰ *Id.* at 1760-63.

¹¹ *Id.* at 1765-68.

affiliates made on favorable terms, and upstream dividends from a depository to a bank holding company (“BHC”) that allow the BHC to capitalize non-depository affiliates. Section 23B is designed to prevent the first form of subsidy leakage by mandating that depositories conduct affiliate transactions on arm’s length terms. As such, exemptions from the arm’s length terms requirement of Section 23B, not the quantitative and qualitative restrictions of Section 23A, are principally responsible for allowing subsidy leakage to affiliates through favorably priced affiliated transactions. With respect to the second form of subsidy leakage, neither Section 23A nor Section 23B restricts dividend payments. Therefore, neither provision can prevent depositories from leaking subsidy to affiliates or individual shareholders through dividends. Given Section 23A and Section 23B’s inability to stop subsidy leakage through dividends, I question whether it is worth trying to prevent the leakage of subsidy to depositories’ affiliates. Congress should either stop subsidizing depository banking or stop trying to limit the inevitable transfer of the subsidy out of depositories.

I then briefly consider Section 23A’s second purpose: preventing depositories from incurring excessive credit risk to their riskiest affiliates.¹² I acknowledge that Section 23A can help accomplish this purpose. But Section 23A is not unique because similar limits apply to non-affiliate transactions, and Section 23A does not bear the weight of preventing excessive credit exposure alone.

Finally, I turn to the Dodd-Frank Act’s amendments to Sections 23A and 23B and explain why the amendments, insofar as they are intended to bolster the subsidy containment goal of the statutes, make little difference. Subsidy containment is impossible so long as a depository can freely declare dividends.

I. THE OPERATION AND PURPOSES OF SECTIONS 23A AND 23B

A. *The Operation of Sections 23A and 23B*

1. *Section 23A*

Section 23A imposes several restrictions on a depository institution’s transactions with its affiliates.¹³ First, it limits a depository’s “covered transactions” with affiliates.¹⁴ The limits are 10% of a depository’s capital stock and surplus for transactions with any individual affiliate, and 20% for aggre-

¹² See Transactions Between Member Banks and Their Affiliates, *supra* note 7, at 76,560.

¹³ Sections 23A and 23B apply to member banks, 12 U.S.C. §§ 371c, 371c-1 (2006), and since 1966, insured non-member banks, An Act to Amend the Bank Holding Company Act of 1956, Pub. L. 89-485, § 12(c), 80 Stat. 236, 242 (1966) (codified as amended in 12 U.S.C. § 1828(j) (2006)).

¹⁴ See 12 U.S.C. § 371c(a)(1) (2006).

gate transactions with all affiliates.¹⁵ A depository's "covered transactions" include the extension of credit to an affiliate, the purchase of an affiliate's securities, the purchase of assets from an affiliate, and the issuance of guarantees on behalf of an affiliate.¹⁶ Second, Section 23A prevents the purchase of "low-quality" assets from an affiliate.¹⁷ Third, Section 23A requires any loan to an affiliate to be collateralized with assets ranging from 100 to 130% of the value of the loan, depending on the quality of the collateral.¹⁸ Fourth, Section 23A requires all covered transactions to be consistent with safe and sound banking practices.¹⁹ Section 23A exempts certain types of transactions from its requirements categorically²⁰: for example, Section 23A does not apply to a depository's loans or guarantees to an affiliate which are fully secured by U.S. government obligations,²¹ a depository's purchase of assets with a readily available market quotation at the quoted price from an affiliate,²² or a depository's purchase of nonrecourse loans from an affiliate.²³

2. Section 23B

Section 23B requires depository institutions to conduct certain affiliate transactions at arm's length. Section 23B applies to "covered transactions" as defined in Section 23A²⁴ as well as to the sale of assets or securities by a depository to its affiliates and to the payment of money or furnishing of services to an affiliate pursuant to a contract.²⁵ Section 23B requires covered transactions to be done on terms and circumstances at least as favorable to the depository as they would be in comparable transactions involving nonaffiliated companies.²⁶ Where comparable transactions are unavailable, affli-

¹⁵ See *id.*

¹⁶ See 12 U.S.C. § 371c(b)(7).

¹⁷ See 12 U.S.C. § 371c(a)(3). Importantly, low-quality assets are not simply risky assets. Low-quality assets are generally defined as assets whose collectability has been impaired. See 12 U.S.C. § 371c(b)(10); 12 C.F.R. § 223.3(v) (2011). A depository may purchase low-quality assets that it had committed to buy before its affiliate acquired them. See 12 U.S.C. § 371c(a)(3).

¹⁸ See 12 U.S.C. § 371c(c).

¹⁹ See 12 U.S.C. § 371c(a)(4).

²⁰ However, exempt transactions are still subject to the § 371c(a)(4) requirement that they be consistent with safe and sound banking practices. See 12 U.S.C. § 371c(a)(4).

²¹ See 12 U.S.C. § 371c(d)(4). Regulation W expands this exemption to exclude transactions from the quantitative limits *to the extent* such transactions are collateralized by U.S. government obligations. See 12 C.F.R. § 223.42(c) (2010).

²² See 12 U.S.C. § 371c(d)(6).

²³ See *id.* These transactions, however, subject to § 371c(a)(3)'s prohibition against purchasing "low-quality" assets.

²⁴ See 12 U.S.C. § 371c-1(a)(2)(A) (2006); 12 U.S.C. § 371c-1(d)(3). Section 23B does not apply to transactions exempt under Section 23A's subsection (d). See 12 U.S.C. § 371c-1(d)(3).

²⁵ See 12 U.S.C. § 371c-1(a)(2).

²⁶ See 12 U.S.C. § 371c-1(a)(1)(A).

ated transactions must be done on terms and circumstances that in good faith would apply to nonaffiliated companies.²⁷

3. Exemptions

Sections 23A and 23B each empower the Board of Governors of the Federal Reserve System (the “Federal Reserve Board” or “Board”) to exempt transactions from those provisions’ restrictions provided that each exemption is “in the public interest” and “consistent with the purposes of” the provisions.²⁸ They also empower the Board to issue rules and regulations to implement the provisions.²⁹ Pursuant to this authority, the Board issued Regulation W in 2002.³⁰ Regulation W clarifies the scope of 23A and 23B of the Federal Reserve Act, sets forth valuation principles, and defines key terms such as “capital stock and surplus.”³¹ As originally issued, Regulation W exempted derivatives transactions categorically from Section 23A, though not from Section 23B.³² The Dodd-Frank Act amended Section 23A to include derivatives transactions.³³

In addition, Regulation W provides that the Federal Reserve Board may issue discretionary exemptions from Sections 23A and 23B.³⁴ A depository may request a discretionary exemption from the quantitative and qualitative restrictions of Section 23A by explaining to the Board: (1) the details of the transaction or relationship for which the member bank seeks exemption, (2) why the Board should exempt the transaction or relationship, and (3) how the exemption would be in the public interest and consistent with the purposes of Section 23A.³⁵ Regulation W does not delineate the process for requesting discretionary exemptions from the arm’s length requirement of Section 23B.

4. Enforcement

The Federal Reserve enforces Sections 23A and 23B through its examination process.³⁶ In examining a member bank, the Federal Reserve reviews the depository’s internal controls³⁷ and its transactions with its affiliates³⁸ to

²⁷ See 12 U.S.C. § 371c-1(a)(1)(B).

²⁸ 12 U.S.C. §§ 371c(f)(2); 371c-1(e)(2)(A).

²⁹ See 12 U.S.C. §§ 371c(f)(1); 371c-1(e)(1).

³⁰ See 12 C.F.R. § 223 (2010).

³¹ See 12 C.F.R. § 223.3(d).

³² See Transactions Between Member Banks and Their Affiliates, *supra* note 7 at 76,587–76,589.

³³ See *infra* Part IV.

³⁴ See 12 C.F.R. § 223.43(a).

³⁵ See 12 C.F.R. § 223.43(b).

³⁶ See John R. Walter, *Firewalls*, 84 FED. RES. BANK OF RICHMOND ECON. Q. 15, 28 (1996).

³⁷ See BD. OF GOVERNORS OF THE FED. RES. SYS., COMMERCIAL BANK EXAMINATION MANUAL § 4050.3 at 3 (2011).

