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## Shareholder Enforced Market Discipline: How Much Is Too Much?

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# SHAREHOLDER ENFORCED MARKET DISCIPLINE: HOW MUCH IS TOO MUCH?

ERIC J. GOUVIN\*

## I. INTRODUCTION

In response to the widespread bank failures of the 1980s and early 1990s, the federal banking regulators developed an arsenal of regulatory weapons designed to impose the cost of bank failure on bank holding companies. Although many justifications for this regulatory strategy have been offered, it appears motivated at least in part by the hope that the threat of potentially massive liability will prompt bank holding companies to more actively monitor bank managers, thereby reducing risky bank activities and saving losses to the deposit insurance fund. While this regulatory dynamic holds much intuitive appeal, it is misguided. It is another example of regulators "fighting the last war."

Although excessively risky bank activity may have been a significant cause of the banking crisis recently past, and although the regulatory weapons may have the effect of discouraging banks from taking risks, the current regulatory arsenal amounts to overkill in light of other changes in the law. Specifically, the development of risk-based capital requirements has already effectively eradicated the risky activity problem that the holding company liability provisions are designed to reach. In the end, the excessive potential liability for bank holding companies creates excessive caution on the part of bank managers and puts the banking industry at a disadvantage relative to its competitors in the financial services industry. The conse-

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quences of over regulation can be devastating, especially when the excessive regulations themselves are unlikely to achieve their purported goal.<sup>1</sup>

The first part of this article examines the moral hazard problem created by the presence of the deposit insurance scheme in the banking industry and the market discipline debate that has attempted to correct the moral hazard problem.<sup>2</sup> If the reader is willing to accept my view that the law has evolved to make bank shareholders, i.e., bank holding companies, the primary enforcers of market discipline, this section may be passed over. The article's second section examines the specific regulatory changes that have been designed to create an incentive for bank holding companies to impose discipline on bank management.<sup>3</sup> Again, readers who are willing to believe that the source of strength doctrine, regulatory agreements, capital restoration plans, the elaboration of a general fiduciary duty to regulators, equitable subordination, cross-guarantee provisions, preferences, and fraudulent conveyances all are part of a strategy to make bank holding companies more responsible for bank failure may skip this section and proceed directly to the third section. That section argues that the regulatory attempts at making shareholders the enforcers of market discipline are misguided because they will not achieve their intended effect.<sup>4</sup> Instead, the banking industry will be saddled with excessive regulations that will place it at a competitive disadvantage relative to the other players in the financial services industry.

## II. THE MORAL HAZARD PROBLEM

Over the past ten years legal scholars have written a great deal about the moral hazard problem created by the existence of deposit insurance, and have suggested ways to correct it.<sup>5</sup> In general, a moral hazard problem results

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<sup>1</sup>See *infra* notes 153–184 and accompanying text.

<sup>2</sup>See *infra* notes 5–89 and accompanying text.

<sup>3</sup>See *infra* notes 90–152 and accompanying text.

<sup>4</sup>See *infra* notes 153–184 and accompanying text.

<sup>5</sup>See, e.g., Douglas D. Evanoff, *Preferred Sources of Market Discipline*, 10 YALE J. ON REG. 347 (1993) (suggesting changes in the capital structure of banks and use of subordinated debt holders as the major source of market discipline); Helen A. Garten, *Banking on the Market: Relying on Depositors to Control Bank Risks*, 4 YALE J. ON REG. 129 (1986) (arguing that greater reliance on market discipline to reduce bank risk is likely to prove counterproductive); Helen A. Garten, *Market Discipline Revisited*, 14 ANN. REV. BANKING L. 187 (1995) [hereinafter Garten, *Revisited*] (suggesting that no single source of market discipline has emerged as an ideal check on bank performance);

whenever one actor or class of actors in a transaction can undertake risky behavior without fear of loss because the loss from the risky activity falls on a different actor or group of actors by contract or other arrangement.<sup>6</sup> By avoiding the consequences of their risky behavior, the actors undertaking that behavior essentially transfer wealth to themselves from the actors who ultimately bear the risk of loss.<sup>7</sup> One glaring moral hazard in the banking industry is the lack of incentive for an FDIC-insured bank to avoid excessive risks because bank management knows that any losses from excessive risk-

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Helen A. Garten, *Still Banking on the Market: A Comment on the Failure of Market Discipline*, 5 YALE J. ON REG. 241 (1988) (commenting on Macey & Garrett's article, *infra*, and reassessing the limited role of market discipline in controlling bank risk); Helen A. Garten, *What Price Bank Failure?*, 50 OHIO ST. L.J. 1159 (1989) (concluding that current bank failure policy is more efficient and far less disruptive than alternatives in facilitating the rapid reallocation of banking resources following bank failure); Jonathan R. Macey & Elizabeth H. Garrett, *Market Discipline by Depositors: A Summary of the Theoretical and Empirical Arguments*, 5 YALE J. ON REG. 215 (1988) (arguing that, for depositor discipline to be effective, depositors' assets must be exposed to some risk); Jonathan R. Macey & Geoffrey P. Miller, *Bank Failures, Risk Monitoring, and the Market for Bank Control*, 88 COLUM. L. REV. 1153 (1988) (suggesting changes in the regulatory scheme governing the behavior of banks to increase the efficiency of two principal sources of constraints on management activities); Manuel A. Utset, *The Discipline of Institutions and the Disciplining of Banks*, 14 ANN. REV. BANKING L. 211 (1995) (exploring how the institutional structure of banks makes it difficult to discipline them).

<sup>6</sup>See RICHARD POSNER, *ECONOMIC ANALYSIS OF LAW* 150 (3d ed. 1986). Moral hazards are not unique to the banking industry, but rather are a common feature of transactions in which an actor may be shielded from liability by insurance or by limited liability business forms. Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 103-04 (1985). Of course, all corporations entail some moral risk because the limited liability form always presents the opportunity to shift losses from the equity holders to creditors and other claimants. *See id.* In banking the problem is aggravated by the presence of deposit insurance; correcting the deposit insurance aspect of the moral hazard problem will not completely eliminate the moral hazard problem.

<sup>7</sup>See Daniel R. Fischel et al., *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301, 314 (1987).

taking will fall on the deposit insurance fund and not on the parties taking the risk, or on the bank's equity holders.<sup>8</sup>

The most common moral risk scenario, and the one that plagued the banking system during the banking crisis of the late 1980s and early 1990s, occurs when an insured bank is nearly insolvent.<sup>9</sup> When facing zero net worth, a bank's managers and equity holders have little to lose and much to gain by causing the bank to make higher-yielding, but riskier, loans and investments. To attract deposits to fund those risky activities, the bank has to raise its deposit interest rates above the market rate.<sup>10</sup> Because the troubled bank can offer insured deposits to the public, depositors may be willing to deposit funds in a bank at a high rate of interest, even when they are generally aware of the bank's poor financial condition.<sup>11</sup> In this classic scenario, the risk of loss from the bank's risky activities falls not on the equity holders, the bank's management, or the depositors,<sup>12</sup> but on the deposit insurance fund.

The existence and workings of the moral hazard problem have been well-understood for a long time, and several approaches to correcting the problem have been suggested. Of course, one way to eliminate banking's special moral hazard problem would be to eliminate deposit insurance.<sup>13</sup>

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<sup>8</sup>See JONATHAN R. MACEY & GEOFFREY P. MILLER, *BANKING LAW AND REGULATION* 266 (1992); see also William A. Lovett, *Moral Hazard, Bank Supervision and Risk-Based Capital Requirements*, 49 OHIO ST. L.J. 1365, 1365-77 (1989) (emphasizing government's obligation to prevent bank failures).

<sup>9</sup>That is, when its net worth is near or approaching zero.

<sup>10</sup>See NICHOLAS A. LASH, *BANKING LAWS AND REGULATIONS: AN ECONOMIC PERSPECTIVE* 105-06 (1987).

<sup>11</sup>See Macey & Miller, *supra* note 5, at 1199-1202. At least this is how the classic conception of the problem worked. Legislative changes made in the late eighties and early nineties have changed the dynamics of the problem significantly. See *infra* notes 17-24 and accompanying text.

<sup>12</sup>See *infra* notes 27-40 and accompanying text.

<sup>13</sup>See Jonathan R. Macey & Geoffrey P. Miller, *Deposit Insurance, the Implicit Regulatory Contract, and the Mismatch in the Term Structure of Banks' Assets and Liabilities*, 12 YALE J. ON REG. 1, 14-15 (1995). Although the conventional wisdom holds that banks must have deposit insurance in order to attract any deposits, and some states even require banks doing business within their borders to have deposit insurance, see, e.g., ME. REV. STAT. ANN. tit. 9-B, § 422(1) (West 1964), at least one bank has considered that the regulatory costs of having deposit insurance coverage outweigh the benefits. See Bill Atkinson, *Oklahoma Banker Drops FDIC Coverage*, BANKING WK., Oct. 4, 1993, at 1 (discussing an Oklahoma bank which, after dropping the FDIC as its insurer, planned to use the savings to pay higher interest rates to customers).

Complete elimination of deposit insurance, however, seems to be an extreme reaction to the problem. Although Macey and Miller have argued that the deposit insurance scheme is nothing but a rent-seeking payoff to bankers,<sup>14</sup> most banking commentators see deposit insurance as more than a mere wealth transfer.<sup>15</sup> The deposit insurance system promotes stability in the banking system by preventing old-fashioned bank runs that cause banks to fail from liquidity crises rather than poor management. By eliminating the incentive for depositors to pull their funds out of an insured bank during times of panic, deposit insurance lends stability to the banking system. At the same time, however, it takes away an important feedback loop for bank management.<sup>16</sup> Before the advent of deposit insurance, the fear of a public perception of financial weakness that could trigger a run acted as a check on bankers' behavior. Deposit insurance removed that important check by eliminating depositors' fears of losing their deposits and thereby paved the way for more risk-taking by bankers, ultimately culminating in the moral hazard problem.

In the wake of the massive bank failures of the 1980s, academics and regulators began to consider ways to ameliorate the moral hazard problem using techniques less drastic than complete elimination of deposit insurance. Two general strategies emerged: (1) disrupt the classic moral hazard scenario so that large amounts of insured funds could not flow into troubled banks; and (2) create incentives for constituencies interested in the bank to take an active role in monitoring, and moderating, the bank's risk-taking. The law has changed to implement both of these strategies.

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<sup>14</sup>Historically, deposit insurance provided an economic payoff to bankers by allowing them to pay below-market rates for their funds. See Macey & Miller, *supra* note 13, at 17-23.

<sup>15</sup>See, e.g., CONGRESSIONAL BUDGET OFFICE, U.S. CONGRESS, *THE CHANGING BUSINESS OF BANKING: A STUDY OF FAILED BANKS FROM 1987 TO 1992*, at 3 (1994) [hereinafter CBO STUDY] (surveying the historical background of deposit insurance); John L. Douglas, *Deposit Insurance Reform*, 27 WAKE FOREST L. REV. 11, 14-16 (1992) (same).

<sup>16</sup>See CBO STUDY, *supra* note 15, at 3.

attracting high-priced deposits to fund high-risk activities.<sup>17</sup> No longer may banks which are "not well capitalized" accept funds from deposit brokers.<sup>18</sup> Banks that do use deposit brokers may not pay deposit interest rates that significantly exceed local market rates.<sup>19</sup> Banks which are undercapitalized may not pay deposit interest rates that significantly exceed local market rates regardless of the means by which they solicit those deposits.<sup>20</sup>

In addition to these prohibitions, the federal banking regulators have been given the authority to use early regulatory intervention to prevent weak banks from deteriorating into large financial disasters. Short of actually closing a troubled bank, the federal bank regulators are empowered to order "prompt corrective action" when banks become undercapitalized.<sup>21</sup> At a minimum, banks deemed to be undercapitalized<sup>22</sup> must submit capital restoration plans.<sup>23</sup> Regulators also have the power to wind up troubled

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<sup>17</sup>These changes were contained in the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), Pub. L. No. 102-242, 105 Stat. 2236 (codified as amended in scattered sections of 12 U.S.C.).

<sup>18</sup>See 12 U.S.C. § 1831f(a) (1994). Deposit brokers employ sophisticated methods to place large deposits in the highest yielding deposit accounts on a nationwide basis. The deposits are placed with FDIC-insured institutions in amounts close to or equalling the maximum deposit insurance amount so that the owners of the deposit funds may chase the highest yields without fear of losing the deposit itself if the bank fails. See *id.* § 1831f(g)(3).

<sup>19</sup>See *id.* § 1831f(e).

<sup>20</sup>See *id.* § 1831f(h).

<sup>21</sup>See *id.* 1831o.

<sup>22</sup>The law classifies banks into five categories: "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critically undercapitalized." *Id.* § 1831o(b)(1).

