# REGULATORY GROWING PAINS: A PERSPECTIVE ON BANK REGULATION IN A DEREGULATORY AGE

**HELEN A. GARTEN***

## TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Introduction</td>
<td>502</td>
</tr>
<tr>
<td>I. The Metamorphosis of Regulation</td>
<td>506</td>
</tr>
<tr>
<td>A. <strong>Traditional Bank Regulation</strong></td>
<td>509</td>
</tr>
<tr>
<td>1. Regulation and Profitability</td>
<td>514</td>
</tr>
<tr>
<td>2. Regulation and Failure Prevention</td>
<td>519</td>
</tr>
<tr>
<td>B. <strong>Banking in Transition</strong></td>
<td>521</td>
</tr>
<tr>
<td>C. <strong>The “New” Regulation</strong></td>
<td>528</td>
</tr>
<tr>
<td>1. Diversification</td>
<td>529</td>
</tr>
<tr>
<td>2. Capital</td>
<td>533</td>
</tr>
<tr>
<td>3. Fiduciary Responsibility of Bank Management</td>
<td>537</td>
</tr>
<tr>
<td>II. A Corporate Finance Analogy</td>
<td>540</td>
</tr>
<tr>
<td>A. Shareholders Versus Debtholders</td>
<td>541</td>
</tr>
<tr>
<td>B. <strong>Bank Regulation from the Debtholder’s Perspective</strong></td>
<td>543</td>
</tr>
<tr>
<td>C. <strong>Bank Regulation from the Equityholder’s Perspective</strong></td>
<td>545</td>
</tr>
<tr>
<td>III. Regulatory Growing Pains</td>
<td>547</td>
</tr>
<tr>
<td>A. <strong>The Problem of Administration</strong></td>
<td>547</td>
</tr>
<tr>
<td>B. <strong>The Problem of Risk Control</strong></td>
<td>550</td>
</tr>
<tr>
<td>1. Bank Regulation and Portfolio Theory</td>
<td>551</td>
</tr>
<tr>
<td>2. Bank Regulation and Market Discipline</td>
<td>558</td>
</tr>
<tr>
<td>3. Bank Regulation and Problem Banks</td>
<td>565</td>
</tr>
<tr>
<td>IV. The Future of the New Bank Regulation</td>
<td>568</td>
</tr>
<tr>
<td>Conclusion</td>
<td>577</td>
</tr>
</tbody>
</table>

* Associate Professor of Law, Rutgers Law School—Newark. A.B. 1975, Princeton University; J.D. 1978, Harvard Law School. I am grateful to the Rutgers University Research Council for its grant support for this project and to the S.I. Newhouse Faculty Research Fund of the Rutgers Law School for its ongoing assistance. I also wish to thank participants in a Rutgers faculty colloquium for their helpful suggestions. The ultimate responsibility for the content is, of course, mine.
INTRODUCTION

In banking, change is a permanent condition. ¹ The pressure for change is coming from many directions: from the banking industry, which has been pushed by external competition and internal financial problems to seek new products and markets, ² from scholars who support the trend toward deregulation of industry, ³ and even from the bank regulators themselves. ⁴ In response to these forces, large portions of traditional bank regulation, including the twin pillars of geographic ⁵ and product restrictions, ⁶ are crumbling rapidly. ⁷

¹ The revolution in the structure, business and regulation of the banking industry has been extensively documented during the past few years, see, e.g., K. Cooper & D. Fraser, Banking Deregulation and the New Competition in Financial Services (1984), but is most dramatically illustrated by the changed services offered by banks to their customers. A bank customer today, unlike her counterpart a decade ago, can obtain discount brokerage and other securities investment services from her bank, can earn a market rate of interest on her bank balance and can withdraw cash from an automated teller machine at a different address or even in a different state from her bank branch. The process of innovation in the banking business has required complex reinterpretation of existing banking statutes and regulation; the effects of innovation have been obvious.