³⁸ See *id.* § 4050.3 at 1–4.

assess compliance with Sections 23A and 23B. Additionally, BHCs must submit to the Federal Reserve a quarterly report signed by an authorized officer of the BHC detailing how the insured depository subsidiaries' affiliate transactions comply with Section 23A.³⁹ No affirmative filings are required to demonstrate compliance with Section 23B.⁴⁰ However, bank examiners periodically scrutinize depositories and BHCs for compliance with both Sections 23A and 23B.⁴¹

B. *The Purposes of Sections 23A and 23B*

The Federal Reserve Board has stated that the purposes of Sections 23A and 23B are twofold: to prevent the subsidy given to depositories by the federal safety net from leaking to their non-depository affiliates, and to prevent depositories from incurring excessive credit exposure to their riskiest affiliates.⁴² Sections 23A and 23B were enacted in 1933 and 1987, respectively, both in the era of the Glass-Steagall Act,⁴³ which prohibited the affiliation of depository institutions with securities firms.⁴⁴ Greater responsibility has been imputed to Sections 23A and 23B ever since the Gramm-Leach-

³⁹ See BD. OF GOVERNORS OF THE FED. RES. SYS., THE BANK HOLDING COMPANY REPORT OF INSURED DEPOSITORY INSTITUTIONS' SECTION 23A TRANSACTIONS WITH AFFILIATES—FR Y-8 (expires Apr. 30, 2012), http://www.federalreserve.gov/reportforms/forms/FR_Y-820110331_f.pdf.

⁴⁰ See generally *Financial Statements*, BD. OF GOVERNORS OF THE FED. RESERVE SYS. (Sept. 8, 2007), <http://www.federalreserve.gov/reportforms/CategoryIndex.cfm?WhichCategory=1> (listing the Federal Reserve's financial statement reporting forms).

⁴¹ See BD. OF GOVERNORS OF THE FED. RES. SYS., COMMERCIAL BANK EXAMINATION MANUAL § 4050.2 at 1 (2011); BD. OF GOVERNORS OF THE FED. RES. SYS., BANK HOLDING COMPANY SUPERVISION MANUAL § 2020.1 at 1 (2012).

⁴² The Board has generally stated that Sections 23A and 23B jointly have these purposes. See, e.g., *Transactions Between Member Banks and Their Affiliates*, *supra* note 7 at 76,560 ("Sections 23A and 23B of the Federal Reserve Act are important statutory provisions designed to protect against a depository institution suffering losses in transactions with affiliates. They also limit the ability of a depository institution to transfer to its affiliates the subsidy arising from the institution's access to the Federal safety net."); Adoption of Regulation W Implementing Sections 23A and 23B of the Federal Reserve Act, Fed. Res. Supervisory Letter SR 03-2 (Jan. 9, 2003), available at <http://www.federalreserve.gov/boarddocs/srletters/2003/sr0302.htm> ("Sections 23A and 23B and Regulation W limit the risks to a bank from transactions between the bank and its affiliates and limit the ability of a bank to transfer to its affiliates the subsidy arising from the bank's access to the Federal safety net."). The Board has also stated, without referring to Section 23B, that Section 23A has these two purposes. See Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Carl Howard, Gen. Counsel, Citigroup Inc., at 2 (Aug. 20, 2007), available at <http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2007/20070820b/20070820b.pdf> (citing *Transactions Between Member Banks and Their Affiliates*, *supra* note 7 at 76,560, in which the Board indicated that Sections 23A and 23B together have these purposes). In addition, before Congress enacted Section 23B, the Board attributed these purposes solely to Section 23A. See *Transactions Between Member Banks and Their Affiliates*, 56 FED. RES. BULL. 518, 518 (1970).

⁴³ Congress enacted Section 23A in the Glass-Steagall Act itself. See Pub. L. 73-66, § 13, 48 Stat. 162, 183. It enacted Section 23B in the Competitive Equality Banking Act of 1987, Pub. L. 100-86, § 102, 101 Stat. 552, 564 (1987).

⁴⁴ See Pub. L. 73-66, §§ 16, 20, 21, 32, 48 Stat. at 184-94.

Bliley Act of 1999 (the “GLB Act”) repealed Glass-Steagall’s restrictions on affiliations with securities firms.⁴⁵ The GLB Act left Sections 23A and 23B as the last line of defense against the spread of the federal safety net to non-depository institutions. Indeed, the Senate Report of the GLB Act cited the continued existence of Sections 23A and 23B as a justification for removing restrictions on depositories’ affiliations:

From a safety-and-soundness perspective, both the bank operating subsidiary and the holding company affiliate structures can provide adequate protection to the insured depository institution from the direct and indirect effects of losses in nonbank subsidiaries or affiliates. . . . [I]n practice, regulatory safeguards for operating subsidiaries . . . and existing safeguards for affiliates, such as Sections 23A and 23B of the Federal Reserve Act, would inhibit a bank from passing any net marginal subsidy either to a direct subsidiary or to an affiliate of the holding company.⁴⁶

The GLB Act’s passage meant that depositories could affiliate with a wider range of institutions than they could under the Glass-Steagall regime.⁴⁷ The magnitude of the problems Sections 23A and 23B were intended to contain changed, but the Board’s use of its exemptive authority did not.⁴⁸

In *From Gramm-Leach-Bliley to Dodd-Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act*, Professor Omarova examines the Federal Reserve Board’s exemptions from the quantitative and qualitative requirements of Section 23A leading up to and during the financial crisis.⁴⁹ She states that the Board issued exemptions that undermined the Section 23A’s protections against subsidy leakage and excessive risk.⁵⁰ Because Dodd-Frank did not fully curtail the Board’s discretion to exempt transac-

⁴⁵ See Transactions Between Member Banks and Their Affiliates, *supra* note 7, at 76,560 (“[T]he new regulatory framework established by the Gramm-Leach-Bliley Act . . . emphasizes the importance of sections 23A and 23B as a means to protect depository institutions from losses in transactions with affiliates”).

⁴⁶ S. REP. NO. 106-44, at 66 (1999) (quoting the testimony of FDIC Chairman Donna Tanoue).

⁴⁷ The GLB Act of 1999 repealed Glass-Steagall’s prohibitions on depositories affiliating with securities firms. See Pub. L. 106-102, § 101, 113 Stat. 1338, 1341. It also repealed the Bank Holding Company Act’s prohibitions on affiliations with insurance sellers and underwriters. See Pub. L. 106-102, § 103(a), 113 Stat. at 1342–43.

⁴⁸ See Omarova, *supra* note 9, at 1701 (arguing that “in granting [post-GLB Act] exemptions from the requirements of section 23A, the Board failed to appreciate fully the radical change in the regulatory landscape as a result of the repeal of the Glass-Steagall era restrictions on bank affiliations”).

⁴⁹ See *id.* at 1705–41.

⁵⁰ See *id.* at 1728 (describing a series of 2007 Board exemptions intended to save the asset-backed securities market as “directly contrary to the twin statutory purposes of protecting depository institutions from losses in transactions with affiliates and limiting the ability of depository institutions to transfer to affiliates the subsidy arising from the institutions’ access to the federal safety net”); *id.* at 1737–38 (describing 2008 Board exemptions intended to provide liquidity in the money markets by allowing depositories to buy assets from their money market mutual fund affiliates as contrary to the subsidy containment purpose of Section

tions from Section 23A, she concludes that we need to “scale back our expectations of Section 23A and stop relying on it as the centerpiece legislative provision that supposedly protects banks from externally generated risks and prevents leakage of public subsidy outside the depository banking system.”⁵¹ While Professor Omarova is correct that we need to stop relying on Section 23A to accomplish its twin purposes, Section 23A’s failures are not due to regulatory exemptions.⁵² In the next Part, I explain how Section 23A could never prevent depositories from transferring to their affiliates any subsidy they may receive.

II. PREVENTING LEAKAGE OF THE FEDERAL SAFETY NET SUBSIDY

A. *Are Depositories Subsidized?*

In listing one of Section 23A and 23B’s purposes as preventing the subsidy given to depositories by the federal safety net from spreading to non-depository affiliates,⁵³ the Federal Reserve Board presupposes that there *is* a subsidy given to depositories by the federal safety net. This is not obvious. Depository institutions pay for the safety net’s two components: federal deposit insurance and access to the Federal Reserve’s discount window system.⁵⁴ The FDIC assesses fees for deposit insurance,⁵⁵ and the Federal Reserve banks charge an interest rate on discount window loans.⁵⁶

1. *Proper Pricing of the Federal Safety Net*

To determine whether a subsidy to depositories actually exists, it is necessary to determine whether deposit insurance and discount window loans are properly priced. If these services are underpriced, a subsidy likely accrues to their recipients because these recipients could obtain funds more cheaply than they could as noninsured or privately insured institutions. Creditors demand less interest on the debt of a firm that has the backing of the

23A); *id.* at 1768–69 (concluding that Section 23A “largely failed to fulfill its stated purposes” because of the Board’s use of its exemptive authority).