<sup>23</sup>See *id.* § 1831o(e)(2). Significantly undercapitalized institutions are subject to further restrictions, such as the requirement that they recapitalize, limitations on transactions with affiliates, restrictions on interest rates, asset growth and activities, changes or improvements in management, and other actions specified in the statute, including the catch-all authority to take "any action that the agency determines will better carry out the purpose of this section." *Id.* § 1831o(f). In addition, critically undercapitalized banks face even more restrictions, such as the suspension of payments of interest and principal on subordinated debt, and the requirement of FDIC approval before making certain transactions, such as entering into any transaction other than in the ordinary course of business, extending credit for a leveraged buyout, making material changes in accounting procedures or paying excessive compensation or bonuses to management. See *id.* § 1831o(h)(i).

institutions while they can still pay off their depositors, thereby preserving the deposit insurance fund.<sup>24</sup>

These regulatory and statutory changes have had the overall effect of disrupting the classic moral hazard scenario that plagued the deposit insurance system in the past decade. Although banks may still engage in risky activities that do not rely on highly volatile brokered deposits for funding, traditional regulatory oversight should keep those activities in check. Yet despite their success in eliminating the most troublesome moral hazard, the regulators have gone even farther and also implemented strategies designed to encourage non-regulators to engage in monitoring bank management.

## B. Imposing Market Discipline

To further address the moral hazard problem, the banking regulators have devised ways to impose "market discipline" on banks. The goal of the market discipline strategy is to heighten the incentives for stakeholders in the banking enterprise to keep tabs on the level of risk being assumed by bank management. The universe of potential stakeholders appropriate for imposing greater discipline on banks includes:<sup>25</sup> (1) depositors; (2) other creditors (such as subordinated debtholders); (3) the market for corporate control; (4) management; (5) private third-party insurers; (6) the government; and (7) shareholders.<sup>26</sup> As the market discipline debate developed, two groups,

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<sup>24</sup>*See id.* § 1823 note (Early Resolution of Troubled Insured Depository Institutions). There are, of course, practical problems that early intervention brings to the fore. For instance, it is often difficult to accurately assess the value of a troubled bank's assets at all relevant times, and in addition, liquidating a bank at an inopportune time could effectively wipe out any going concern value that the institution possessed. Finally, there may be constitutional questions entwined in the decision to close a bank before it is actually insolvent. *See Fahey v. Mallonee*, 332 U.S. 245, 253-54 (1947) (raising separation of powers and due process concerns).

<sup>25</sup>This list is an expansion of one found in Garten, *Revisited*, *supra* note 5, at 193. Professor Garten's excellent article provides a tidy analysis of market discipline, but does not include management or outside third parties as potential sources of market discipline.

<sup>26</sup>One would think that having such a large number of potential monitors would be the best of all possible worlds for insuring that bank managers pay attention to the level of risk-taking, but having too many monitors raises its own set of problems, such as the potential for inaction caused by all of the monitors trying to free ride on the others with the result that no potential monitor actually performs the monitoring role. *See Utset*,



subordinated debtholders and depositors, emerged as seemingly the most appropriate actors to enforce market discipline on bank managers. Despite the intuitive appeal of using creditors as risk-monitors however, the following discussion shows that creditors, and most other potential monitors, are not well suited for the role. As policy has evolved in banking regulation, the burden of enforcing market discipline has fallen increasingly on the shoulders of the equity holders.

## 1. Depositors

One way to keep bank managers attuned to the level of risk they are undertaking is to encourage the highly liquid, short-term creditors of the bank—its depositors—to withdraw their funds when they sense that the bank's activities render it too risky. Although the fear of a bank run could act as an effective check on reckless management behavior, under our current deposit insurance scheme depositors have no incentive to cause a bank run. Indeed, deposit insurance was developed primarily to create a disincentive for depositors to withdraw their funds in the event of perceived bank instability.<sup>27</sup> While the deposit insurance program has increased the stability of the banking system, it has taken away the *in terrorem* effect of bank runs and shifted the burden of monitoring bank riskiness to the government regulators who administer the insurance fund.<sup>28</sup> Of course, the present deposit insurance scheme could be modified to give depositors some stake in the quality of bank management. In reality, however, attempts to make depositors more interested in banking only with solid firms, such as by

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*supra* note 5, at 219–21 (explaining that the greater the number of potential monitors, the greater the free-rider problem).

<sup>27</sup>See Jonathan R. Macey & Geoffrey P. Miller, *America's Banking System: The Origins and Future of the Current Crisis*, 69 WASH. U. L.Q. 769, 803–04 (1991) (explaining that in a world without deposit insurance, banks would have to design contractual solutions to the collective action problem).

<sup>28</sup>See generally CBO STUDY, *supra* note 15, at 3 (“Deposit insurance was supposed to immunize the system as a whole against a contagious response to individual bank failures, but in so doing it transferred the burden of monitoring individual institutions from the creditors of depositories to regulators.”).

lowering insurance coverage<sup>29</sup> or providing for co-insurance or deductibles, are too politically infeasible to merit serious discussion.<sup>30</sup>

Even if an occasional bank run might be a good idea, the typical bank depositor likely lacks the sophistication or information to act in the monitoring role.<sup>31</sup> Depositors may be prone to act on rumors or even to misconstrue events and cause runs on banks that should not fail. Given these obstacles, charging depositors with the important task of monitoring bank management does not make much sense.

Perhaps focusing on the typical (small) depositor is inappropriate. The largest, and therefore uninsured, depositors might serve as effective risk-monitors if the task were left to them. Yet even depositors who possess the sophistication to process information about banks might not have complete access to the information they need to make a complete assessment of the financial condition of the bank.<sup>32</sup> Even assuming the information is accessible, it remains to be seen whether one or more depositors can interpret the information properly and communicate a correct conclusion to the depositor class. The logistics of such a task are formidable.

To help depositors cope with the overwhelming amount of information needed to assess bank health, several companies have taken on the task of rating the riskiness of banks and providing bank customers with a report, for a fee.<sup>33</sup> Using this information, some sophisticated depositors may be able

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<sup>29</sup>Despite the significant changes made to deposit insurance in the late 1980s and early 1990s, Congress made no attempt to lower the \$100,000 insurance limit, to prevent depositors from increasing coverage through the use of different accounts held in different capacities, or to limit the aggregate per depositor at all institutions. See Richard S. Carnell, *A Partial Antidote to Perverse Incentives: The FDIC Improvement Act of 1991*, 12 ANN. REV. BANKING L. 317, 368-69 (1993).

<sup>30</sup>See Howell E. Jackson, *The Expanding Obligations of Financial Holding Companies*, 107 HARV. L. REV. 507, 591 (1994) (noting the serious political resistance that a scheme to increase depositor liability would encounter).

<sup>31</sup>See R. Mark Williamson, *Regulatory Theory and Deposit Insurance Reform*, 42 CLEV. ST. L. REV. 105, 114-17 (1994).

<sup>32</sup>While bank examination reports are confidential, securities filings for publicly-traded banks and call reports for all banks are public knowledge. See Alfred D. Mathewson, *From Confidential Supervision to Market Discipline: The Role of Disclosure in the Regulation of Commercial Banks*, 11 J. CORP. L. 139, 141 (1986).

<sup>33</sup>Richard H. Gamble, *Will Your Banks Clear The Bar? Measures of Financial Strength*, CORP. CASHFLOW, Nov. 1992, at S18-22 (discussing how to assess important bank financial data to discover banks' weaknesses and providing information on vendors of bank data that perform analysis for a fee).

to operate as market disciplinarians. Indeed, the law has taken some limited steps to force depositors to step into the monitor's role, especially by apparently repealing the "too big to fail" doctrine.<sup>34</sup> By explicitly restricting the FDIC's ability to provide insurance coverage to depositors with funds at risk over the insurance limits, Congress is telling these large depositors to do their homework to make sure the banks they deal with are strong enough not to fail.

In a dynamic system where large depositors monitor bank health on an ongoing basis, changes in the bank's relative health should result in the depositors withdrawing their funds when they judge themselves insecure. The withdrawal of large institutional accounts could cause the bank to fail.<sup>35</sup> It is unclear, however, how such a precipitous failure would help conserve the deposit insurance fund. Once the large depositors flee, the bank's failure is guaranteed. The FDIC will still have to make good all of the insured deposits in the institution. The only beneficial effect of this form of discipline is to convince bank management along the way that it must be conservative enough not to lose its big institutional accounts. Whether this connection is strong enough to have any real effect on management behavior is certainly a matter for debate.<sup>36</sup> Many factors in addition to bank riskiness influence whether a large depositor does business with a particular bank. These factors include pricing, the availability of credit, the need to maintain compensating balances under a loan agreement, convenience, capacity, and other important

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<sup>34</sup>Some commentators had suggested that depositors were ineffective risk-monitors because of the so-called "too big to fail" doctrine, which made whole all of the depositors of key banks, whether they were fully covered by deposit insurance or not. The too big to fail doctrine may have been eradicated by a provision in FDICIA. See FDICIA § 141(a), 12 U.S.C. § 1823(c)(4)(E)(i) (1994) (forbidding the FDIC from taking "any action . . . with respect to any insured depository institution that would have the effect of increasing losses to any insurance fund").

<sup>35</sup>This is what happened when the depositors holding volatile electronically-brokered deposits that had been funding Continental Illinois decided to jump ship. See generally Hilary Foulkes, *The Federal Deposit Insurance Corporation: The Rescue of Continental Illinois National Bank and Trust Company*, 1985 ANN. SURV. AM. L. 137, 139-40 (indicating the withdrawal of institutional accounts was one of the causes of failure for Continental Illinois); Jeff Bailey et al., *Anatomy of Failure: Continental Illinois, How Bad Judgments and Big Ego Did It In*, WALL ST. J., July 30, 1984, at A1 (describing the factors which contributed to the failure of Continental Illinois).

<sup>36</sup>See Garten, *Revisited*, *supra* note 5, at 196-97.

considerations.<sup>37</sup> Against those factors the large depositor must weigh the risk of failure, something it can help avoid by leaving its money in the bank, and the likelihood that the “too big to fail” doctrine really is dead.<sup>38</sup> Finally, sophisticated large depositors may be able to avoid the pain of bank failure by structuring their deposits in innovative ways.<sup>39</sup> Clever planning will permit large depositors to structure their deposits so that the bulk of the funds are covered by deposit insurance. Then the portion not covered by insurance could be structured not as a deposit, but as a repurchase agreement or other contractual arrangement that provides security to the “depositor” in lieu of deposit insurance.<sup>40</sup> Given the relative ease with which large deposi-

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<sup>37</sup>See GEORGE H. HEMPEL ET AL., *BANK MANAGEMENT* 145–48 (2d ed. 1986).

<sup>38</sup>While 12 U.S.C. § 1823(c)(4) ostensibly eliminates the too big to fail doctrine by strengthening the requirement of “least cost resolution” on the FDIC’s actions, it should be noted that section 1823(c)(4) coexists with the statutory authority of the FDIC to make payments in excess of the insurance coverage amounts if necessary to protect the local economy where the bank failure occurred. See 12 U.S.C. § 1823(c)(4)(G) (1994). How these two provisions will work together in the future remains to be seen.

<sup>39</sup>The statutory deposit insurance coverage limit of \$100,000 can be expanded by setting up accounts in different “rights and capacities.” See *Is That Deposit Insured or Not?*, A.B.A. BANKING J., Aug. 1990, at 20; Rick J. Taylor, *Maximizing FDIC Coverage at a Single Financial Institution*, TAX MGMT. FIN. PLAN. J., July 21, 1992, at 267.

<sup>40</sup>A repurchase agreement, or “repo,” is a form of short-term secured loan, in which the borrower “sells” a security, typically an obligation of the U.S. Treasury, to the lender and at the same time the borrower agrees to repurchase the security at a given time and price from the seller. The difference in the prices represents the interest on the loan. The lender is protected from the borrower’s failure to repurchase the security by having title to the security and therefore the ability to sell the security on the secondary market. Although repurchase agreements once were employed primarily as a method for banks to lend money to each other for short periods of time, today many banks make these arrangements available to deposit customers, especially those customers whose deposit accounts exceed the deposit insurance limit. See *generally Banks Weigh the Costs of Deposit Insurance*, A.B.A. BANKING J., Sept. 1991, at 41 (evaluating the effects of FDIC insurance assessment increases on banks and their business structure and finding that some banks use repurchase agreements as a source of alternative funds); Steve Cocheo, *Municipal Deposits: “Yes,” “No,” and “Maybe,”* A.B.A. BANKING J., Apr. 1992, at 22 (discussing the advantages and disadvantages of handling municipal deposits and explaining banks’ alternatives to these deposits such as 30-day repurchase agreements, securities pledges, and term funds); *Old Tool Brings New Bucks to Oregon Bank*, A.B.A. BANKING J., June 1991, at 7 (describing how National Bank of Oregon raised \$152 million in medium-term funds through the use of bank notes, an attractive alternative to traditional retail deposits because they are exempt from insurance assessments).

tors can circumvent or at least substantially avoid the deposit insurance limits, it appears that even the most sophisticated depositors may be poorly-suited for the role of monitor.