² See, e.g., Hayes, Investment Banking: Commercial Banks' Inroads, Fed. Reserve Bank of Atlanta Econ. Rev. 50 (May 1984) (banks offer new securities services); Sudo, Bank Groups in Crucial States to Renew Push on Insurance, Am. Banker, Nov. 18, 1987, at 1, col. 2 (banking groups lobby for new insurance powers); see also infra notes 99-137 and accompanying text (discussing profitability crisis in banking industry).


⁴ See, e.g., Trigaux, Corrigan Endorses Proxmire-Garn Bill, Am. Banker, Dec. 11, 1987, at 3, col. 2 (President of the New York Federal Reserve Bank favors new securities powers for banking organizations). Despite philosophical differences among the three federal bank regulators—the Federal Reserve Board, the Federal Deposit Insurance Corporation and the Comptroller of the Currency—there appears to be a consensus as to the need for further deregulation. According to one regulator, "[T]oday, it is neither fashionable nor practical to speak out against deregulation." Taylor, Deregulation and Prudent Supervision, 6 Ann. Rev. Banking L. 253, 253 (1987).

⁵ Federal laws such as the McFadden Act, 12 U.S.C. § 36 (1982), and the Douglas Amendment to the Bank Holding Company Act, 12 U.S.C. § 1842(d) (1982), and various state laws restrict the ability of banking organizations to open branches or acquire additional banks outside of a single state. For a description of these restrictions, as well as recent innovations, see Cohen, Interstate Banking: Myth and Reality, 18 Loy. L.A.L. Rev. 965 (1985).

Most recent commentary about bank regulation either documents the changes or proposes further regulatory dismantling. In contrast, this Article offers a different perspective on the progress of deregulation of banking by examining the new strategies of regulation that are emerging to take the place of the old regulatory controls.

Initially, the notion of a new regulation would seem to run counter to the goal of deregulation of banking. Yet this new regulation is essential to the continued progress and success of the deregulatory process. Unlike the deregulation of many industries, deregulation of banking has not meant that banks simply are unshackled from regulatory controls. The fundamental aim of traditional bank regulation, protection of the safety and soundness of the banking system, remains an important concern of...
regulators and deregulators alike. Although critics differ as to the best approach to guaranteeing soundness, as illustrated by the continuing debate over government bailouts of failing banks, they generally agree that, under any new regulatory scheme, the bank regulators must still monitor bank safety to prevent risk to the banking system as a whole. Thus, deregulation of banking has forced the bank regulators to develop new strategies for monitoring bank safety as their traditional regulatory tools are taken away.

This Article analyzes the shift in regulatory strategy that has accompanied deregulation of banking. As a way of contrasting the old and new strategies of bank regulation, this Article proposes an analogy to familiar concepts of corporate governance. Traditional bank regulation viewed bank safety from the point of view of a depositor or other debtholder. This regulation was characterized by restrictions on the types of activities in which banks could engage, policies that encouraged asset growth and protection of depositors in the event of failure. The strategy of this regulation was to ensure banks a stable rate of return from traditional

9. Proponents of deregulation share this goal of reducing bank risk, but argue that some aspects of bank regulation do not work to maintain a healthy banking industry. See, e.g., Fischel, Rosenfield & Stillman, supra note 3, at 322-38 (criticizing product and geographic restrictions).


11. See, e.g., Shumway, The Compatability of Deregulation and Increased Supervision, 6 Ann. Rev. Banking L. 247 (1987) (deregulation will require increased regulatory supervision of banks). Most proponents of deregulation favor retention of deposit insurance protection of small depositors and central bank lending to provide liquidity to banks. See, e.g., Fischel, Rosenfield & Stillman, supra note 3, at 312-18; Isaac, The Role of Deposit Insurance in the Emerging Financial Services Industry, 1 Yale J. on Reg. 195, 195-215 (1984). If these regulatory devices survive deregulation, then, as a practical matter, the regulators will be required to monitor and control bank risk in order to prevent depletion of the insurance fund as a result of massive bank failure. See infra notes 371-74 and accompanying text.