⁵¹ *Id.* at 1767.

⁵² Because Omarova attributes the subsidy-containment purpose of Sections 23A and 23B to Section 23A alone, *see* Omarova, *supra* note 9, at 1686, she overlooks the dominant role Section 23B plays in preventing subsidy leakage through mispriced transactions, *see infra* Part II.B.1.

⁵³ *See supra* note 42 and accompanying text.

⁵⁴ There may be a third component to the federal safety net in Fedwire, the Fed’s transfer system for large, critical fund transfers between member banks. The Federal Reserve assumes intraday credit risk by guaranteeing the finality of these payments. Arguably, this service is underpriced. *See* Kenneth Jones & Barry Kolatch, *The Federal Safety Net, Banking Subsidies, and Implications for Financial Modernization*, 12 FDIC BANKING REV. 1, 2 (1999). To the extent that Fedwire is underpriced, the analysis of this Part applies with equal force.

⁵⁵ *See* 12 C.F.R. § 327.3 (2011).

⁵⁶ *See* 12 C.F.R. § 201.51 (2011).

federal safety net than on the debt of a firm without such backing.⁵⁷ If the federal safety net is underpriced, a firm could pay less interest to creditors without paying the full price for the federal safety net that allows it to obtain the cheaper credit. A lower cost of funds will, all else being equal, increase earnings. As I will discuss in Part II.B, these increased earnings can be transferred out of the firm through mispriced transactions or dividends.

It is outside the scope of this Note to assess empirically whether deposit insurance and discount window loans are properly priced, but I will offer some observations.⁵⁸ Deposit insurance is properly priced if the insurance premiums are actuarially fair given the risk that the FDIC incurs in insuring the depository institution.⁵⁹ The FDIC has assessed various forms of risk-based premiums on banks ever since the 1993 implementation of the Federal Deposit Insurance Corporation Improvement Act of 1991.⁶⁰ Congress and the FDIC continually refine the methodology used to calculate these premiums to prevent any subsidy.⁶¹ Most recently, the Dodd-Frank Act revised the formula to make large firms pay a greater share of deposit insurance premiums.⁶²

Along with insurance premiums, Congress imposes activity restrictions⁶³ and risk-weighted capital requirements⁶⁴ on insured banks. Activity restrictions reduce the risk of bank failure and thereby limit the degree to which the insurance premiums may be underpriced.⁶⁵ Capital buffers are akin to insurance deductibles; they serve as a cushion to absorb an institu-

⁵⁷ See John R. Walter, *Can A Safety Net Subsidy Be Contained?* 84 FED. RES. BANK OF RICHMOND ECON. Q. 1, 10 (1998).

⁵⁸ “[E]mpirical research has not reached a consensus on whether deposit insurance is underpriced.” Gary Gorton & Richard Rosen, *Corporate Control, Portfolio Choice, and the Decline of Banking*, 50 J. FIN. 1377, 1379 n.8 (1995); see also *infra* text note 95 and accompanying text. There is, however, consensus that the discount window is underpriced because the Federal Reserve does not charge a commitment fee. See *infra* text accompanying notes 71–80.

⁵⁹ See Christopher Sleet & Bruce D. Smith, *Deposit Insurance and Lender-of-Last-Resort Functions*, 32 J. MONEY, CREDIT AND BANKING 518, 519–22 (2000) (acknowledging that that deposit insurance premiums ought to be actuarially fair to prevent a subsidy but arguing, contrary to conventional wisdom, that the pricing of deposit insurance is irrelevant to depositories’ risktaking in that depositories will compensate for higher insurance premiums by paying lower interest rates to depositors rather than increasing their risk).

⁶⁰ See 12 U.S.C. § 1817(b) (2006).

⁶¹ See, e.g., Federal Deposit Insurance Reform Act of 2005, Pub. L. 109-171, §§ 2104–2105, 120 Stat. 9, 12–15 (2005).

⁶² The FDIC must now base deposit insurance premiums on total consolidated assets of a bank minus tangible equity, rather than the historical assessment base of total domestic deposits. Compare Pub. L. No. 111-203, § 331(b), 124 Stat. at 1538 with Assessments, 71 Fed. Reg. 69,270, 69,272 (Nov. 30, 2006).

⁶³ See, e.g., 12 U.S.C. § 29 (2006) (limiting national banks’ ability to hold real property); 12 U.S.C. § 24(7) (2006) (limiting national banks’ ability to deal in equity securities and underwrite securities).

⁶⁴ See 12 U.S.C. 1831o (2006).

⁶⁵ See Stephen A. Buser et. al, *Federal Deposit Insurance, Regulatory Policy, and Optimal Bank Capital*, 36 J. FIN. 51, 52 (1981) (conceptualizing regulation as an implicit price of insurance premiums).

tion's initial losses.⁶⁶ More stringent capital requirements should reduce any net subsidy to the insured depository as well as limit the margin of error in pricing the insurance premiums, because less insurance is needed to cover the bank's insured deposits.⁶⁷ Thus, while deposit insurance premiums may not be priced perfectly, it is likely that premiums reasonably account for the FDIC's actual insurance risk.

Discount window loans, however, are improperly priced in two ways. First, the Federal Reserve does not properly take into account the borrower's risk of default. To be properly priced, the loan's interest rate, like an insurance premium, must be actuarially fair given the risk of the borrower's default. In setting discount window interest rates, the Federal Reserve only distinguishes between "generally sound" depositories and those depositories that are not "generally sound" but are likely to make a "timely return to a reliance on market funding sources."⁶⁸ The former group pays the primary credit rate, and the latter pays the higher secondary credit rate.⁶⁹ Within those broad categories, the Federal Reserve does not tailor discount rates to individual firms' risk profiles.

This need not mean that the Federal Reserve *directly* subsidizes those institutions that pay less than their risk suggests they should. On average, the Federal Reserve might be compensated for the risk it bears. Instead, the Federal Reserve's categorical approach could create a cross-subsidy from less risky institutions, which overpay for the discount window given their risk profiles, to more risky institutions that underpay.⁷⁰ This cross-subsidy may be by design. An individualized risk-weighted interest rate might price the smallest, riskiest banks out of being able to afford discount window loans. Still, a net subsidy exists to the firms that underpay.

Second, the Federal Reserve does not properly take into account the opportunity cost of lending to depository institutions during a liquidity crisis.⁷¹ If a depository's liquidity needs coincide with a market-wide tightening of credit, the interest it pays on a new loan could skyrocket as a depository's cost of borrowing increases. A properly priced discount window loan would charge exceptionally high rates of interest during a credit crunch because of a rise in market interest rates.⁷²

⁶⁶ See Jones & Kolatch, *supra* note 54, at 3.

⁶⁷ See *id.*

⁶⁸ 12 C.F.R. § 201.4(a)–(b) (2011).

⁶⁹ See *id.*

⁷⁰ Most likely there is both a subsidy from the Federal Reserve *and* a cross-subsidy from less-risky firms to more risky firms.

⁷¹ See Walter, *supra* note 57, at 5.

⁷² For example, the one month and three month LIBOR rates—the average rates at which banks in London charge other banks for one month and three month loans—shot up more than 84% and 71%, respectively, in the month after Lehman Brothers declared bankruptcy during the 2008 financial crisis. See *Key Rates*, BLOOMBERG, <http://www.bloomberg.com/markets/rates-bonds/key-rates/> (last visited Mar. 28, 2012).

Clearly, the Federal Reserve does not charge a proper price for discount window loans.⁷³ In fact, properly priced discount window loans would be antithetical to the Federal Reserve's recent interest rate policy, which is to provide *cheaper* credit to banks during a credit crunch.⁷⁴ No private lender would charge what the Federal Reserve does at these special times without a prepaid commitment fee to keep a line of credit open.⁷⁵ Because the Federal Reserve does not charge a commitment fee, it is undercompensated for its commitment to lend at low rates at any given time.⁷⁶

One might argue that the Federal Reserve's discount window loans are riskless because they are fully collateralized.⁷⁷ However, if collateralized loans were truly riskless, depositories would be able to find private collateralized financing and would not need to rely on the Federal Reserve in emergency conditions.⁷⁸ Moreover, in crises, uncertainty about the value of collateral curbs private lending.⁷⁹ Thus, by engaging in crisis-time lending at relatively low interest rates, the Federal Reserve almost certainly is undercompensated for its role as lender of last resort.⁸⁰

⁷³ See George Kanatas, *Deposit Insurance and the Discount Window: Pricing under Asymmetric Information*, 41 J. FIN. 437, 438 (1986) ("Any bank receiving such emergency funds has presumably been rationed out of the market, i.e., private lenders refuse to lend at any finite price . . .").