## 2. Subordinated Debentureholders

Subordinated debentureholders were also considered well-suited to the monitoring role for several reasons.<sup>41</sup> First, they were considered to have the right degree of risk aversity, sandwiched as they are between the risk-taking equity holders and the risk-averse ordinary creditors.<sup>42</sup> Second, unlike depositors, they could not cause a bank run by withdrawing the funds they had lent to the bank.<sup>43</sup> Third, because the debentureholders were the first to lose money after the bank exhausted its equity, they had a great incentive not to allow matters to deteriorate too far.<sup>44</sup> Fourth, they were likely to possess a degree of financial sophistication that depositors lacked.<sup>45</sup> Finally, they had the potential to act as a group through the bond trustee named in the indenture who is charged with monitoring the debt issue on behalf of the debentureholders.<sup>46</sup>

Indeed, lawmakers to some extent have adopted the idea that subordinated debentureholders might be useful enforcers of market discipline, and have changed the banking laws to create incentives for debentureholders to act as monitors. For example, the Federal Deposit Insurance Corporation Improvement Act of 1991<sup>47</sup> ("FDICIA") prohibits critically undercapitalized institutions from making payments on their subordinated debt.<sup>48</sup> This financial threat could be effective to make debentureholders serve as vigilant watchdogs of bank management. In reality, however, debentureholders will not be effective monitors. As a practical matter, the holders of publicly-traded debt would rather switch than fight. That is, they have little incentive

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<sup>41</sup>See Evanoff, *supra* note 5, at 355-60.

<sup>42</sup>See *id.* at 359.

<sup>43</sup>See *id.*

<sup>44</sup>See *id.*

<sup>45</sup>See Jackson, *supra* note 30, at 596.

<sup>46</sup>See MACEY & MILLER, *supra* note 8, at 269.

<sup>47</sup>Pub. L. No. 102-242, 105 Stat. 2236 (codified as amended in scattered sections of 12 U.S.C.).

<sup>48</sup>FDICIA § 131, 12 U.S.C. § 1831o(h)(2) (1994).

to stick around and make management act more prudently when they can sell their holdings on the market and effectively limit their exposure.

Even if they wanted to police the bank's management, the debentureholders would be too diffuse to do so effectively. With regard to financial sophistication, little support exists for the proposition that subordinated debentureholders have any special skill in assessing the health of banks.<sup>49</sup> Finally, although the debentureholders are likely to be represented by an indenture trustee, in reality the trustee engages in only the most pedestrian activities prior to an actual default on the debt issue.<sup>50</sup> In light of these realities, subordinated debentureholders do not emerge as likely candidates to enforce market discipline.

### 3. The Market for Corporate Control

The idea that the market for corporate control might enforce market discipline holds some intellectual appeal,<sup>51</sup> but once again reality intrudes and spoils the party. In short, the market for corporate control idea provides that poorly managed firms will trade at prices below their intrinsic value because the market will discount for poor management. Once a poorly-managed firm becomes cheap enough, the market will recognize that the firm is a bargain and parties seeking to control the firm will bid for it. The bidding will stop at the point where the bidders believe the present value of the improvements they will make in the target equals the price of the shares. The ongoing threat of a takeover hangs over the heads of management and forces them to do a good job or face the consequences.<sup>52</sup> This mechanism does not provide meaningful monitoring in the banking context for several reasons.

First, one must appreciate that in general the market for corporate control is a very blunt tool for the task of providing a feedback mechanism

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<sup>49</sup>See R. Alton Gilbert, *Market Discipline of Bank Risk: Theory and Evidence*, ECON. REV. (Federal Reserve Bank of St. Louis), Jan.-Feb. 1990, at 3, 11-17.

<sup>50</sup>Prior to default, the trustee is primarily concerned with "back office" operations such as keeping track of the interest payments and sinking fund provisions. See Richard B. Smith et al., *The Trust Indenture Act of 1939 Needs No Conflict of Interest Revision*, 35 BUS. LAW. 161, 163-67 (1979).

<sup>51</sup>See Macey & Miller, *supra* note 5, at 1202-25 (arguing for changes in the law to make mergers easier).

<sup>52</sup>See RICHARD E. POSNER & KENNETH E. SCOTT, *ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION* 195-96 (1980).

for management.<sup>53</sup> Second, not all banks could be in the market—some are just too big to be in play, while others remain closely-held and not subject to outside pressures. Third, institutions interested in acquiring banks realize that they are better off financially to wait until the target bank actually fails, when they can acquire the institution for very little, or perhaps even have the receiver of the failed institution pay them to take over the bank. Fourth, it has become increasingly obvious that combining banking institutions does not necessarily result in a more efficient or profitable institution<sup>54</sup> thereby discouraging would-be acquirors from taking over would-be targets. Fifth, takeover bids are expensive and often fail in the objective of gaining control.<sup>55</sup> In light of these realities, the market for corporate control loses its promise as a means of enforcing market discipline.

#### 4. Management

Some commentators have suggested that one good approach to reducing the moral hazard problem generally is to impose personal liability on corporate management.<sup>56</sup> As a practical matter, bank managers have a great deal to lose if the bank should fail; to a great extent their fortunes are tied to the fortunes of the enterprise they manage.<sup>57</sup> Intuitively, bank managers' great personal exposure would seem to make them ideal risk monitors. Indeed, banking laws have traditionally tended to require that bank directors be residents of the state in which the bank is located and that they have a certain amount personally invested in the institution, presumably to ensure that they would have some personal stake in the enterprise and thereby take

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<sup>53</sup>See Robert Charles Clark, *The Regulation of Financial Holding Companies*, 92 HARV. L. REV. 789, 820 (1979) ("Yet takeovers have serious drawbacks. They are not suitable for fine tuning of rewards and punishments . . .").

<sup>54</sup>See Stephen A. Rhoades, *A Summary of Merger Performance Studies in Banking, 1980-93, and an Assessment of the "Operating Performance" and "Event Study" Methodologies*, Federal Reserve Board Staff Study No. 167 (1994) (surveying the results of 39 studies analyzing the effects of bank mergers on efficiency, profitability and shareholder wealth during the period 1980 through 1993 and concluding that the studies provide little support for the view that bank mergers improve performance).

<sup>55</sup>See Clark, *supra* note 53, at 820-21.

<sup>56</sup>See Easterbrook & Fischel, *supra* note 6, at 115-16.

<sup>57</sup>See Utset, *supra* note 5, at 221-22.

their duties seriously.<sup>58</sup> Recent changes to the federal banking laws have taken this approach as well and subjected bank officers and directors to potentially huge liability for bank failure.

The Financial Institutions Reform, Recovery and Enforcement Act of 1989<sup>59</sup> ("FIRREA") significantly expanded the authority of the federal regulatory agencies to assess civil money penalties while at the same time increasing the amount of the penalties that they can assess.<sup>60</sup> Grounds for assessing civil money damages include engaging in unsafe and unsound practices, violating a written condition, violating a regulation or *violating a fiduciary duty*.<sup>61</sup> In light of the last provision, the banking regulators could

<sup>58</sup>See, e.g., National Bank Act, 12 U.S.C. § 72 (1994) (stating that generally, directors of national banks must be U.S. citizens and two-thirds of the board must have been residents of the state in which their institution is located for at least one year prior to election; and each director must own stock in the institution with a par value of \$1000 or more, or an equivalent security in the bank holding company); ME. REV. STAT. ANN. tit. 9-B, § 316 (West Supp. 1994) (requiring directors of state financial institutions to own stock in the institution having a par value of at least \$2500 or to be the nominee of a holding company; and that two-thirds of the directors must be state residents); MASS. GEN. LAWS ch. 172, § 13 (1994) (requiring bank directors to own stock in the bank or the company that owns the bank having a par value of at least \$1000; and that three-fourths of the directors must be U.S. citizens and state residents).

<sup>59</sup>Pub. L. No. 101-73, 103 Stat. 183 (codified as amended in scattered sections of 12, 26 U.S.C.).

<sup>60</sup>12 U.S.C. § 1818(i)(2) authorizes three tiers of civil money penalties. Tier three authorizes civil money penalties of up to \$1 million per day against any institution-affiliated party who—

(i) knowingly—

(I) commits any violation described in any clause of subparagraph (A) [which includes any law, regulation, temporary or final cease-and-desist order, condition imposed in writing by the federal banking agency in connection with the grant of any application or other request, or any written agreement with the federal banking agency];

(II) engages in any unsafe or unsound practice in conducting the affairs of the depository institution; or

(III) breaches any fiduciary duty; and

(ii) knowingly or recklessly causes a substantial loss to the depository institution . . . [because] of the violation, breach, or practice.

12 U.S.C. § 1818(i)(2)(C) (1994).

<sup>61</sup>Exactly what fiduciary duties the directors of a bank owe and to whom they owe them is a very difficult and under-analyzed question. The question becomes even more complex when the bank is a subsidiary of a bank holding company. I have discussed this problem in some detail in another article: Eric J. Gouvin, *Resolving the Subsidiary Director's Dilemma*, 47 HASTINGS L.J. 287 (1996). A moment's reflection on the potentially wide-ranging scope of liability should give all bank officers and directors nightmares.



use their authority to assess penalties against subsidiary directors for dividend payments, service fee payments, favorable participation agreements or other transactions between the bank subsidiary and its parent holding company.<sup>62</sup>

FIRREA also broadened the banking regulators' powers by making clear that they may use the cease-and-desist power to require restitution or reimbursement in those cases where the violating party was unjustly enriched and the violation involved a reckless disregard for the law, or applicable regulations, or for violation of a prior order of the federal banking agency.<sup>63</sup> Federal regulators may also use the cease-and-desist authority to recover payments made to the holding company in violation of orders, written agreements and regulations.<sup>64</sup>

Holding bank directors personally liable may, however, be too harsh and unfair. Most banks in the United States are subsidiaries of bank holding companies, so therefore most bank directors are directors of subsidiaries. Elsewhere I have advanced the idea that the directors of subsidiaries, including bank subsidiaries of bank holding companies, should not be subject to the usual fiduciary duties that the law imposes on directors generally.<sup>65</sup> Instead, I have argued that subsidiary directors should be bound only to take actions that are in the best interest of the subsidiary's shareholder, the holding company. To the extent that the law generally imposes duties on corporate directors that go above and beyond looking out for the best interests of the shareholder, those duties should be imposed on the holding company directly. I believe that without the articulation of subsidiary directors' duties I have described, the role of the subsidiary director is exceptionally difficult, if not impossible, to discharge properly.<sup>66</sup> Because subsidiary directors fre-

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<sup>62</sup>The National Bank Act, 12 U.S.C. §§ 56, 60 (1994), may provide a receiver with grounds for challenging actual or constructive dividends.

<sup>63</sup>*Id.* § 1818(b)(6).

<sup>64</sup>*See id.*

<sup>65</sup>*See* Gouvin, *supra* note 61, at 294.

<sup>66</sup>The following hypothetical provides an illustration of diverging interests that frequently confront bank directors: BHC Bancorp is a Delaware corporation regulated by the Federal Reserve Board as a bank holding company. BHC owns all the shares of C Bank, a commercial bank chartered by the state of Connecticut, and N Bank, a national bank that operates primarily in Maine. Assume also that BHC owns several subsidiaries whose activities are "so related to the business of banking so as to be a proper incident thereto," including such businesses as a courier service, a leasing company, a mortgage

quently find themselves trapped in what Professor Lawrence Mitchell refers to as "horizontal conflicts"<sup>67</sup> between their duty to the shareholder (holding company) and their duty to other constituencies (such as the

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company and a data processing firm. Assume further that C Bank has run into serious financial difficulties as a result of a dramatic and unforeseen economic downturn in its market area. In order to shore up C Bank, the directors of the BHC direct N Bank to transfer N Bank's lucrative credit card operation to C Bank. Assume this transfer can be successfully carried out in light of inter-affiliate restrictions, of sections 23A and 23B of the Federal Reserve Act, 12 U.S.C. §§ 371c to 371c-1 (1994), but that the quality of the collateral may or may not meet the requirements of those sections. Assume further that if the directors of the bank subsidiary were making that decision on behalf of a truly independent bank they never would approve the transaction. Nevertheless, in the context of a bank holding company, a request by the holding company is likely to be approved by the bank directors on the assumption that, at a minimum, they owe a fiduciary duty to the bank's sole shareholder. Unfortunately for the bank's directors, if the transfers are ill-advised and the bank fails, the directors may find themselves the target of lawsuits brought by the failed bank's receiver alleging breach of fiduciary duty for failure to take action in the best interest of the corporation. See Gouvin, *supra* note 61, at 290-93. Expecting the subsidiary banks' directors to disregard the directives of the holding company is unrealistic. Putting bank management in the line of fire for the failure of policies implemented by the holding company is unfair.

<sup>67</sup>As Professor Mitchell describes:

These conflicts between virtually omnipotent managers and relatively powerless constituents of the corporation (or the corporation itself) can be described as "vertical conflicts of interest," since they exist between a powerful group and relatively powerless groups within the hierarchical corporate structure. . . . The exception to this unitary approach is the recent focus on conflicts *among* constituents, which has been sharpened by the dislocations caused by the takeover phenomenon. I term these conflicts, which exist among two or more relatively powerless groups that have interests in the corporation, "horizontal conflicts."

Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579, 591 (1992); see also Lawrence E. Mitchell, *The Puzzling Paradox of Preferred Stock (And Why We Should Care About It)*, 51 BUS. LAW. 443 (1996) (describing the tension between the directors' fiduciary duty and their contractual duty to the preferred stockholders).

corporation itself as an entity, the insurance fund, and depositors),<sup>68</sup> it is unfair to place the bank managers in a no win situation.

## 5. Private Deposit Insurance

On another front, some have suggested that the deposit insurance program be completely or partially privatized.<sup>69</sup> Although government deposit insurance has long been considered necessary to doing business, Canadian banks managed without it until 1968.<sup>70</sup> Alternatively, in some states, non-banks are able to make do with state-sponsored or coopera-

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<sup>68</sup>The exact extent of bank directors' fiduciary duties remains unclear. One leading treatise of banking law from the mid-nineteenth century through the mid-twentieth century contained black letter passages like the following: "The directors of a bank are not trustees for the stockholders alone, but they owe an even earlier duty to the depositors, and, if the bank exercises the privilege of circulation, still a prior duty to the public at large." JOHN T. MORSE, JR., A TREATISE ON THE LAW RELATING TO BANKS AND BANKING § 125, at 114 (2d ed. 1879); JOHN T. MORSE, JR., A TREATISE ON THE LAW RELATING TO BANKS AND BANKING § 125, at 252 (3d ed. 1888); JOHN T. MORSE, JR., A TREATISE ON THE LAW OF BANKS AND BANKING § 125, at 264 (Frank Parsons ed., 4th ed. 1903); JOHN T. MORSE, JR., A TREATISE ON THE LAW RELATING TO BANKS AND BANKING § 125, at 256 (James N. Carter ed., 5th ed. 1917); JOHN T. MORSE JR., A TREATISE ON THE LAW OF BANKS AND BANKING § 125, at 317 (Harvey C. Voorhees ed., 6th ed. 1928); *see also* 4 CARL ZOLLMANN, THE LAW OF BANKS AND BANKING § 2011, at 53 (1936) ("Directors occupy a fiduciary relation to the stockholders, creditors, and depositors which demands of them careful attention, good faith, and honest management."). As of the 1954 cumulative pocket part, the assertion had not been changed by the editors of Morse's treatise. These fiduciary duties may continue to exist in some form, together with duties that the directors may owe to the subsidiary bank as an entity and duties the directors may owe to creditors and other constituencies. *See* Gouvin, *supra* note 61, at 307-15.

<sup>69</sup>*See, e.g.*, U.S. TREASURY DEP'T, MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS VII-8 to -11 (1990) (reviewing practical proposals to reform and strengthen the federal deposit insurance system, including a proposal to have a privately-operated and capitalized insurance system within a framework established by the federal government); PETER J. WALLISON, BACK FROM THE BRINK: A PRACTICAL PLAN FOR PRIVATIZING DEPOSIT INSURANCE AND STRENGTHENING OUR BANKS AND THRIFTS (1990) (advocating restructuring the deposit insurance system to rely on private contractual agreements to create incentives for banks and S&Ls to be primarily responsible for safety and soundness of individual depository institutions while retaining the benefits of the current depository insurance system).

<sup>70</sup>*See* Fischel et al., *supra* note 7, at 316-17.

tive deposit insurance schemes.<sup>71</sup> On a very limited basis, Congress has experimented with some privatization techniques by authorizing the FDIC to engage in reinsurance of the deposit insurance risk.<sup>72</sup> Indeed, some private insurers already offer insurance to cover the uninsured portion of large deposit accounts.<sup>73</sup>

While the idea of a privately-underwritten deposit insurance product is intriguing, it raises many questions that have no answer at the present time.<sup>74</sup> For example, it is not clear that depositors would voluntarily buy such a policy when they could reasonably conclude that they can get a free ride on other monitors who are keeping track of the bank's activities. One might also wonder if an insurance company would ever pay out on such a policy or if it would instead cancel the policy when the bank got into serious trouble (just when the insurance is needed most). The form of the insurance arrangement raises questions as well, such as, would the insured be the bank itself or the depositor? Of course, after more than sixty years in the deposit insurance business, the government may find it politically impossible to exit the field.<sup>75</sup> In any event, the immediate future does not hold a significant role for private insurers as enforcers of market discipline on bank management.

## 6. The Government

Regulators have imposed discipline to make banks more risk sensitive through the examination process, regulatory policies, and administrative actions. Another way that regulators could enforce market discipline on banks would be to make the FDIC act more like a regular

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<sup>71</sup>See Victor L. Saulsbury, *The Current Status of Non-Federal Deposit Insurance Programs*, ISSUES BANK REG., Spring 1985, at 3.

<sup>72</sup>See 12 U.S.C. § 1817(b)(1)(B) (1994). For an excellent discussion of the many issues raised by the possible use of the reinsurance market to help spread the risks of deposit insurance, see Anna Kuzmik Walker, *Harnessing the Free Market: Reinsurance Models for FDIC Deposit Insurance Pricing*, 18 HARV. J.L. & PUB. POL'Y 735 (1995).

<sup>73</sup>See William W. Streeter, *Excess Deposit Insurance*, A.B.A. BANKING J., July 1993, at 92.

<sup>74</sup>For a general discussion, see Fischel et al., *supra* note 7, at 316-17.

<sup>75</sup>See Jackson, *supra* note 30, at 600-01.

private insurance company.<sup>76</sup> The law has already moved in this direction. For example, common experience with other types of insurance products tells us that insureds who engage in highly risky activities (such as smoking, in the context of life insurance) have to pay higher premiums than insureds who engage in less risky activities. The FDIC now imposes such risk-based premiums on banks,<sup>77</sup> and, to some extent, pegs deposit insurance premiums to a bank's exposure to interest rate risk, credit risk, insider abuse, operating risk, and diversification risk.<sup>78</sup> Risk-based premiums alone, however, could just exacerbate the moral hazard problem. If a risky bank has to pay higher insurance premiums, it may need to invest the deposits it receives in riskier, higher-yielding assets in order to get the return necessary to cover its costs and provide an acceptable return to its investors.

Although the government might tinker with deposit insurance to make it mimic private insurance, the attempt is probably going to produce results that are not entirely satisfactory. The idea of using regulation to emulate private market forces suffers from a deep flaw: government regulators do not possess the wherewithal to effectively serve as surrogate private actors. The government regulators are not animated by the same forces that make private parties act. Furthermore, the government actors do not have any personal stake in the success of the risk monitoring enterprise, and in any event, even a conscientious regulator can be trumped by political forces.<sup>79</sup> The government therefore does not seem to be a strong candidate to serve as a provider of consistent and meaningful discipline.

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<sup>76</sup>For a general discussion of the pros and cons of this idea, see James R. Barth et al., *Reforming Federal Deposit Insurance: What Can Be Learned from Private Insurance Practices?*, 45 CONSUMER FIN. L.Q. 140, No. 2 (1991).

<sup>77</sup>See 12 U.S.C. § 1817(b)(1)(A) (1994).

<sup>78</sup>See James S. Chessen, *How FDIC's Risk-Based Insurance Premiums Work*, A.B.A. BANKERS WKLY., Oct. 6, 1992, at 8 (explaining that under FDICIA banks will pay a risk-based deposit insurance premium to be determined by the bank's capital and supervisory rating).

<sup>79</sup>Even though the regulatory agencies are ostensibly independent, political forces affect their agendas. See generally L. WILLIAM SEIDMAN, *FULL FAITH AND CREDIT: THE GREAT S&L DEBACLE AND OTHER WASHINGTON SAGAS* (1993) (memoirs of a former FDIC chairman illustrating the constant interplay of political forces and regulatory policy).

## 7. Shareholders

In the end, the law has evolved primarily to place the burden of enforcing market discipline on the shareholders, which in most cases means bank holding companies.<sup>80</sup> This development has come as something of a surprise because shareholders are often perceived as less than ideal monitors.<sup>81</sup> The reasons for this perception are several. First, of all the potential monitors interested in keeping bank managers from taking too many risks, shareholders, as the residual takers in the firm, seem to be the stakeholders most inclined to take risks.<sup>82</sup> Indeed, the more risk the firm takes through heavy use of leverage, the greater the returns on an equity investment.<sup>83</sup> Second, the moral hazard problem arises when shareholders have nothing to lose, so just when their monitoring services would be most needed—when failure is imminent—their incentive to act as monitors is very low. Finally, the realities of the equity market show that shareholders usually vote with their feet.<sup>84</sup> That is, they do not suffer through the bad times, but instead sell their shares and move on to the next investment.

The fallacy in the reasoning leading to the conclusion that bank shareholders would make poor risk monitors is the failure to appreciate that bank holding companies<sup>85</sup> control the vast majority of U.S.

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<sup>80</sup>As of 1994, bank holding companies controlled banks holding 92.9% of the banking deposits in the country. See Dean F. Amel, *Trends in the Structure of Federally Insured Depository Institutions, 1984-94*, 82 Fed. Res. Bull. 1, 5 (1996).

<sup>81</sup>See MACEY & MILLER, *supra* note 8, at 268.

<sup>82</sup>See Garten, *Revisited*, *supra* note 5, at 202.

<sup>83</sup>See MACEY & MILLER, *supra* note 8, at 268.

<sup>84</sup>See JOSEPH A. LIVINGSTON, *THE AMERICAN STOCKHOLDER* 60-61 (1958).

<sup>85</sup>As defined by statute, a bank holding company is any company that has control over a bank or over a company that has control of a bank. See 12 U.S.C. § 1841(a)(1) (1994). Typically, although not always, bank holding companies are corporations. See *generally id.* § 1841(b) (defining bank holding company to mean any "corporation, partnership, business trust, association, or similar organization"). The bank holding company itself is merely a regular corporation formed under state incorporation laws. Although bank holding companies do not require special charters, they are regulated by the Federal Reserve Board under the Bank Holding Company Act. See Bank Holding Company Act of 1956, 12 U.S.C. §§ 1841-1850 (1994). Bank holding companies may engage in activities through their non-banking subsidiaries which banks may not participate in directly. For a general discussion of the issues involved in the lines of business in which bank holding companies are allowed to engage, see James R. Smoot,

banks.<sup>86</sup> Many debates concerning banking policy discuss bank shareholders as if they were like the widely scattered, unaffiliated shareholders of public corporations, when clearly that is not the case. In light of, or perhaps in spite of, the special relationship between banks and bank holding companies,<sup>87</sup> shareholders have emerged as the preferred monitors of bank management.

The most effective way to make bank shareholders care about whether the bank succeeds or fails is to ensure that they have enough capital at stake so that failure becomes a very unpalatable option.<sup>88</sup> The genius of recent reforms has been to link the capital requirements to the risks that a bank undertakes.<sup>89</sup> While increased capital requirements alone should be enough to make bank holding companies more attentive to the possibility of bank failure and more conservative with risk-taking, as the following section discusses, the regulatory devices designed to make bank holding companies impose market discipline extend far beyond capital requirements.

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*Striking Camp and Moving to Higher Ground: The Hazardous Subtleties of "Subtle Hazards" in Bank Regulation*, 4 GEO. MASON L. REV. 21 (1995).

<sup>86</sup>The reasons for the predominance of the bank holding company structure can be attributed to various historical, economic and political forces. Bank holding companies can be seen as a marketplace response to the restrictive laws affecting the banking industry. While banks were restricted as to the kinds of businesses they could engage in and where they could branch, bank holding companies did not face those restrictions, and provided an effective way to avoid the constraints of the banking laws. See generally MACEY & MILLER, *supra* note 8, at 293–96 (discussing reasons for restricting bank holding companies); Clark, *supra* note 53, at 816 (same).

<sup>87</sup>For a description of this special relationship, see Gouvin, *supra* note 61, at 289–90 (noting the control that bank holding companies exert over their bank subsidiaries). See also Clark, *supra* note 53, at 819–22 (discussing the need for regulation to correct the potential abuses inherent in the parent/subsidiary relationship).

<sup>88</sup>See U.S. TREASURY DEP'T, MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS (1991), reprinted in [1990–1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 88,367, at 97,335 (Feb. 8, 1991) (expressing the view that "banks are less likely to take excessive risk when they have substantial amounts of their own money at stake").

<sup>89</sup>See 12 C.F.R. § 208.13 & app. A (1996); FDIC Capital Maintenance; Statement of Policy On Risk-Based Capital, *id.* pt. 325; Comptroller of the Currency Risk-Based Capital Guidelines, *id.* pt. 3 & app. A.

### III. THE IMPOSITION OF LIABILITY ON BANK HOLDING COMPANIES

Traditionally, bank holding companies, while subject to some prophylactic regulations designed to keep them out of certain businesses, have generally not been saddled with many affirmative regulatory obligations with respect to their subsidiary banks.<sup>90</sup> More recently, however, the regulatory burdens imposed on bank holding companies have grown. The banking regulators have attempted to hold bank holding companies responsible for the health of their subsidiaries through various strategies, with varying degrees of success. This section discusses each of those developments in turn. Each development, as will be shown, creates potential liability for the bank's shareholders, and in doing so creates an incentive for bank holding companies not only to monitor the risks that their bank subsidiaries undertake, but to actively avoid risks that the bank might undertake. In this sense the regulatory devices are all adjuncts to the market discipline scheme and work to make bank equity holders the chief enforcers of market discipline.