⁷⁴ In response to the financial crisis, the Federal Reserve decreased discount window primary credit rates from 5.75% in August 2007 to 0.5% by December 2008. *Historical Discount Rates*, FED. RESERVE DISC. WINDOW & PAYMENT SYS. RISK (last visited Mar. 25, 2012), <http://www.frbdiscountwindow.org/primarysecondary.xls>. The Federal Reserve also reduced interest rates in response to the September 11, 2001 terrorist attacks. See Antoine Martin, *Reconciling Bagehot and the Fed's Response to September 11*, 41 J. MONEY, CREDIT AND BANKING 397, 400 (2009). This interest rate policy is contrary to Walter Bagehot's principles of central banking in his seminal text, *Lombard Street: A Description of the Money Market*. Bagehot argued that in a crisis a central bank ought to lend liberally but at very high interest rates. See WALTER BAGEHOT, *LOMBARD STREET: A DESCRIPTION OF THE MONEY MARKET* 197 (1873).

⁷⁵ See Walter, *supra* note 57, at 5 n.9 (noting that private lenders charge 5 to 20 basis points per dollar amount of a loan commitment).

⁷⁶ See *id.* at 5; Bert Ely, *Revisiting an Old Debate: Do Banks Receive A Federal Safety Net Subsidy?*, 18 NO. 21 BANKING POL'Y REPORT 8, 19 (1999).

⁷⁷ See Ely, *supra* note 76, at 10 ("The Fed should not suffer any losses as a lender since it lends to banks only on a fully collateralized basis . . .").

⁷⁸ See Jones & Kolatch, *supra* note 54, at 3 ("Although discount window loans must be fully collateralized, the window's existence in periods when other sources of credit may not be available under any terms means this backup source of credit provides a subsidy to depository institutions."). However, collateralized lending can serve the purpose of reducing the risk to the lender by preventing a borrower from substituting the collateral for more variable assets. See Clifford W. Smith, Jr. & Jerold B. Warner, *Bankruptcy, Secured Debt, and Optimal Capital Structure: Comment*, 34 J. FIN. 247, 250 (1979).

⁷⁹ Cf. Gary Gorton, *The Subprime Panic*, 15 EUR. FIN. MGMT., 10, 36 (2009) ("The amount lent depends on the perceived market value of the asset offered as security. If that value cannot be determined, because there is no market – no liquidity, or there is the concern that if the asset is seized by the lender, it will not be saleable at all, then lender will not engage in repo.")

⁸⁰ See Andrew H. Chen & Sumon C. Mazumdar, *Impact of Regulatory Interactions on Bank Capital Structure*, 8 J. FIN. SERVICES RES. 283, 285 (1994) ("The discount window may provide subsidized credit to avoid assets' liquidation at fire sale value for purposes of meeting a temporary liquidity need and 'preserve the value of the bank charter.' The window is thus the first line of defense in the 'safety net' jointly provided by the Fed and the FDIC.") (citation

Could one persuasively argue that a healthier, more stable banking system is compensation to the government for its commitments? I doubt it. To say that the government receives some non-pecuniary benefit in exchange for its subsidy is *not* to say that there is no subsidy. An agricultural subsidy that produces its intended benefits of stable food prices and rural employment is still a subsidy to the agricultural industry.⁸¹

2. *Too Big to Fail*

A “too big to fail” regime under which the government is expected to take extraordinary steps to protect depository institutions might further subsidize depository institutions. During the 2008 financial crisis, Congress raised the deposit insurance limit from \$100 thousand to \$250 thousand per depositor and forbade the FDIC from taking this increase into account in setting assessments for insured institutions.⁸² The FDIC also guaranteed all senior unsecured debt of banks, thrifts, and certain holding companies with the Debt Guarantee Program component of the Temporary Liquidity Guarantee Program (“TLGP”).⁸³ The FDIC stated the goal of TLGP was to “decrease the cost of bank funding so that bank lending to consumers and businesses will normalize.”⁸⁴ The FDIC at least attempted to charge a price for its guarantees that reflected the scale of its commitments. TLGP imposed a sliding scale fee structure based on the maturity of the debt guaranteed.⁸⁵ To recoup losses to the Deposit Insurance Fund sustained during the crisis because of underpriced insurance the FDIC imposed a fund restoration plan⁸⁶ and special assessments on depository institutions.⁸⁷ Additionally, Dodd-Frank restricted the FDIC’s ability to guarantee depositories’ senior debt in the future.⁸⁸

omitted). Empirical analysis supports this conclusion. *See* Walter, *supra* note 75, at 5 (reporting that discount window rates were on average 75 basis points below the federal funds rate, at which banks loan funds to each other overnight, from 1986 to 1996).

⁸¹ *Cf.* Ely, *supra* note 76, at 19 (“Arguably, a public good—systemic stability—flows from non-bank access to the discount window. However, that good does not warrant this subsidy any more than the public good of federal deposit insurance would warrant a taxpayer subsidy for banks.”).

⁸² Emergency Economic Stabilization Act of 2008, Pub. L. 110-343, § 136(a)(1)–(2), 122 Stat. 3765, 3799 (2008). This change was initially temporary, *see id.*, but was later made permanent in the Dodd-Frank Act, Pub. L. No. 111-203, § 335, 124 Stat. 1376, 1540.

⁸³ *See* 12 C.F.R. § 370.3 (2011).

⁸⁴ *See* Press Release, Fed. Deposit Ins. Corp., FDIC Board of Directors Approves TLGP Final Rule (Nov. 21, 2008), <http://www.fdic.gov/news/news/press/2008/pr08122.html>.

⁸⁵ *See* 12 C.F.R. § 370.6(d)(1) (2011).

⁸⁶ *See* Press Release, Fed. Deposit Ins. Corp., FDIC Board Adopts Restoration Plan—Proposes Higher Assessments on Insured Banks (Oct. 7, 2008), <http://www.fdic.gov/news/news/press/2008/pr08094.html>.

⁸⁷ *See* Press Release, Fed. Deposit Ins. Corp., FDIC Extends Restoration Plan; Imposes Special Assessment (Feb. 27, 2009), <http://www.fdic.gov/news/news/press/2009/pr09030.html>.

⁸⁸ *See* Pub. L. 111-203, § 1105(c), 124 Stat at 2121.

3. Regulatory Costs

Until now, I have described subsidies as the cost to the provider of services—the government. This cost is *gross* subsidy. A subsidy might also be defined as the net benefit to the receiver of services that the receiver could not obtain privately. This benefit is *net* subsidy.⁸⁹ These amounts diverge when the provider imposes regulations on the receiver as a special condition of the benefits. Insured depository institutions with access to the discount window must comply with certain capital requirements,⁹⁰ prudential regulations,⁹¹ and other restrictions that do not apply to non-depository financial institutions.⁹² Compliance with these regulations is costly.⁹³ If any gross subsidy remains in depositories after incurring compliance costs, then the depositories receive a net subsidy.⁹⁴ Conclusions are mixed as to whether depositories receive a net subsidy.⁹⁵ While it is possible that depositories do not receive a net subsidy from the federal safety net, the analysis of subsidy-containing statutes in the following Parts of this Note will proceed as though depositories do receive a net subsidy because the Federal Reserve exercises its exemptive authority under Sections 23A and 23B on that assumption.⁹⁶

B. Section 23A Does Not Prevent Subsidy Leakage

There are two ways in which any subsidy given to depository institutions might leak to their non-depository affiliates: through a mispriced transaction with a non-depository affiliate or through a dividend to a BHC followed by capitalization of the non-depository affiliate.

⁸⁹ See Jones & Kolatch, *supra* note 54, at 5 (distinguishing between gross subsidies and net subsidies).

⁹⁰ See 12 C.F.R. § 208.43 (2011).

⁹¹ See *supra* note 63 and accompanying text.

⁹² For example, depositories must file detailed call reports with the Federal Financial Institutions Examination Council (“FFIEC”)—an interagency body including the Board, the FDIC, and the Comptroller of the Currency—which then makes the reports public. See generally *FFIEC: Reports of Condition and Income Instructions*, FED. DEPOSIT INS. CORP., http://www.fdic.gov/regulations/resources/call/crinstd/callinst2011_Sep.html (instructions for filling out reports) (last visited Apr. 6, 2012); 12 U.S.C. § 1817(a)(1) (2006) (legal authority for filing requirement).

⁹³ There are also opportunity costs to the depository in foregoing profitable but risky opportunities that prudential regulation bans or de-incentivizes.

⁹⁴ See Bernard Shull & Lawrence J. White, *The Right Corporate Structure for Expanded Bank Activities*, 115 *BANKING L.J.* 446, 466 (1998).

⁹⁵ Compare Jones & Kolatch, *supra* note 54, at 10–12 (finding that depositories do not receive a net subsidy) with Myron L. Kwast & S. Wayne Passmore, *The Subsidy Provided by the Federal Safety Net: Theory and Evidence*, 16 *J. FIN. SERVICES RES.* 125 (2000) (finding that depositories receive a net subsidy).

⁹⁶ See, e.g., Letter from Robert deV. Frierson, Deputy Sec’y of the Bd., Fed. Reserve Bd., to Carl Howard, Gen. Counsel, Citigroup Inc., at 4 (Aug. 20, 2007), available at <http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2007/20070820b/20070820b.pdf>.

1. *Mispriced Transactions*

A depository could transfer subsidy to an affiliate through a mispriced transaction by (a) making a loan to its affiliate at below-market terms, (b) receiving a loan from its affiliate at above-market terms, (c) buying an asset from its affiliate at above-market terms, or (d) selling an asset to its affiliate at below-market terms. By mandating that a depository's transactions with its affiliates are made on terms at least as favorable to the depository as to a would-be third party, Section 23B, not Section 23A, prevents subsidy from leaking to affiliates through mispriced transactions. A discretionary regulatory exemption only allows this form of subsidy leakage if it is an exemption from the arm's length requirement of Section 23B.

In her article, Professor Omarova identifies certain Section 23A exemptions made during the financial crisis as having allowed depositories to transfer subsidy to non-depository affiliates. These exemptions were intended to bolster the markets for asset-backed securities and auction rate securities by allowing depositories to purchase or finance the purchase of these instruments.⁹⁷ However, the Federal Reserve Board explicitly did not waive Section 23B for these transactions.⁹⁸ Thus, if any depositories transferred subsidy to their non-depository affiliates, they did so in disregard of Section 23B. Section 23B requires terms at least as favorable to depositories "as those prevailing at the time for comparable transactions with or involv-

⁹⁷ See *supra* note 50 and accompanying text. To bolster the market for mortgage and other asset-backed securities, the Federal Reserve Board's exemptions allowed certain large depositories to engage in repo financings with their broker-dealer affiliates, which in turn engaged in repo transactions with third parties. See Omarova, *supra* note 9, at 1726–27. In addition to troubles in the mortgage markets, the market for auction rate securities froze in early 2008, leaving investors unable to exit investments that they thought were as liquid as cash, and leaving issuers—many of whom were tax-exempt entities—paying high rates of interest. See Jenny Anderson & Vikas Bajaj, *New Trouble in Auction-Rate Securities*, N.Y. TIMES, Feb. 15, 2008, at C6. To add liquidity to the auction rate securities market, the Board granted exemptions to a number of depositories to purchase the securities from their affiliates. See Omarova, *supra* note 9, at 1731–34.

⁹⁸ For its exemptions in 2007 intended to save the asset-backed securities market, see Omarova, *supra* note 9, at 1726–1730, the Board required Section 23B compliance as a condition of Section 23A exemption, *e.g.*, Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Carl Howard, Gen. Counsel, Citigroup Inc., at 4 (Aug. 20, 2007), <http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2007/20070820b/20070820b.pdf>. Again, for transactions in December 2008 and January 2009 intended to inject liquidity into auction-rate securities markets, see Omarova, *supra* note 9, at 1731–35, the Board again required Section 23B compliance, *e.g.*, Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Charles M. Horn, Mayer Brown LLP (BB&T Corp.), at 4–5 (Jan. 9, 2009), http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2009/20090109/20090109_1.pdf. Before the financial crisis, the Board was sometimes less explicit and granted Section 23A exemptions without discussing Section 23B compliance. See *e.g.*, Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to S. Alan Rosen, Horgan, Rosen, Beckman & Coren (Valley Indep. Bank) (Aug. 14, 2003), <http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2003/20030814/>; Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Carl V. Howard, Gen. Counsel, Citigroup, Inc. (Aug. 28, 2001), <http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2001/20010828/>.

ing other nonaffiliated companies,” or in the absence of comparable transactions, on terms that in good faith would be offered to nonaffiliated companies.⁹⁹ During a panic in which market lenders refuse to purchase short-term liabilities or auction-rate securities, there are no reasonable market terms or even good faith approximations of market terms that could comply with Section 23B. Thus, these transactions likely violated Section 23B.

In 2009, to inject liquidity into the money markets, the Federal Reserve Board amended Regulation W to exempt from Section 23A depositories’ purchases of asset-backed commercial paper from their money market fund affiliates.¹⁰⁰ Omarova argues that this categorical Section 23A exemption undermined the provision’s twin purposes.¹⁰¹ By itself, the Section 23A exemption did not allow subsidy leakage. The Federal Reserve Board enacted a *concurrent* amendment to Regulation W that also exempted these transactions from Section 23B.¹⁰² The Section 23B exemption allowed affiliated money market funds to receive subsidy.

One might argue that Section 23A, by itself, limits opportunities for subsidy leakage by controlling the type and quantity of a depository’s affiliate transactions. Meanwhile, Section 23B seems rife with opportunities for abuse. Depository institutions must show that their transactions with affiliates are on arm’s length terms; but if depositories systematically misstate the value of transferred assets in times of illiquidity and volatility, resource-strapped regulators might have trouble policing Section 23B. One could imagine the quantitative and qualitative restrictions of Section 23A as an imperfect regulatory hedge against any enforceability problems of Section 23B.

If Section 23A is a prophylactic rule limiting subsidy leakage, then it is a poorly drafted one. Section 23A applies to neither a depository’s sale of assets below market terms nor its receipt of loans above market. It covers “with respect to an affiliate of a member bank—(A) a loan or extension of credit *to the affiliate*; . . . [or] (C) a purchase of assets, including assets subject to an agreement to repurchase, *from the affiliate*.”¹⁰³ Because Section 23A covers a member bank’s loan to a non-member bank affiliate and a member bank’s purchase of assets from a non-member bank affiliate but not the other way around,¹⁰⁴ two of the four types of mispriced transactions iden-

⁹⁹ 12 U.S.C. § 371c-1(a)(1)–(2) (2006) (emphasis added).

¹⁰⁰ See Transactions Between Member Banks and Their Affiliates, 74 Fed. Reg. 6,226, 6,227 (Feb. 6, 2009) (codified at 12 C.F.R. § 223.42(o) (2010)).

¹⁰¹ See Omarova, *supra* note 9, at 1735–38.

¹⁰² See Transactions Between Member Banks and Their Affiliates, *supra* note 100, at 6,228.

¹⁰³ 12 U.S.C. § 371c(b)(7) (2006) (emphasis added).

¹⁰⁴ See BD. OF GOVERNORS OF THE FED. RES. SYS., COMMERCIAL BANK EXAMINATION MANUAL § 4050.1, at 6 (Oct. 2010) (“Among the transactions that generally are not subject to section 23A are . . . sales of assets by a member bank to an affiliate for cash . . .”). By contrast, Section 23B expressly covers a member bank’s sales of assets to an affiliate, *see* 12 U.S.C. § 371c-1(a)(2)(B), and receipt of credit from an affiliate, *see* 12 U.S.C. § 371c-1(a)(2)(C), in addition to “covered transactions” as defined in Section 23A, *see* 12 U.S.C. § 371c-1(a)(2)(A).

tified above are still available—without Section 23A’s quantitative limitations—to a depository seeking to leak subsidy to its affiliates. Section 23A fails to act prophylactically against two kinds of mispriced transactions that allow subsidy leakage.

2. Upstream Dividends

Subsidy might leak to non-depository affiliates a second way: through upstream dividends.¹⁰⁵ A depository could issue a dividend to its holding company, which could then use those dividend proceeds to capitalize a non-depository subsidiary.¹⁰⁶ Neither Section 23A nor Section 23B can prevent this form of leakage because neither statute restricts dividend payments.¹⁰⁷

Existing dividend statutes do not prevent a depository from sending subsidy upstream.¹⁰⁸ However, the FDIC’s Prompt Corrective Action regime prevents an insured depository from making dividend payments that would leave it undercapitalized.¹⁰⁹ Other statutory provisions require a depository to show that paying a dividend will not impair its capital by barring any dividend payments in excess of the year’s current profits plus recent retained earnings.¹¹⁰ These statutes are not particularly restrictive. If a depository is adequately capitalized, it can issue dividends up to the full amount of its earnings. Given the fungibility of money and the difficulty of calculating the net subsidy given to depositories, it is difficult to imagine how any statute could plausibly restrict subsidy transfers through dividends. A statute could not keep the subsidy within a depository because it would be impossible to attribute particular earnings to the subsidy.