#### A. Source of Strength Doctrine

Probably the most celebrated method for imposing a duty on the holding company to monitor its bank subsidiaries is the Federal Reserve Board's "source of strength" doctrine.<sup>91</sup> Much has been written about

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<sup>90</sup>See Jackson, *supra* note 30, at 516-17.

<sup>91</sup>It is important to note that the source of strength doctrine is based on Federal Reserve Board policy, not on legislative mandate. The banking regulators have attempted to have Congress pass legislation specifically authorizing the source of strength doctrine. In 1988, for example, the regulators supported a proposal that would have empowered the Federal Reserve Board to require a bank holding company and its non-bank subsidiaries to contribute or transfer to any failing bank within the holding company system "such assets or services as are customarily utilized by a bank in the conduct of its business or operations." Emergency Bank Consolidation Act of 1988, 134 CONG. REC. S11,441 (daily ed. Aug. 10, 1988). To date, those efforts have been unsuccessful, although FIRREA did contain cross-guarantee provisions that serve similar ends. See Federal Deposit Insurance Act § 5(e), *amended by* FIRREA, 12 U.S.C. § 1815(e) (1994); *infra* notes 138-145 and accompanying text.



it,<sup>92</sup> and a brief summary will serve the purposes of this discussion. The Federal Reserve Board ("Fed" or "FRB"), as the regulator of bank holding companies,<sup>93</sup> has articulated the source of strength doctrine as the cornerstone of bank holding company regulation.<sup>94</sup> The doctrine requires that the bank holding company assist bank subsidiaries in difficult financial times by providing financial assistance to failing bank subsidiaries.<sup>95</sup>

In 1987 the Fed issued a Policy Statement reiterating its understanding of the source of strength doctrine as an independent legal obligation imposed on bank holding companies to support bank subsidiaries, including capital infusions, if necessary.<sup>96</sup> It further states that violation of the source of

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<sup>92</sup>See, e.g., Leonard Bierman & Donald R. Fraser, *The "Source of Strength" Doctrine: Formulating the Future of America's Financial Markets*, 12 ANN. REV. BANKING L. 269 (1993) (addressing controversy surrounding the promulgation and application of the source of strength doctrine); Jackson, *supra* note 30, at 528-32 (discussing Federal Reserve Board's 1987 policy statement of the source of strength doctrine and its ensuing application to the *MCorp* case); Kieran J. Fallon, Note, *Source of Strength or Source of Weakness?: A Critique of the "Source of Strength" Doctrine in Banking Reform*, 66 N.Y.U. L. REV. 1344 (1991) (criticizing the source of strength doctrine in banking reform).

<sup>93</sup>See 12 U.S.C. § 1844 (1994).

<sup>94</sup>The "source of strength" doctrine is codified in the Federal Reserve Board's Regulation Y, which states that "a bank holding company shall serve as a source of financial and managerial strength to its subsidiary banks." 12 C.F.R. § 225.4(a)(1) (1996).

<sup>95</sup>The doctrine grows out of the Federal Reserve Board policy governing the formation of bank holding companies. In 1976, the Fed denied an application by First Lincolnwood Corporation to form a bank holding company on the ground that the applicant would not be able to "provide a source of financial and managerial strength to its subsidiary bank(s)." *First Lincolnwood Corp.*, 62 Fed. Res. Bull. 153 (1976). In the resulting litigation over the Fed's authority to deny the application, the Supreme Court held that the FRB could deny an application on grounds of financial and managerial weakness. *Board of Governors of the Fed. Reserve Sys. v. First Lincolnwood Corp.*, 439 U.S. 234, 250 (1978). Citing the FRB's source of strength policy, the Supreme Court decided that the Fed could deny the application even when the application was not the cause of the financial weakness or would not exacerbate it. *Id.* at 251.

<sup>96</sup>See *Responsibility of Bank Holding Companies to Act as Sources of Strength to Their Subsidiary Banks*, 52 Fed. Reg. 15,707 (1987). Acting under its statutory authority to regulate bank holding companies, the Board of Governors of the Federal Reserve System reiterated its long-standing policy that bank holding companies act as sources of strength to subsidiary banks by using holding company resources to provide adequate capital to subsidiary banks during periods of financial stress or adversity. A bank holding company's failure to assist a troubled or failing subsidiary bank under these circumstances would generally be viewed as an unsafe and unsound banking practice or a

strength doctrine constitutes an “unsafe or unsound” banking practice,<sup>97</sup> or a violation of Regulation Y, or both, thereby establishing grounds to impose administrative sanctions.<sup>98</sup>

The first big test for the Fed’s source of strength policy statement came in *MCorp v. Board of Governors*, in which a bank holding company sought and received relief in the federal district court enjoining the FRB from proceeding with pending administrative actions that would have forced the holding company to inject additional resources into its failing banks.<sup>99</sup> On appeal, the Fifth Circuit reversed the district court decision on procedural grounds.<sup>100</sup> In so doing, however, the Fifth Circuit found that the FRB had exceeded its statutory authority by using the source of strength doctrine to require MCorp to transfer funds to its subsidiary banks.<sup>101</sup> The Fifth Circuit found that the support the FRB claimed to have under its regulations and policy statements exceeded its statutory authority, finding that “Congress never intended to grant authority to the [FRB] to require a holding company to inject capital into subsidiary banks as a safeguard against ‘unsafe or

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violation of Regulation Y or both. See *id.* at 15,707–08. In support of its policy the FRB cited the *First Lincolnwood* decision, and the incorporation of the source of strength doctrine into Regulation Y in 1984. See *Bank Holding Companies and Change in Bank Control*, 12 C.F.R. § 225.4(a)(1) (1996).

<sup>97</sup>“Generally speaking, an ‘unsafe or unsound’ practice embraces any action, or lack of action, which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk of loss or damage to an institution, its shareholders, or the insurance fund administered by the corporation.” *Overdrafts and Correspondent Banking Practices: Hearings Before the Senate Comm. on Banking, Hous. and Urban Affairs*, 94th Cong. 782 (1977) (statement of George LeMaistre, chairman, FDIC), quoted in EDWARD L. SYMONS, JR. & JAMES J. WHITE, *BANKING LAW* 554 (3d ed. 1991).

<sup>98</sup>12 U.S.C. § 1818(b) provides the federal regulatory agencies with an arsenal of administrative sanctions that may be employed to remedy: (1) an unsafe or unsound practice; or (2) a violation of a law, rule or regulation, any condition imposed in writing by the agency in connection with the granting of any application or other request, or any written agreement entered into with the agency.

<sup>99</sup>*MCorp v. Board of Governors of the Fed. Reserve Sys.*, 101 B.R. 483 (Bankr. S.D. Tex. 1989), *rev’d in part and vacated in part*, 900 F.2d 852 (5th Cir. 1990), *rev’d on other grounds*, 502 U.S. 32 (1991).

<sup>100</sup>The circuit court ruled that 12 U.S.C. § 1818(i)(1) prohibited the district court from enjoining an FRB administrative proceeding unless the FRB had exceeded its statutory authority. *MCorp*, 900 F.2d at 857.

<sup>101</sup>*Id.* at 860–62.

unsound' practices."<sup>102</sup> The Supreme Court, in turn, reversed the Fifth Circuit on procedural grounds without reaching the merits of MCorp's challenge to the source of strength doctrine.<sup>103</sup>

The status of the source of strength doctrine therefore remains an open question. Because the Federal Reserve Board continues to apply the source of strength doctrine to the bank holding companies it regulates,<sup>104</sup> clearly it is still a tool for shifting the costs of bank failure to the holding company when such a shift is convenient for the banking regulators.

## B. Regulatory Agreements

Regulatory agreements serve as another method of extracting resources from a bank holding company. Regulators and the institutions they regulate have for some time entered into agreements to define the type of mutually agreeable relationship they desire.<sup>105</sup> The agreements are enforced primarily through administrative actions, informal negotiations and, in some cases, litigation.

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<sup>102</sup>*Id.* at 863.

<sup>103</sup>*MCorp*, 502 U.S. at 37-44. The Supreme Court held that 12 U.S.C. § 1818(i)(1) prohibits the district court from enjoining an ongoing administrative proceeding before a banking agency until the banking agency issues a final order. *Id.*

<sup>104</sup>*E.g.*, *Deutsche Bank AG*, 79 Fed. Res. Bull. 133, 137 (1993); *Banc One Corp.*, 78 Fed. Res. Bull. 159, 161 (1992).

<sup>105</sup>Thrift regulators routinely required persons in control of savings and loan associations to enter into a contractual version of the source of strength doctrine. *See* 12 C.F.R. § 571.6(d)(4) (1996) (imposing net worth maintenance agreements in connection with the requirements for obtaining a de novo charter for an association). *But see id.* § 574.8(c)(2) (stating that failure to enter into net worth agreements in connection with stock issuances by undercapitalized associations will not result in a denial of application to acquire shares). As a condition of approval, the agreement between the regulator and the party seeking control of the thrift imposed an ongoing duty to maintain the capital of the savings and loan association at or above required levels and to contribute additional capital to the S&L if necessary to maintain the required levels. These agreements sometimes took the form of an "affidavit" or "stipulation" signed by the party seeking control. Sometimes the agreement took the form of letters between the regulator and the acquiring party, and, more recently, the agreements have taken the form of a formal "capital maintenance agreement," signed by the regulator and the acquirer. *See* Paul L. Lee, *Liability of Bank Holding Companies, Savings and Loan Holding Companies and Their Affiliates for Failed Bank and Thrift Subsidiaries*, in *COUNSELLING CREDITORS OF BANKS AND THRIFTS: DEALING WITH THE FDIC AND RTC* at 363, 379 (PLI Commercial Law & Practice Course Handbook Series No. 561, 1991).

In the hands of the regulators, the written agreements appear to provide a great deal of leverage. The Office of Thrift Supervision ("OTS") has authority to initiate a cease-and-desist proceeding<sup>106</sup> if a party has violated any condition imposed in writing by the agency in connection with an application or request or has violated any written agreement entered into with the agency.<sup>107</sup> When both the acquiror and the agency sign written capital maintenance agreements, there may be a strong argument that these documents constitute written agreements for purposes of section 1818(b)(1).<sup>108</sup> In addition, the OTS has the authority to assess civil money penalties in the amount of up to \$1 million per day for knowing violations of conditions imposed in writing by the regulatory agency or knowing violations of written agreements if a substantial loss is caused thereby to the depository institution.<sup>109</sup>

While violation of written agreements may provide regulators with some leverage over persons in control of financial institutions, the validity of imposing capital maintenance as a condition of regulatory approval is subject to challenge. The regulators can rely on precedent to support their position that imposing conditions is within their authority.<sup>110</sup> Regulated parties, however, have argued with some success that "net worth maintenance agreements" are not enforceable contracts, but are rather part of the regulatory approval process.<sup>111</sup>

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<sup>106</sup>See 12 U.S.C. § 1818(b)(1) (1994).

<sup>107</sup>The federal banking regulators have brought cease-and-desist actions to enforce "net worth maintenance agreements" on this basis with mixed results. *Compare* *Wachtel v. OTS*, 982 F.2d 581 (D.C. Cir. 1993) (maintaining a skeptical attitude toward the administrative remedy in the context of capital maintenance agreements), *with* *Akin v. OTS*, 950 F.2d 1180, 1186 (5th Cir. 1992) (expressing general support of the administrative remedy approach).

<sup>108</sup>See *Akin*, 950 F.2d at 1183-84. On the other hand, the OTS's position may be weaker where the obligation takes the form of a "stipulation," "affidavit" or set of letters.

<sup>109</sup>See 12 U.S.C. § 1818(i)(2) (1994).

<sup>110</sup>See, e.g., *Kaneb Servs., Inc. v. FSLIC*, 650 F.2d 78, 82 (5th Cir. 1981) (upholding a restriction on the payment of dividends imposed as a condition of regulatory approval, reasoning that Congress had delegated to the FSLIC broad authority to regulate acquisitions).

<sup>111</sup>This theory has been successfully employed to dismiss suits by RTC/FDIC as "third party beneficiaries" seeking to enforce the agreements. See *In re Conner Corp.*, 127 B.R. 775, 780 (Bankr. E.D.N.C. 1991), *aff'g* No. 87-01697-MO4, 1990 WL 124052 (Bankr. E.D.N.C. June 20, 1990); *RTC v. Savers, Inc.*, No. LR-C-89-529, 1990 WL 290314 (E.D. Ark. June 12, 1990); *RTC v. Tetco, Inc.*, 758 F. Supp. 1159 (W.D.

The significance of such agreements may be fading in light of the power granted to banking regulators under FDICIA to require and enforce capital restoration plans.<sup>112</sup> Even so, these agreements still represent a method by which the regulators may extract additional financial commitments from bank holding companies in an effort to stave off failure of a financial institution. They should have the effect of making bank holding companies even more leery of risk-taking at the bank subsidiary level.