Bank regulators recognized this problem as Congress debated the GLB Act. Several officials discussed the issue in Congressional committee hear-

¹⁰⁵ Twenty years before the Gramm-Leach-Bliley Act passed in Congress and eight years before Section 23B was enacted, Professor Robert Clark identified additional variations of subsidy leakage. A depository could overpay for management fees and services charges, transfer operations into or out of itself, or prepay its debt to the BHC. See Robert C. Clark, *The Regulation of Financial Holding Companies*, 92 HARV. L. REV. 789, 803 (1979). While Section 23B covers the first type transaction, see 12 U.S.C. § 371c-1(a)(2)(C) (2006) (covering service contracts), as well as the second, see 12 U.S.C. § 371c-1(a)(2)(A)–(B) (covering purchases and sales of assets), it does not appear to cover the prepayment of debt to affiliates.

¹⁰⁶ See Bevis Longstreth & Ivan E. Mattei, *Organizational Freedom for Banks: The Case in Support*, 97 COLUM. L. REV. 1895, 1913 (1997). The BHC could also use that money to extend credit to the non-depository affiliate because a holding company’s extension of credit to its subsidiaries is outside the scope of Sections 23A and 23B. See Constance Z. Wagner, *Structuring the Financial Service Conglomerates of the Future: Does the Choice of Corporate Form to House New Financial Activities of National Banks Matter?*, 19 ANN. REV. BANKING L. 329, 418–19 (2000).

¹⁰⁷ See generally 12 U.S.C. § 371c; 12 U.S.C. § 371c-1.

¹⁰⁸ See generally 12 U.S.C. § 1831o(d)(1) (2006); 12 U.S.C. § 56 (2006); 12 U.S.C. § 60 (2006).

¹⁰⁹ See 12 U.S.C. § 1831o(d)(1).

¹¹⁰ See 12 U.S.C. § 56; 12 U.S.C. § 60. These rules also apply to state member banks through 12 U.S.C. § 324 (2006).

ings.¹¹¹ Then-Federal Reserve Board Chairman Alan Greenspan believed capital requirements would deter subsidy leakage.¹¹² He observed that dividend transfers to holding companies for the purpose of funding affiliates generally did not occur:

It is worth noting that a dividend payment by a bank to its holding company results in a real decline in bank capital. This is a genuine constraint on the subsidy transfer from banks to their holding company affiliates and helps explain the reality that bank dividends historically have not chronically exceeded the dividends paid out by holding company parents plus debt service. The use of bank dividends to fund holding company expansion would, of course, incorporate a modest safety net subsidy because bank earnings are higher than they otherwise would be because of the safety net. But the capital constraint—plus the supervisor’s natural tendency to guard against significant capital reductions—has limited such transfers.¹¹³

Chairman Greenspan failed to consider that “the fungibility of money makes it impossible to reach a conclusion about extensions of the safety net subsidy to the extent BHCs provide any funds to their nonbank subsidiaries.”¹¹⁴

To take a simplified example, suppose that a depository receives a net subsidy of \$5 million from the federal safety net and sends it in dividends to its BHC, which uses all of it to capitalize an investment bank subsidiary. Suppose that the investment bank uses that money for projects that yield \$6 million in earnings, and the investment bank then sends \$6 million in divi-

¹¹¹ See, e.g., *Modernization of the Financial System: Hearing Before the Subcomm. on Financial Institutions and Consumer Credit of the H. Comm. on Banking and Financial Services*, 105th Cong. 136 (1997) (statement of Alan Greenspan, Chairman, Fed. Res. Bd.) (“It is true that a bank could pay dividends from its earnings, earnings which have been enhanced by the safety net subsidy, to fund its parent’s nonbank affiliates.”); *Financial Modernization Legislation: Hearing Before the Subcomm. on Finance and Hazardous Materials of the H. Comm. on Commerce*, 105th Cong. 6 (1997) (statement of Eugene A. Ludwig, Comptroller of the Currency) (“But a bank can also pay dividends to its holding company—a transfer of funds which is not subject to [S]ections 23A and 23B. Those funds may then, in turn, be down-streamed to a holding company affiliate.”); Julie L. Williams, Chief Counsel, Office of the Comptroller of the Currency, *Banking Powers & Structure: Affiliates vs. Subsidiaries*, Remarks before the American Enterprise Institute for Public Policy Research (Mar. 26, 1997), <http://www.occ.gov/static/news-issuances/news-releases/1997/nr-occ-1997-35.pdf> (“[Section 23A] does not limit the amount of equity, in the form of dividends, that a bank may transfer to its holding company parent. Thus, it is the affiliate structure, not the subsidiary structure, that offers the greatest potential for transference of the hypothetical subsidy.”).

¹¹² *S. Comm. on Banking, Housing, and Urban Affairs*, 105th Cong. 14 (1998) (statement of Alan Greenspan, Chairman, Fed. Res. Bd.).

¹¹³ *Id.*

¹¹⁴ Longstreth & Mattei, *supra* note 106, at 1912–13. See also Jones & Kolatch, *supra* note 54, at 14 (“Unfortunately, despite Greenspan’s assertion that they do not, the fungibility of money and the mixing of funds at the holding company level prevent us from determining whether bank dividends actually do make their way to nonbank affiliates within the holding company.”) (citation omitted).

dends to the BHC, which pays \$6 million in dividends to BHC shareholders. In this situation, the depository's dividends to its BHC (\$5 million) did not exceed dividends from the BHC to its shareholders (\$6 million). Despite Greenspan's conclusion that such a result is consistent with at least some subsidy transfer constraint, in our example the full subsidy given to depositories has been transferred from the depository to its investment banking affiliate.¹¹⁵ Therefore, Greenspan's evidence does not prove that capital constraints prevent significant subsidy leakage.

C. Are Restrictions on Subsidy Leakage to Affiliates Worthwhile?

Subsidy can leak to a depository's affiliates through the payment of dividends to a BHC. Importantly, subsidy can also leak to BHC shareholders through dividend payments by a BHC. And even depositories without any affiliations can transfer subsidy to their owners through dividends.

Some believe that an important purpose of regulatory firewalls such as Glass-Steagall or strengthened Sections 23A and 23B is to prevent the receipt of subsidy by certain types of financial institutions like investment banks.¹¹⁶ It follows from this view that policymakers should abolish the affiliate structure because it allows these financial institutions to receive subsidy from their depository affiliates; bank regulation should return to the days of Glass-Steagall.¹¹⁷ Advocates of this view assume first that the subsidy given to depositories is likely to be transferred to investment bank affiliates rather than transferred to BHC shareholders, and second, that subsidy transfer to investment bank affiliates is somehow more problematic than a subsidy transfer to depository shareholders.

BHCs shareholders have some incentive to transfer a meaningful amount of subsidy from depository subsidiaries to investment bank subsidiaries rather than receive it as dividends, but the incentive is limited. If an investment bank had profitable projects for which it could use a depository's subsidized funds, it could conceivably fund itself through the capital markets

¹¹⁵ Even if the investment bank does not use the money for profitable projects that return dividends to the BHC, and instead squanders the subsidy, we could also imagine that a *third* affiliate sent enough dividends to the BHC to achieve the same result: dividends from the depository to the BHC are less than dividends from the BHC to its shareholders and the investment bank received subsidy from the depositories.

¹¹⁶ See, e.g., Omarova, *supra* note 9, at 1693 (describing a purpose of Section 23A as "prevent[ing depositories] from subsidizing affiliates' risky business activities with the protection afforded by federal deposit insurance"); Shull & White, *supra* note 94, at 463 ("[T]he spread of the subsidy will give banks an unfair advantage vis-a-vis their nonbank rivals in these nontraditional areas, as well as encouraging the inefficient expansion of banks into these areas."); Longstreth & Mattei, *supra* note 106, at 1901 ("[A]ll sides would agree that the subsidy, if there is one, should be limited as much as possible."). Others claim that the purpose of a firewall is to prevent against subsidizing certain types of activities. See 156 CONG. REC. H5244 (statement of Rep. Gutierrez) (stating that the Volcker Rule should be designed to "minimize a bank's ability to use subsidized funds for risky trading practices.").

¹¹⁷ See Omarova, *supra* note 9, at 1767-68 (stating that a return to Glass-Steagall principles is one possible policy response to Section 23A's failings).

rather than through subsidy transfer. However, there are a number of reasons a firm will probably prefer to use the subsidy transfer. First, there are transactional frictions, including the taxation of dividends paid to individual shareholders¹¹⁸ and the fees associated with securities offerings,¹¹⁹ that make it more efficient to fund the investment bank through a subsidy transfer from the BHC rather than through a dividend to BHC shareholders followed by a securities offering. Second, if the investment bank is on the verge of insolvency, a securities offering could signal the BHC's managerial incompetence and raise the cost of capital to the depository in the future,¹²⁰ although dividends tend to have the opposite effect.¹²¹ Third, the BHC might want to avoid "being irrationally starved of capital due to cyclicalities and investment fads" in the capital markets.¹²² Fourth, in liquid, efficient markets, much of the value of subsidy will accrue to BHC shareholders as capital gains even if the subsidy is reinvested in the depository or transferred to the investment bank, rather than sent to the shareholders through dividends.¹²³ But the existing BHC shareholders would balance these costs against the benefits of receiving cash in hand immediately, including the ability to diversify their holdings without selling BHC stock and reducing their control. Thus, in the ordinary course of business, the BHC's owners may have an incentive to transfer subsidy from a depository to its affiliates only to the extent that the transactional and other costs outweigh the benefits of receiving dividends immediately.¹²⁴

¹¹⁸ Congress fully taxes the receipt of dividends by individual shareholders but not by a BHC. A holding company, unlike an individual shareholder, can deduct up to 100% of the dividends it receives. See 26 U.S.C. § 243(a) (2006).

¹¹⁹ See James W. Wansley & Upinder S. Dhillon, *Underwriting Costs and Market Value Effects of Raising Bank Capital*, 23 *MANAGERIAL FIN.* 55, 65 (1997) (finding that BHCs pay underwriting costs that average 7.11% of the face value of common stock issues, 2.62% of preferred stock issues, and 1.06% of subordinated debt issues).

¹²⁰ See Walter, *supra* note 36, at 33.

¹²¹ See Ross N. Dickens et al., *Bank Dividend Policy: Explanatory Factors*, 41 *Q. J. BUS. & ECON.* 3, 6 (2002). The excessive retention of earnings also can signal distress. See Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 *AM. ECON. REV.* 261, 293 n.53 (1958).

¹²² Julia Porter Liebeskind, *Internal Capital Markets: Benefits, Costs, and Organizational Arrangements*, 11 *ORG. SCI.* 58, 58 (2000).

¹²³ Modigliani and Miller posited that in the absence of taxes, investors should be indifferent between dividends and capital gains. See Modigliani & Miller, *supra* note 121, at 293 n.53.

¹²⁴ In extraordinary situations, a BHC may want to transfer a large loss from a well-capitalized subsidiary, in which the BHC will bear the full loss, to a thinly capitalized depository subsidiary, where creditors will bear some of the loss as equity is wiped out, to take advantage of shareholder limited liability. See Walter, *supra* note 36, at 30–31. To the extent depositors would suffer a loss, the FDIC would bear that loss and make them whole. Restrictions on affiliate transactions thus protect the FDIC from bearing losses from mispriced affiliate transactions and prevents depositories from *extracting* subsidy from the government by shifting losses to the FDIC. However, the FDIC, as receiver of a failed depository, would likely be able to avoid such an insolvency-inducing affiliate transaction as a fraudulent conveyance. See 12 U.S.C. § 1821(d)(17). It is also difficult to imagine a BHC willingly reaping the ensuing market and regulatory wrath if it intentionally caused a depository to fail. See Walter, *supra* note 36, at 36.

Given that subsidy can accrue to shareholders through dividends and capital gains, why should policymakers try to prevent subsidy from leaking to non-depository affiliates? By taxing the receipt of subsidy by non-corporate shareholders, the government recaptures some of the subsidy immediately, rather than deferring this collection until the subsidy transferred to an investment bank eventually results in dividends to BHC shareholders. In addition, some have argued that subsidy leakage would give affiliated non-depository institutions a funding advantage over their unaffiliated competitors, causing market inefficiency.¹²⁵ Such inefficiencies might be outweighed by the synergistic efficiencies of large banking organizations.¹²⁶ Furthermore, research suggests that a conglomerate's internal allocations of funds can create more value than allocations by the external capital markets.¹²⁷ It is therefore not clear that public policy concerns militate in favor of restricting subsidy transfer among affiliates.

As the U.S. regulatory regime emerges from the financial crisis, a more pressing problem than constraining the destination of the subsidy given to depository institutions should be eliminating the subsidy provided to uninsured and less-regulated "shadow banking" financial institutions directly through an implicit extension of the federal safety net.¹²⁸ Because shadow banks, unlike depositories, do not pay for this support *ex ante*, they receive large subsidies through a lower cost of funds.¹²⁹ Any attempt to eliminate the

¹²⁵ See Walter, *supra* note 57, at 11 ("Nonbank access to subsidized funding, either through loans from the bank, or through the bank's equity investment in the nonbank, grants the nonbank an advantage not available to competitors who are not bank affiliated. The advantage encourages the growth of bank affiliates at the expense of other firms. Growth because of access to a subsidy, rather than because of some market advantage, is likely to lead to misallocation of resources."); Shull & White, *supra* note 94, at 463 ("[T]he spread of the subsidy will give banks an unfair advantage vis-a-vis their nonbank rivals in these nontraditional areas, as well as encouraging the inefficient expansion of banks into these areas."); James R. Barth et al., *Policy Watch: The Repeal of Glass-Steagall and the Advent of Broad Banking*, 14 J. ECON. PERSP. 191, 199 (2000).

¹²⁶ See generally Abdullah Mamun et al., *The Wealth and Risk Effects of the Gramm-Leach-Bliley Act (GLBA) on the US Banking Industry*, 32 J. BUS. FIN. & ACCOUNTING 351 (2005) (describing the welfare gains in the banking industry as a result of the GLB Act).

¹²⁷ See Stewart C. Myers & Nicholas S. Majluf, *Corporate Financing and Investment Decisions When Firms Have Information That Investors Do Not Have*, 13 J. FIN. ECON. 187, 188–89 (1984) (describing how managers can use inside information to create more value for existing shareholders by reinvesting earnings rather than issuing stock). *But see* Liebeskind, *supra* note 122, at 59 (identifying limits to the advantages of internal capital markets).

¹²⁸ During the crisis, the "paramount objective" of the government's emergency policy response was to prevent the holders of short-term liabilities issued by non-insured "shadow banking" institutions from selling their liabilities en masse. See Morgan Ricks, *Regulating Money Creation After the Crisis*, 1 HARV. BUS. L. REV. 75, 88 (2011). To that end, the Federal Reserve, Treasury, and FDIC extended several trillion dollars of credit, capital and guarantees to these institutions and their short-term creditors. See *id.*

¹²⁹ See, e.g., Morgan Ricks, *A Regulatory Design for Monetary Stability*, 63 n.99 (Harvard John M. Olin Discussion Paper No. 706, 2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1933890 (estimating that requiring Goldman Sachs to "term out" to long term financing—obligations the government would have less need to guarantee in a crisis—would have resulted in an 85% reduction in the firm's pre-tax earnings from 2006 to 2008).

receipt of government subsidies by non-depository financial institutions should include provisions to make these institutions pay for the value of this implicit but direct support.

III. PREVENTING EXCESSIVE CREDIT EXPOSURE TO RISKY AFFILIATES

The second purpose of Section 23A is to protect a depository from excessive credit exposure to its riskiest affiliates.¹³⁰ The quantitative limits of Section 23A limit the amount of exposure a depository can have to its most likely counterparties: its affiliates.¹³¹ However, affiliate transactions are not special in this respect. Quantitative limits apply to all national banks.¹³² Congress limits loans to any one borrower to 15% of a depository's capital and surplus, plus an additional 10% for fully secured lending.¹³³ The Comptroller of the Currency has interpreted this requirement to not apply to affiliate transactions.¹³⁴ However, nothing in the legislation—other than the simultaneous existence of Section 23A—compels this reading.

Quantitative restrictions appear to be able to reduce risk exposure independently of Section 23B. For example, a BHC's management might want a subsidiary depository to purchase risky assets, such as high yield bonds or derivatives, from a non-depository affiliate at arm's length terms. These kinds of transactions will not necessarily violate the arm's length requirements of Section 23B, yet will be reduced somewhat by the quantitative restrictions of Section 23A.