### C. Capital Restoration Plans

FDICIA requires institutions defined as "undercapitalized" to submit a capital restoration plan ("CRP") to the institution's federal banking agency.<sup>113</sup> If a bank holding company controls the financial institution, FDICIA prohibits the banking agency from approving the CRP unless the holding company guarantees compliance with the CRP for one year and provides adequate assurances of compliance.<sup>114</sup>

While CRPs are yet another example of how the regulators have found a way to impose the costs of bank distress onto bank holding companies, the CRP also provides some benefit to the bank holding company. By guaranteeing the subsidiary's obligation under a CRP, the holding company limits its direct liability for the institution's failure to the lower of either "an amount equal to 5 percent of the institution's total assets at the time the institution became undercapitalized" or "the amount which is necessary (or would have been necessary) to bring the institution into compliance with all capital standards applicable" at the time the institution failed to comply with the plan.<sup>115</sup>

On the other hand, if the financial institution fails to submit a plan or to implement a plan that has been submitted and approved, FDICIA provides the regulators with a number of sanctions to employ against the institution, including the power to seize the institution.<sup>116</sup> It should be noted, however, that no provision of FDICIA expressly requires a holding company to

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Tex. 1990), *vacated by agreement*, No. 91-5612, 1992 WL 437650 (5th Cir. Apr. 22, 1992).

<sup>112</sup>12 U.S.C. § 1831o(e)(2) (1994).

<sup>113</sup>*Id.* § 1831o(e)(2)(D)(i)-(ii).

<sup>114</sup>*Id.* § 1831o(e)(2)(C)(ii)(I).

<sup>115</sup>*Id.* § 1831o(e)(2)(E).

<sup>116</sup>*Id.* § 1831o(g)(3).

guarantee compliance with a subsidiary's CRP.<sup>117</sup> The optional aspect of these plans may have been designed to facilitate early resolution of the insured institutions by requiring the holding company to either make a financial commitment to the subsidiary's continued survival, or, alternatively to decline such a commitment and in doing so indicate to the regulators that the holding company is willing to let the subsidiary fail.<sup>118</sup> While this arrangement provides the holding company with some flexibility regarding the commitment to the troubled subsidiary, failure to back a CRP could have catastrophic results for the holding company. Without the limitations created by the guarantee of the CRP, holding company liability for the bank's failure could be great, and failure to back up the CRP could raise the ire of the regulators who could find ways to punish an uncooperative holding company. So, when viewed in a more skeptical light, the apparent leeway afforded by the CRP provisions could in reality be nothing more than an invitation to play a high stakes game of "chicken" with the regulators.

#### D. Fiduciary Duty to Regulators

Federal banking regulators have discussed the existence of a fiduciary duty running from the insured financial institution directly to the insurance fund.<sup>119</sup> If such a duty exists, it would create yet another incentive for bank holding companies to monitor bank management because the duty to the federal government would necessarily come at the expense of the existing duty to the bank's shareholders.<sup>120</sup> If granted standing, the banking regulators could bring suit against insured institutions for breaching this fiduciary

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<sup>117</sup>See Cassandra Jones Havard, *Back to the Parent: Holding Company Liability for Subsidiary Banks—A Discussion of the Net Worth Maintenance Agreement, the Source of Strength Doctrine, and the Prompt Corrective Action Provision*, 16 CARDOZO L. REV. 2353, 2388 (1995).

<sup>118</sup>See Carnell, *supra* note 29, at 339.

<sup>119</sup>The most complete articulation of this idea was given by Harris Weinstein, Chief Counsel to the Office of Thrift Supervision, in a speech he delivered at Southern Methodist University in 1990. By drawing analogies to the law of bankruptcy, Mr. Weinstein concluded that insured banks and their fiduciaries owe the federal government a general fiduciary duty "not to risk insolvency and the resulting loss of funds deposited with the institution." *Speech by OTS Chief Counsel Weinstein on Duties of Depository Institution Fiduciaries*, 55 Banking Rep. (BNA) 510, 511 (Sept. 24, 1990).

<sup>120</sup>See Lawrence G. Baxter, *Fiduciary Issues in Federal Banking Regulation*, 56 LAW & CONTEMP. PROBS. 1, 18-19 (1993).

duty to the insurance fund.<sup>121</sup> Any recovery of damages would mean less for the residual taker, the holding company, and under the cross-guarantee provisions, could mean an even larger liability for affiliated institutions.<sup>122</sup>

Commentators who have considered this issue have largely dismissed the idea of a free-floating fiduciary duty to the insurance fund as inappropriate from the perspective of regulatory policy,<sup>123</sup> from the perspective of portfolio theory,<sup>124</sup> and from the perspective of the institution affiliated parties that would have to discharge the duty.<sup>125</sup> Whether the general fiduciary duty idea is dead or merely hibernating is not known at this time. In any event, it remains a possible source of financial obligation for bank holding companies.

### E. Equitable Subordination

The FDIC also has employed the bankruptcy doctrine of equitable subordination to reach indirectly the holding company's resources to help pay for the resolution of failed financial institutions. Grounded in the case of *Pepper v. Litton*,<sup>126</sup> the equitable subordination doctrine holds that when the owners of a bankrupt enterprise have engaged in inequitable conduct, the claims of ownership against the bankrupt estate should be subordinated to the claims of other bankruptcy creditors to the extent necessary to correct the

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<sup>121</sup>In addition, the existence of such a duty could be an affirmative ground for the government to recover additional monies from institution affiliated parties because, among other things, the banking agencies are authorized to seek civil money damages for violations of fiduciary duties. See 12 U.S.C. § 1818(i)(2)(B)(i)(III), (C)(i)(III) (1994).

<sup>122</sup>See *infra* notes 138–145 and accompanying text.

<sup>123</sup>See Baxter, *supra* note 120, at 10 (demonstrating that although a fiduciary duty to the regulator is theoretically plausible, Congress has already supplanted the need for a general fiduciary duty by enacting a detailed regulatory scheme and imposing the duty to act safely and soundly).

<sup>124</sup>See Andrew J. Nussbaum, *Like Money in the Bank? An Economic Analysis of Fiduciary Duties to Protect the S&L Deposit Insurance Fund*, 44 ADMIN. L. REV. 355, 359–71 (1992) (employing portfolio theory to show the economic inefficiency of such a rule and its negative consequences).

<sup>125</sup>See Keith R. Fisher, *Nibbling on the Chancellor's Toesies: A "Roguish" Concurrence with Professor Baxter*, 56 LAW & CONTEMP. PROBS. 45, 48–50 (1993) (pointing out that the new fiduciary duty would be imposed on parties, such as attorneys, whose fiduciary duty runs only to the client, with no direction on how to accommodate the new duty).

<sup>126</sup>308 U.S. 295 (1939).

harm done to those non-owner claimants by the inequitable conduct.<sup>127</sup> The FDIC, in its role as receiver, has raised this doctrine in several cases, especially in states like Texas where the holding company structure is merely a way around branching restrictions and the separate banks of the system act like one large branching system.<sup>128</sup>

In these situations some banks in the holding company system fail while other banks remain solvent. Frequently the affiliates within the holding company system owe each other monetary obligations. The FDIC adopted a policy of equitably subordinating the inter-affiliate claims.<sup>129</sup> The equitable subordination approach failed to win the support of the court in the *MCorp* litigation.<sup>130</sup>

The FDIC as receiver also has employed a related but slightly different approach to achieve the same ends by discriminating between affiliated and non-affiliated claims in the resolution process. By giving non-affiliated claims a payout premium that affiliated claims do not share, the FDIC can achieve results in the resolution of banks in a multi-bank holding company that more closely resemble the results that would obtain from the resolution of a branched-based bank of similar size.<sup>131</sup>

This approach has a real impact for bank holding companies because the entities controlled by a bank holding company commonly share their capital resources. Elaborate arrangements for intra-company loans, repurchase agreements, debentures, lines of credit, correspondent banking relationships, participation agreements, and other sorts of financial engineering keep the affiliates in close dependence on each other.<sup>132</sup> The FDIC approach holds great power because the financial arrangements between stronger and weaker affiliates expose the stronger affiliates to the risk of insolvency if the weaker affiliates fail. As it commonly does in resolving failed institutions, in the *MCorp* case, the FDIC as receiver transferred substantially all the bank assets

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<sup>127</sup>See *id.* at 306, 308–10. For example, the FDIC could treat a holding company's loans to a failed bank as equity.

<sup>128</sup>See *MCorp v. Clarke*, 755 F. Supp. 1402 (N.D. Tex. 1991).

<sup>129</sup>*E.g.*, *Texas Am. Bancshares, Inc. v. Clarke*, 740 F. Supp. 1243 (N.D. Tex. 1990), *rev'd* 954 F.2d 329 (5th Cir. 1992); *MBank New Braunfels, N.A. v. FDIC*, 721 F. Supp. 120 (N.D. Tex. 1989).

<sup>130</sup>See *MCorp*, 755 F. Supp. at 1416–17.

<sup>131</sup>See *Texas Am. Bancshares*, 954 F.2d at 337–38.

<sup>132</sup>See *supra* note 87 and accompanying text.



and liabilities to new "bridge banks," but it left behind in the "bad bank" the liabilities due to the holding companies and their healthy affiliate banks.<sup>133</sup>

Leaving the holding company and affiliate claims behind in the bad banks resulted in those claims being worth next to nothing. The reduction in value of those claims had a domino effect on the balance sheets of the healthy affiliates. The FDIC's use of this technique was successfully challenged as a violation of the National Bank Act's requirement that claims against a bank receive "ratable" treatment.<sup>134</sup> In *MBank New Braunfels, N.A. v. FDIC*,<sup>135</sup> the district court found that this disparate treatment violated the ratable treatment requirement, despite the FDIC's argument that the action was justified because the National Bank Act requires only that the claims left in the receivership receive as much as they would have received in a straight liquidation of the bank's assets.<sup>136</sup>

To strengthen the FDIC's hand in the resolution of failed institutions, FIRREA amended the Federal Deposit Insurance Act to set the FDIC's maximum liability on any claim at the amount that the claimant would have received if the FDIC had simply liquidated the failed bank without the use of FDIC funds.<sup>137</sup> This amendment has the practical effect of overturning contrary case law, and establishing the FDIC's authority to treat affiliate and non-affiliate obligations differently. As a result, stronger affiliates in a bank holding company system are now at much greater risk when dealing with weaker affiliates in intra-company financial transactions. Indirectly, this amounts to increased liability for the bank holding company, because some of its wealth, i.e., the value of its strong affiliates, is transferred to the failed institution.

## F. Cross-Guarantee Provisions

Like the affiliate obligations that may be equitably subordinated, the cross-guarantee provisions of FIRREA<sup>138</sup> are not technically obligations of the holding company; but they have the effect of indirectly transferring

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<sup>133</sup>See *MBank New Braunfels*, 721 F. Supp. at 122.

<sup>134</sup>See 12 U.S.C. § 194 (1994).

<sup>135</sup>721 F. Supp. at 120 (N.D. Tex. 1989).

<sup>136</sup>*Id.* at 123-25; accord *Texas Am. Bancshares, Inc. v. Clarke*, 740 F. Supp. 1243 (N.D. Tex. 1990).

<sup>137</sup>FIRREA § 212(a), 12 U.S.C. § 1821(i)(2) (1994).

<sup>138</sup>12 U.S.C. § 1815(e) (1994).

holding company assets by making affiliates liable for each other. FIRREA gave the FDIC, when acting as conservator or receiver of an insured depository institution, or when providing emergency assistance to allow an insured institution to remain in business, the power to assess other depository institutions controlled by the same holding company for any loss that the FDIC incurs or anticipates that it will incur in disposing of or assisting the insured institution.<sup>139</sup> In a sense, the cross-guarantee provisions allow the FDIC to aggregate all of the banking subsidiaries of a bank holding company and treat them as one functional bank.

Although the cross-guarantee provisions do not operate to take funds from the holding company or its non-banking subsidiaries directly, the assessments that the FDIC charges against the holding company's otherwise healthy banking subsidiaries could be significant enough to render them insolvent as well, thereby resulting in a significant transfer of wealth from one holding company asset to another.<sup>140</sup> The cross-guarantee provisions have been challenged as unconstitutional takings,<sup>141</sup> but the Supreme Court has yet to settle the issue.<sup>142</sup>

In any event, recent changes in branching laws may presage the end of the multi-bank holding company era. As of the end of 1994, there were no more unit banking states and only two states that did not permit branching on a state-wide basis.<sup>143</sup> In addition, the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994<sup>144</sup> permits nationwide branching after

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<sup>139</sup>*Id.*

<sup>140</sup>This is exactly the situation that transpired when Bank of New England ("BNE") collapsed in the late 1980s. BNE's healthy sister bank, Maine National Bank, was served with an assessment to make good the costs that the FDIC anticipated in bailing out BNE. The assessment was sufficient to render Maine National insolvent as well. See William F. Sheehan & Celestine R. McConville, *FIRREA's Cross-Guarantee Provisions, Solvent Banks, and the Fifth Amendment*, 112 *BANKING L.J.* 574, 575-76 (1995).

<sup>141</sup>In *Meriden Trust & Safe Deposit Co. v. FDIC*, 868 F. Supp. 29 (D. Conn. 1994), *aff'd*, 62 F.3d 449 (2d Cir. 1995), the cross-guarantee provision was found to be constitutional, while in *Branch ex rel. Maine National Bank v. United States*, 31 Fed. Cl. 626 (1994), *rev'd*, 69 F.3d 1571 (Fed. Cir. 1995), *cert. denied*, 1996 WL 247226 (Oct. 7, 1996), the Court of Appeals for the Federal Circuit reversed the lower court and held that the cross-guarantee provision creates a special exception to the normal rule of limited corporate liability and is not a taking.

<sup>142</sup>For a general discussion, see Jennifer J. Alexander, Note, *Is The Cross-Guarantee Constitutional?*, 48 *VAND. L. REV.* 1741 (1995).

<sup>143</sup>See Amel, *supra* note 80, at 3.

<sup>144</sup>Pub. L. No. 103-328, 108 Stat. 2338 (codified in scattered sections of 12 U.S.C.).

June 1, 1997, thereby negating the requirement that holding companies operating in several states have a bank chartered in each of those states.<sup>145</sup>

### G. Preferences and Fraudulent Conveyances

Like the trustee in bankruptcy,<sup>146</sup> the FDIC as receiver of a national bank has the power to avoid transfers made with the intent of either preventing the ratable application of the failed bank's assets or preferring one creditor to another.<sup>147</sup> Although somewhat less well-developed than its bankruptcy counterpart, the banking version of preference law has started to come into its own as a tool for clawing assets into the failed institution's coffers.<sup>148</sup> Given the vast array of obligations running between holding companies and their bank subsidiaries, the preference could be a very effective way for the FDIC as receiver to force a holding company to justify each and every transaction entered into during the period of insolvency. Under this approach, all payments made by a failed bank to its holding company and affiliates will be closely scrutinized as possible preferences.

Similarly, fraudulent conveyance law provides another avenue through which the FDIC can attack the validity of a financial institution's asset transfers in the period leading up to insolvency. Support for a fraudulent conveyance theory might be found in state law or federal common law,<sup>149</sup> and would require the FDIC to show either intent to hinder, delay, or defraud creditors, or receipt of inadequate consideration.<sup>150</sup> In 1991 with the passage of FDICIA, Congress adopted a federal standard for fraudulent

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<sup>145</sup>As of this writing, only Texas had opted out of the Riegle-Neal branching provisions. See *Interstate Branching: Who's Opting In, Who's Opting Out, Who's Looking at the Options*, 87 A.B.A. BANKING J., Oct. 1995, at 22.

<sup>146</sup>See 11 U.S.C. § 547 (1994).

<sup>147</sup>See 12 U.S.C. § 91 (1994).

<sup>148</sup>See, e.g., *FDIC v. Goldberg*, 906 F.2d 1087 (5th Cir. 1990) (denying an investor in a failed institution the opportunity to walk away when board "rescinded" his subscription agreement for additional stock after the institution was declared insolvent).

<sup>149</sup>For a discussion of the impact of *O'Melveny & Meyers v. FDIC*, 114 S. Ct. 2048 (1994), on federal common law, see Michael D. Floyd, *Could D'Oench Be Doomed? The Impact of O'Melveny & Myers v. FDIC*, 15 ANN. REV. BANKING L. 325 (1996).

<sup>150</sup>Most states have modeled their fraudulent conveyance law on either the Uniform Fraudulent Conveyance Act or the Uniform Fraudulent Transfer Act. Cf. UNIFORM FRAUDULENT CONVEYANCE ACT, 7a U.L.A. § 7, at 155-56 (Supp. 1996); UNIFORM FRAUDULENT TRANSFER ACT, 7a U.L.A. § 5, at 209-10 (Supp. 1996).

conveyances.<sup>151</sup> The statutory standard permits a receiver or conservator for an insured depository institution to avoid certain transfers made with the intent to hinder, delay, or defraud the depository institution, the FDIC or any other appropriate federal banking agency.<sup>152</sup>

#### IV. RETHINKING THE SHAREHOLDER'S ROLE IN MARKET DISCIPLINE

The regulatory strategy of using non-regulators to keep a check on bank management makes sense—to a point. Increasing managerial accountability is an admirable goal, since there can be no doubt that management weaknesses contributed to the banking and thrift crises of the 1980s and early 1990s.<sup>153</sup> But the goal of implementing stringent management oversight may be easier to state than to execute. As the autopsies of failed institutions roll in, management factors seem to play an important role in the failures, but most of these lapses constitute garden variety negligence.<sup>154</sup>

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<sup>151</sup>12 U.S.C. § 1821(d)(17)(A) (1994).

<sup>152</sup>*Id.*

<sup>153</sup>The Congressional Budget Office reports that a study by the Office of the Comptroller of the Currency found that so-called “management-driven weaknesses” played a “significant role” in the decline of 90% of the resolved and problem banks. CBO STUDY, *supra* note 15, at 19–20; *see also* Comptroller of the Currency, *Bank Failure: An Evaluation of the Factors Contributing to the Failure of National Banks*, [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 87,387, at 93,979 (June 1988) (discussing OCC study which concluded that policies and procedures of a bank’s management and board of directors have greater influence on success or failure than economic conditions).

<sup>154</sup>The CBO hastened to add, however, that “[t]hese results do not imply that 90 percent of bank losses can be attributed to management problems, nor does it mean that different management could have averted 90 percent of bank failures.” CBO STUDY, *supra* note 15, at 20. It should be noted that these findings for individual bank resolutions are based on subjective evaluations of examiners who set out to list a group of factors contributing to the failure of a particular bank. Even with the most sophisticated techniques, distinguishing between management quality and the economic environment in which banks operate is obviously difficult; the categories are not mutually exclusive. *See id.* As a witness to several bank examinations done during the relevant time period, I would add the caveat that the post mortem analysis was performed by examiners with precious little banking experience, who tend to have a strong belief in written policies to the exclusion of all else. As the banking crisis unfolded, the existing corps of examiners was stretched to the limit and newer examiners went into the field with less

Although I am unaware of any statistics that show to what extent healthy banks commit the same negligent acts without serious consequences, I know from experience that even healthy, well-run banks can be, and frequently are, criticized by their examiners for actions, policies and procedures which, in the context of a failed institution, would be deemed "management-driven weaknesses."<sup>155</sup> It remains to be seen whether increased monitoring by holding companies will result in fewer run-of-the-mill lapses of judgment that necessarily plague all human activity.<sup>156</sup> Even if stringent oversight could reduce or eliminate bad decision-making, sometimes market forces beyond anyone's control cause a bank to fail.<sup>157</sup>

Accepting for the moment the broad proposition that monitoring management may be a useful approach to reducing the risk of bank failure, we still need to assess how useful it might be in practice. When we examine the policy more closely, we may find that it overstates the role that directors can realistically play in insuring the safety and soundness of the institutions they run.<sup>158</sup> One must keep in mind that most bank directors are not themselves banking professionals and therefore have limited expertise in second-

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seasoning than they ideally should have had. Given these limitations, they were more likely to see management mistakes where others would have found only bad luck.

<sup>155</sup>These management-driven weaknesses include everything from poorly followed loan policies, excessive loan growth and overconcentration in a particular industry to inadequate compliance systems, poor loan monitoring and accounting deficiencies. *See id.*

<sup>156</sup>Generally, bank directors will not be liable for simple lapses of judgment. *See, e.g., Muller v. Planters' Bank & Trust Co.*, 275 S.W. 750 (Ark. 1925) (holding that bank directors must exercise good faith and diligence in managing a bank, but are not liable for mere exercise of poor judgment); *Warren v. Robison*, 70 P. 989 (Utah 1902) (holding that directors will not be responsible for depreciation in value of bank stock when such depreciation results from errors of judgment).

<sup>157</sup>The OCC study found that 35% of the banks that failed did so due to "external economic conditions" such as inflation, recession, competition and interest rate volatility. *See CBO STUDY, supra* note 15, at 20. But as the CBO warned, that 35% figure could be misleading because "[i]t is not possible to separate 'external economic conditions' neatly from problems of asset quality [which is considered a management driven weakness]." *Id.*

<sup>158</sup>*See* John D. Hawke, Jr., *The Limited Role of Directors in Assuring the Soundness of Banks*, 6 ANN. REV. BANKING L. 285 (1987) (arguing that bank directors typically neither have access to information nor the banking skills necessary for the effective prevention of bank failure).

guessing their senior management.<sup>159</sup> Even in well-run banks, it is difficult for directors to have access to and to correctly interpret the kinds of information they need to properly run a bank; and even if they could, it is not feasible or desirable for directors to become involved in operational matters, such as determining the appropriate loan loss reserve or the writing down of loans.<sup>160</sup> These facts, together with the point made above that to err is human, create doubts about the ability of bank directors to change the way banking business is conducted.

Generally, corporate directors are not required by the law to do more than an ordinarily prudent person, acting in good faith, in a manner she reasonably believes to be in the best interest of the corporation, would do in a like position under similar circumstances.<sup>161</sup> Clearly, bank directors are

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<sup>159</sup>One commentator has noted:

A director of a typical small bank is likely to be a local businessman or businesswoman who is neither an expert in banking nor a professional manager. Very often the director is an entrepreneur who has been successful in his or her own business. Most small banks do not take on directors for their business management expertise. Rather the principal criterion is the likelihood that the director will bring business to the bank.

Hawke, *supra* note 158, at 286–87. The typical large bank directors often “are professional managers who are top executives for the bank’s corporate customers and thus are more sophisticated in complex business transactions than the typical small bank director.” *Id.* The sorry state of bank directors has prompted one commentator to call for licensure of bank directors. See Martin Lowy, *We Need Licensed Bank Directors*, AM. BANKER, Nov. 5, 1991, at 4.

<sup>160</sup>See Hawke, *supra* note 158, at 288. The difficulties facing directors are even greater for the “outside” directors, who not only must rely on second-hand information, but also operate under severe time constraints due to pressure from their other non-bank commitments. See Hugh Farrell Sharber, Comment, *A Realistic Duty of Care for Outside Bank Directors*, 51 TENN. L. REV. 569, 573 (1984) (arguing that outside directors should have a lower standard of care when they can show that they had no role or responsibility for the area of the bank where the mismanagement occurred); see also Committee on Corporate Laws, *Guidelines for the Unaffiliated Director of the Controlled Corporation*, 44 BUS. LAW. 211, 212–13 (1988) (pointing out that outside directors face “practical difficulties” in fulfilling the review function, especially lack of access to relevant information for decision-making purposes); Bayless Manning, *The Business Judgment Rule and the Director’s Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477 (1984) (arguing that the business judgment of directors should be determined using a standard that reflects the practical realities of the time constraints and other pressures on directors).

<sup>161</sup>This is the standard by the typical state corporate law. See MODEL BUS. CORP. ACT § 8.30(a) (1994).

not expected to be insurers of corporate success.<sup>162</sup> Except for an antiquated and spotty line of cases that state otherwise,<sup>163</sup> bank directors are not held to a higher standard than corporate directors generally.<sup>164</sup>

Although some commentators have wondered whether FIRREA had essentially established a nationwide standard of gross negligence, thereby pre-empting states that had held directors liable for mere negligence,<sup>165</sup> the

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<sup>162</sup>*See, e.g.*, *Atherton v. Anderson*, 99 F.2d 883 (6th Cir. 1938) (finding directors liable for losses caused by mismanagement when directors negligently failed to perform their duties); *Payne v. Ostrus*, 50 F.2d 1039 (8th Cir. 1931) (holding bank directors personally liable only for losses or damage sustained by the bank as a result of the directors' violation of duty); *McRoberts v. Spaulding*, 32 F.2d 315 (S.D. Iowa 1929) (finding that directors are not liable for unsuccessful loans provided the loans were made in good faith and even if made as an error of judgment); *FDIC v. Boone*, 361 F. Supp. 133 (W.D. Okla. 1972) (holding that directors are liable only for losses caused by their fault or neglect of duty).

<sup>163</sup>*See, e.g.*, *Gadd v. Pearson*, 351 F. Supp. 895, 903 (M.D. Fla. 1972) (holding directors and officers liable for violating their fiduciary obligations by receiving stock in the liquidation of a bank); *First Nat'l Bank v. Doherty*, 161 S.W. 211 (Ky. 1913) (holding bank directors liable as trustees for the stockholders of the bank); *Cosmopolitan Trust Co. v. Mitchell*, 136 N.E. 403, 408 (Mass. 1922) (treating trustees of savings banks as having the same fiduciary obligations as technical trustees of specific trust property); *Greenfield Sav. Bank v. Abercrombie*, 97 N.E. 897, 899-900 (Mass. 1912) (interpreting state law as creating a trust relationship between officers and depositors of savings banks); *Litwin v. Allen*, 25 N.Y.S.2d 667, 668 (N.Y. Sup. Ct. 1940) (holding that, in light of the day's complex economic transactions, increasingly fewer distinctions between "financial" and "industrial" corporations are viable). These cases have been roundly criticized. The modern view is that a special duty of care for bank directors is "unjustified and anachronistic." PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01, at 161 n.18 (Discussion Draft 1994).