Affiliate transactions should not be a primary source of risk to a depository. Risk-weighted capital requirements and deposit insurance premiums make it more costly to hold risky assets within a depository than within an investment bank, reducing the incentive for a BHC to shift risk to a depository subsidiary.¹³⁵ To the limited extent that BHCs want to transfer risky

¹³⁰ See *supra* text accompanying note 42. The Board has not been consistent in its formulation of the second purpose of Sections 23A and 23B. The Board has sometimes stated the purpose is to prevent risk. See *id.* Other times, it has described the second purpose as to prevent depositories from incurring losses in their transactions with affiliates. See *id.* This latter formulation seems to have an element of subsidy leakage prevention as well as risk constraint, because Section 23B prevents depositories from incurring losses on transactions by underpricing them.

¹³¹ Section 23A is overbroad in this respect, because it applies to asset purchases as well as the extension of loans.

¹³² See 12 U.S.C. § 84(a) (2006).

¹³³ See *id.* Similarly, the Dodd-Frank Act restricts large BHCs and supervised nonbank financial companies from having credit exposure to any non-affiliated company exceeding 25% of the BHC or financial company's capital stock and surplus. See Pub. L. No. 111-203, § 165, 124 Stat. 1376, 1427.

¹³⁴ See 12 C.F.R. § 32.1(c) (2011) ("This part does not apply to loans made by a national bank and its domestic operating subsidiaries to the bank's 'affiliates,' as that term is defined in 12 U.S.C. 371c(b)(1), to the bank's operating subsidiaries, or to Edge Act or Agreement Corporation subsidiaries.").

¹³⁵ However, in limited circumstances, the BHC might want to shift a risk sufficient to cause insolvency from an investment bank to a depository if the investment bank has a larger equity cushion. See Walter, *supra* note 36, at 30–31.

assets at market prices to depositories from non-depository subsidiaries, Section 23A helps prevent depositories' excessive risk taking. But regulators have several other tools to regulate more directly depositories' risk taking, including activity restrictions,¹³⁶ disclosure requirements,¹³⁷ capital requirements,¹³⁸ and prompt corrective action.¹³⁹ Any failure to curb depository risk taking should be attributed first to gaps in these other regulatory tools; Section 23A can only limit—but not prevent—risky affiliate transactions.

IV. DODD-FRANK AND SECTIONS 23A AND 23B

Dodd-Frank has addressed some of Section 23A and 23B's shortcomings. Among other changes,¹⁴⁰ Dodd-Frank amended Section 23A and Section 23B to cover derivatives and securities lending transactions that cause a depository to incur credit exposure to its affiliate counterparties,¹⁴¹ an adjustment "difficult to overestimate."¹⁴² Dodd-Frank expanded exemptive authority in one instance by amending Section 23A to give the Office of Comptroller of the Currency and the FDIC the power to exempt transactions of institutions they oversee from Section 23A's requirements.¹⁴³ In addition, although the Federal Reserve Board retains the exclusive power to exempt transactions from or ignore Section 23B in times of distress,¹⁴⁴ Dodd-Frank provides the FDIC with veto power over exemptions from Sections 23A and 23B¹⁴⁵ that pose an "unacceptable risk" to the Deposit Insurance Fund.¹⁴⁶ These changes should, on balance, help Section 23A and 23B limit depositories' risk exposure. The FDIC's veto power, in particular, may help reduce regulatory forbearance, given the FDIC's mandate to protect its fund.¹⁴⁷ Indeed, the FDIC has already objected to a proposed affiliate transaction by

¹³⁶ See, e.g., 12 U.S.C. § 24(7) (2006) (prohibiting national banks from dealing in stock for their own accounts and from underwriting securities); 12 U.S.C. § 335 (2006) (applying those restrictions to state member banks).

¹³⁷ See *supra* note 92.

¹³⁸ See 12 C.F.R. § 208.43 (2011).

¹³⁹ See generally 12 U.S.C. § 1831o (2006) (mandating that the FDIC take heightened corrective actions as a depository institution becomes increasingly undercapitalized).

¹⁴⁰ In addition to the changes discussed in this Part, the Dodd-Frank Act also amended Section 23A to eliminate the existing exemption from the quantitative limits for covered transactions between a bank and its financial subsidiaries, see Pub. L. No. 111-203, § 609(a), 124 Stat. 1376, 1611, and to require collateralization for the full life of affiliate loans, see Pub. L. No. 111-203, § 608(a), 124 Stat. at 1608.

¹⁴¹ See Pub. L. No. 111-203, § 608(a)(1)(B), 124 Stat. at 1608.

¹⁴² Omarova, *supra* note 9, at 1758.

¹⁴³ See Pub. L. No. 111-203, § 608(d), 124 Stat. at 1611. Dodd-Frank did not similarly extend responsibility for Section 23B exemptions to the Comptroller and FDIC. See *id.*

¹⁴⁴ See *supra* text accompanying note 102.

¹⁴⁵ *Id.*; see Pub. L. No. 111-203, § 608(b)(6), 124 Stat. at 1610.

¹⁴⁶ See 12 U.S.C. § 371c(f) (2006); 12 U.S.C. § 371c-1(e)(2) (2006).

¹⁴⁷ See, e.g., *Fed. Deposit Ins. Corp. v. Isham*, 782 F. Supp. 524, 531 (D. Colo. 1992) ("FDIC's regulatory oversight of banks is intended only to protect depositors, the insurance fund, and the public")

Bank of America in direct opposition to the Federal Reserve Board's position.¹⁴⁸

But Dodd-Frank did not help Sections 23A and 23B contain subsidy within depositories. Section 23A still does not apply to a depository's sale of assets or receipt of loans, so Section 23A still cannot effectively operate prophylactically against mispriced transactions. Further, even if Dodd-Frank can help reduce mispriced transactions, the problem of subsidy leakage through dividends to BHCs remains unaffected. Here, Sections 23A and 23B have been given a job they cannot do. The government has constructed a wall that banks can simply walk around.

CONCLUSION

Congress has attempted to contain subsidy within depository institutions through a number of statutory schemes over the past century of banking regulation. The quantitative restrictions of Section 23A were once thought to be so capable of containing any subsidy within depositories that the removal of Glass-Steagall's restrictions on affiliations was partially premised on Section 23A's continued existence. But Section 23A is not capable of containing subsidy within depositories; it only restricts some types of mispriced transactions that allow subsidy transfer. While its sister provision, Section 23B, prohibits more types of mispriced transactions by mandating that borrowing, lending, asset sales, and asset purchases among affiliates are done at arm's length, Section 23B does not fix a more fundamental problem: subsidy can always leak out of depositories through dividends. A BHC can then transfer the subsidy to non-depository subsidiaries or to BHC shareholders.

Despite reforming Sections 23A and 23B in a number of ways, the Dodd-Frank Act failed to fix this problem. Reconstructing the Glass-Steagall wall could slow any subsidy from arriving at certain destinations—non-depository financial institutions that would be prohibited from affiliating with depositories—but the case for doing so is weak. Even Glass-Steagall's restrictions would not prevent depository owners from receiving subsidy in the form of dividends and reinvesting it elsewhere. Further, because of the fungibility of money, it would be difficult, if not impossible, to stop subsidy leakage by regulating dividend transfers directly. Thus, the most effective way to prevent subsidy leakage is simply to eliminate the subsidy to depository institutions. However, Dodd-Frank did not institute a commitment fee for the Federal Reserve's commitment to lend in liquidity crises. At least a gross subsidy to depository institutions remains.

¹⁴⁸ See Bob Ivry et al., *BofA Said to Split Regulators Over Moving Merrill Derivatives to Bank Unit*, BLOOMBERG (Oct. 18, 2011, 1:45 PM), <http://www.bloomberg.com/news/2011-10-18/bofa-said-to-split-regulators-over-moving-merrill-derivatives-to-bank-unit.html>.

That is not to say that the subsidy to depository institutions is unintentional or even that it should necessarily be eliminated. It may be that the government intentionally subsidizes depositories because regulated depository banking would not otherwise be profitable enough for private actors to engage in. But policymakers should face the reality that subsidy can be transferred out of depository institutions in meaningful quantities irrespective of restrictions on affiliations or on affiliate transactions. Thus, policymakers should think carefully about either allowing well-capitalized depository institutions to transfer subsidy to their affiliates freely or preventing the subsidy from accruing to depositories in the first place. Until the subsidy to depositories is eliminated, Section 23A will be tilting at windmills trying to contain it.