<sup>164</sup>An even trickier question concerns what standard of care to apply to director action: should it be gross negligence or simple negligence? The question arises because of an ambiguous sentence in FIRREA that amended section 1821(k) of the Federal Deposit Insurance Act. 12 U.S.C. § 1821(k) (1994). The language in FIRREA establishes a cause of action against bank managers for gross negligence, but also includes a savings clause which stated that "[n]othing in this paragraph shall impair or affect any right of the [FDIC] under other applicable law." *Id.*

<sup>165</sup>This issue generated a great deal of legal commentary. *See, e.g.*, Douglas V. Austin & Sidney M. Weinstein, *Bank Officer and Director Liability Under FIRREA: The Need for a National Standard of Gross Negligence*, 111 BANKING L.J. 67 (1994) (recommending adoption of a national negligence standard of liability to avoid the desertion of a large number of competent directors who fear that they will be liable for simple mistakes); Cindy A. Schipani, *Should Bank Directors Fear FIRREA: The FDIC's Enforcement of the Financial Institutions Reform, Recovery and Enforcement Act*, 17 J.

issue seems to have been resolved by the Supreme Court decision in *O'Melveny & Meyers v. FDIC*,<sup>166</sup> which held that federal courts must look to state substantive law to fill in the blanks in federal statutes.<sup>167</sup> In light of that decision, lower court interpretations of section 1821(k) finding that FIRREA establishes a nationwide cause of action for gross negligence, overriding states where the standard was higher, while at the same time preserving the right of the FDIC to proceed under a lower negligence standard where permitted by state law, seem to state the correct view of the law.<sup>168</sup> Regardless of whether the legal standard to hold directors liable for their actions is simple negligence or gross negligence, there is a limit to what we can expect directors to do.

Perhaps enhanced monitoring should focus not on the bank's directors but on the officers instead. If the officers are committing fraud, or even just covering their mistakes, however, it will be extremely difficult for any monitor to detect, because the officers can conceal information from the monitor with relative ease.<sup>169</sup> As banking policy moves toward establishing directors and holding companies as watchdogs over bank officers, the

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CORP. L. 739 (1992) (stating that directors on corporate boards who, although not usually liable for negligent business decisions under federal law, are increasingly held liable for grossly negligent business decisions; the majority of courts have ruled that the gross negligence standard of section 1821(k) does not preempt state law causes of action for simple negligence); Ronald W. Stevens & Bruce H. Nielson, *The Standard of Care For Directors and Officers of Federally Chartered Depository Institutions: It's Gross Negligence Regardless of Whether Section 1821(k) Preempts Federal Common Law*, 13 ANN. REV. BANKING L. 169 (1994) (arguing that courts should develop a federal common law standard of care with reference to, and by incorporation of, state law).

<sup>166</sup>114 S. Ct. 2048 (1994). For a useful summary of the *O'Melveny* case and the controversy surrounding the appropriate standard of care for bank directors, see Afi Ahmadi & Robert W. Guazzo, *Developments in Banking Law 1995: Director and Officer Liability/Fiduciary Liability*, 15 ANN. REV. BANKING L. 181, 181-88 (1996).

<sup>167</sup>*O'Melveny & Meyers*, 114 S. Ct. at 2054.

<sup>168</sup>*See, e.g., RTC v. Williams*, 887 F. Supp. 1415 (D. Kan. 1995) (applying Kansas law in determining liability of directors because the institution had converted to a national charter only seven years prior to insolvency and because state law provided greater certainty and fewer practical difficulties than FIRREA standard); *FDIC v. Raffa*, 882 F. Supp. 1236 (D. Conn. 1995) (interpreting 12 U.S.C. § 1821(k) as not explicitly preempting state law because language in statute is not restrictive and because the savings clause preserved the "other applicable law").

<sup>169</sup>*See Hawke, supra* note 158, at 287.



officers will face increasing temptation to conceal necessary information in order to avoid criticism.<sup>170</sup>

If the real goal of the market discipline regulatory strategy is to make holding companies step up to the plate to help stop the moral hazard problem, the way it has been implemented amounts to regulatory overkill. Since the movement to increase bank capital in the late 1980s gained momentum, bank holding companies have been attentive to bank risks because the amount of capital they stand to lose is significant. Requiring banks to put large amounts of capital at risk is the best way to make holding companies pay attention to the riskiness of bank management.<sup>171</sup> To the extent some degree of market discipline from the equity holders was desirable to increase monitoring of bank management, the regulatory structure did not need a complete overhaul. The only change necessary was to make the capital requirements of banks significant enough to prevent the temptation to over-leverage, and to provide a cushion for the risks of the banking business.<sup>172</sup> Once the regulators increased the capital requirements of banks, the self-interest of holding companies coincidentally served to further regulatory interests by tempering bank risk.

Beyond the risk-based capital standards, enhanced holding company obligations add little to heightened shareholder oversight. The additional obligations do not materially increase the level of scrutiny because the maximum amount of shareholder effort is already applied in order to protect the capital investment, and shareholder monitoring alone cannot have any further impact on management behavior. That is, there is a real limit to how much shareholder monitoring alone can do in changing management action, especially since the regulatory changes described in the first section effectively squelched the most pernicious moral hazard problem by prohibiting the flow of brokered insured deposits into troubled institutions.<sup>173</sup> The enhanced capital standards with which banks have been living for the last few years provide equity holders with sufficient economic incentive to monitor management as well as they can. It is unlikely that the

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<sup>170</sup>*See id.*

<sup>171</sup>*See supra* note 88.

<sup>172</sup>There appears to be a strong connection between capital levels and thrift failure. *See* Lawrence R. Cordell et al., *Corporate Ownership and the Thrift Crisis*, 36 J.L. & ECON. 719, 724-27 (1993). "The ability to take on riskier investments at higher leverage ratios directly benefitted stock S&L owners, who could capitalize these benefits directly through appreciation of their stock holdings." *Id.* at 726.

<sup>173</sup>*See supra* notes 17-24 and accompanying text.

additional potential liabilities imposed on banks make the monitoring process any more effective. In short, everything after the increased capital requirements results in diminishing returns in terms of enhanced monitoring.

While the mismatch between the potential liability placed on bank holding companies and the role the regulatory scheme expects them to play could be written off as an unavoidable problem of trying to correctly calibrate a regulatory response, the consequences of such excessive monitoring can be severe. Despite the fact that additional potential liabilities cannot make equity holders any more effective as monitors, the presence of those liabilities can have a real effect on bank managers who know of their existence and may be overly deterred by them. Bank managers are already too cautious<sup>174</sup> and any additional regulation designed to make holding companies exert more oversight may make them even more so.<sup>175</sup> Managers may react by exercising too much caution and investing bank funds in U.S. government securities instead of extending credit to small businesses in the community, for example. On the credit that they do extend, an oversensitivity to risk may result in higher pricing, overly conservative asset valuations, and higher loan loss reserves, which in turn could lead to a self-fulfilling prophecy of closer regulatory scrutiny, examiner-ordered write downs, and ultimately, a diminution in stock value long before the underlying credits warrant such actions.<sup>176</sup>

Additionally, the current extensive holding company obligations act as disincentives for firms to invest in or acquire banks.<sup>177</sup> As the regulators of the thrift industry discovered when they miscalculated the amount of liability to exact from acquirors of failed thrifts, substantial holding company obligations discourage investors.<sup>178</sup> Given the growing competition between

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<sup>174</sup>See Garten, *Revisited*, *supra* note 5, at 192.

<sup>175</sup>See Utset, *supra* note 5, at 222 ("Managers, realizing that their investment in human capital will be lost completely if they lose their jobs, will pay close attention to regulators' signals, in some cases becoming much more cautious than the regulators intended.").

<sup>176</sup>See Paul H. Irving & T. Hale Boggs, *Financial Institution Directors: Mitigating Risks of Liability in Shareholder Actions*, 109 *BANKING L.J.* 336, 349 (1992).

<sup>177</sup>See Jackson, *supra* note 30, at 605-06 (noting the argument and providing some responses).

<sup>178</sup>In discussing the changes in the Federal Home Loan Bank Board's ("FHLBB") capital maintenance agreements from being open-ended ongoing commitments by acquirors to being more limited, four attorneys with the FHLBB noted that the open-ended policy "probably was detrimental to attracting new capital and well-capitalized acquirors into the thrift industry." Julie L. Williams et al., *FHLBB's New Approach to*

the banking industry and other suppliers of financial services, the increased holding company burden could act as a serious obstacle to the banking industry's ability to attract new capital.

While we have seen that the regulators are fighting a rear-guard action, Congress is fighting the last war too. It focuses public policy on financial problems that occurred years ago without paying sufficient attention to crises looming in the foreseeable future. Much of the financial services regulation in the United States is focused on banks. The legislators on Capitol Hill seem to assume that every family in America has its life savings tied up in the local bank. But the reality of how financial assets are held is quite different. Banks have been playing an increasingly smaller role in the financial market place. Over the past twenty years, banks' share of U.S. financial assets has fallen to less than thirty percent from sixty-six percent.<sup>179</sup> Mutual fund assets now total almost as much as the deposits in domestic U.S. banks, yet there exists a major disparity in the number of regulatory personnel supervising the two industries.<sup>180</sup> Mutual funds, finance companies, and securities firms are free from the capital requirements, business restrictions, and Community Reinvestment Act requirements that burden banks. Although the additional regulation of banks may be justified on the ground that they enjoy the benefit of deposit insurance, one must ask at what point the burden outweighs the benefit.

By piling on disincentives to risk-taking, the regulators are essentially fighting the last war instead of looking ahead to the challenges on the horizon. Although poor credit decisions and the availability of "hot" money certainly played an important role in the bank failures of the 1980s, there is reason to believe that lack of caution in the lending area funded by volatile deposits may no longer be the biggest problem facing the banking indus-

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*Regulatory Capital Maintenance Obligations of Acquirors of S&Ls*, 52 Banking Rep. (BNA) 233 (Jan. 30, 1989).

<sup>179</sup>See William S. Haraf, *Emerging Issues in Financial Markets*, REGULATION, Winter 1994, at 12.

<sup>180</sup>One report states that there were 214 SEC staff members assigned to supervising the mutual fund industry in 1992, while there were a total of 21,000 staff in the agencies regulating banks, thrifts and credit unions. *See id.* at 13. These numbers seem to be stacked in favor of presenting a dramatic disparity, but it seems as though a significant disparity exists, even with more conservative numbers.

try.<sup>181</sup> Today, the biggest problem confronting the banking industry is surviving the competitive pressures from other financial services providers.<sup>182</sup> The next big war will pit mutual funds, investment bankers, insurance companies, pension funds, credit unions and other financial services providers against the banking industry in a battle for the funds of investors and customers.

In light of this "next war" scenario, imposing disincentives on bank holding companies is counterproductive, unless the public policy is designed to handicap the banking industry in order to give its competitors an advantage in the heated competition that is already underway. Systemically, over-regulating the banking industry and bank holding companies has an overall negative effect on the banking industry compared to its competitors.<sup>183</sup> Some commentators have argued that the current U.S. bank capital structure puts the costs of bank capital too high,<sup>184</sup> and this, added to the implicit costs of the hidden holding company obligations, makes banks' capital even more expensive. The increase in bank capital costs could have the effect of retarding the growth of the banking industry, or even contributing to its decline. In an era of multi-national banking, this could be a serious handicap for U.S. banks.

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<sup>181</sup>See Garten, *Revisited*, *supra* note 5, at 189–90 (citing the asset composition of banks in the 1990s as evidence that banks are focusing less on lending and more on conservative investments).

<sup>182</sup>See *id.* at 192.

<sup>183</sup>Banks suffer from a structural handicap when competing against mutual funds on yield alone, because the costs of doing business as a bank are higher than the costs of doing business as a mutual fund, especially if one takes into account the cost of deposit insurance premiums, reserve requirements and compliance with social policy legislation such as the Community Reinvestment Act. See Randall Smith, *Banks Could be Pinched for Deposits to Lend After Consumer Exodus*, WALL ST. J., June 30, 1993, at C1 (surveying banks' loss of market share of consumer deposits to the mutual fund industry and noting that some banks have tried to ameliorate the loss by selling their own mutual funds).

<sup>184</sup>*Cf.* Sanford Rose, *Higher Capital May Impair Bank Safety*, AM. BANKER, Aug. 7, 1990, at 1 (arguing that banks will try to satisfy capital requirements by eliminating high-grade credits from their portfolios, resulting in increases in risk profiles of assets and increased likelihood of default and bank failures).

## V. CONCLUSION

In the quest to find non-governmental monitors of bank management, Congress and the federal banking regulators have developed cost shifting strategies designed to create financial incentives for bank shareholders, and specifically bank holding companies, to pay more attention to the risks their banks undertake. The policy changes have, however, gone too far. The regulators resolved the biggest problem confronting the industry by outlawing the practice of permitting brokered high-interest insured deposits to fund risky activities in insolvent banks. By enacting higher capital requirements, the regulatory scheme increased incentives for bank equity holders to the optimal level. The employment of regulatory devices that potentially impose liability on bank holding companies above and beyond the loss of the capital invested in the bank do not increase the effectiveness of shareholder monitoring but instead only create an unfair drag on the banking industry relative to its non-banking competitors.