12. Observers of bank regulation often have drawn a distinction between formal regulation of banks by statute, rulemaking and adjudication and less formal supervision by regulatory examination and oversight. See Shumway, supra note 11, at 248; see also K.C. Davis, 1 Administrative Law Treatise § 4.04, at 249-50 (1958). This distinction between regulation and supervision is not always clear-cut. For example, bank regulators always have played a role in interpreting formal statutes and rules in the process of deciding specific applications by banks for new activities or acquisitions and often have imposed their own conditions on approval, thereby creating an informal set of rules that could be applied to other banks. Cf. Easterbrook, Foreword: The Court and the Economic System, 98 Harv. L. Rev. 4, 39 (1984) (describing this regulatory "conditioning power").

13. A bank's assets consist primarily of loans, but may also include United States government securities and other securities eligible for purchase by a bank under applicable banking law, Eurodollar placements and deposits in other banks.
and safe banking businesses, while maintaining a cushion of protection for depositors in the event of unforeseen losses. Like typical debtholders, the bank regulators were averse to excessive risk-taking by banks, preferring a steady rate of return to aggressive profit-seeking.

Recently, many of the static controls that characterized traditional bank regulation have proved counterproductive, actually weakening rather than strengthening the financial position of many banks. As these controls are being dismantled, a new regulatory strategy is developing that views bank safety from the point of view of an equityholder. This "new" regulation actually encourages banks to engage in additional risk-taking to improve profitability and to diversify activities as a hedge against risk. Like typical equity investors, the regulators increasingly are concerned with improving the quality of bank management, especially management's ability to adapt to market changes and to prevent fraud and conflicts of interest. In addition, the bank regulators have increased their reliance on the market for bank stocks both to confirm their assessments of banks and to assist them in monitoring bank condition.

This shift in regulatory strategy from a debtholder's to an equityholder's viewpoint is neither as complete nor as formal as this summary suggests. Nevertheless, this categorization is useful for two reasons. First, it permits some sense to be made of the seemingly random and unplanned changes that are occurring in bank regulation. Second, it provides a means of identifying the problems that already have emerged for the bank regulators in their new roles as managers of deregulation. In part, these growing pains are the inevitable result of adjustment to a changing banking and regulatory environment. In addition, they may be symptomatic of a deeper problem with the new regulatory strategy.

Part I of this Article analyzes the rise and fall of traditional bank regulation, and, in particular, the relationship between regulation and profitability in the banking industry. To the extent that traditional bank regulation helped to sustain the profitability of the banking business after the banking crisis of the 1930s, such regulation was highly successful. Traditional regulation began to fail only when banks could no longer operate profitably within its confines. The need to find new profit sources

14. Likewise, the divergence of interest between equityholders and debtholders in reality is not as pronounced as corporate governance models would suggest. See infra notes 224-25 and accompanying text. Nevertheless, the classic model provides a useful way of illustrating the differences in approach between what this Article calls the old and the new bank regulation.

15. The current confusion surrounding the progress of bank deregulation is illustrated by a congressional committee's decision to institute a comprehensive investigation of the present state of the bank regulatory framework in order to determine why "supposedly elemental matters—such as... the meaning of 'bank'... should be the subject of intense debate." See House Comm. on Government Operations, Confusion in the Legal Framework of the American Financial System and Services Industry, H.R. Rep. No. 692, 98th Cong., 2d Sess. 2 (1984).
Part II develops the characterization of these changes in regulatory approach as a shift from the strategy of the debtholder to that of the equityholder. This change in perspective is evident in the new regulatory approach toward bank risk-taking and diversification, leverage and corporate governance. More generally, this shift in regulatory strategy has meant a significant change in techniques of risk control at banking institutions. Rather than relying on regulatory "debt covenants" that prevented many opportunities for risk-taking, the new regulatory approach must depend on more active management of the novel and often complex risks facing banks.

Part III examines some problems that have emerged from this new regulatory strategy. To the extent that this strategy relies on active risk management, it raises the question of who bears primary responsibility to control risk-taking at banking institutions—the bank's regulators, its management or its shareholders. Although the regulators' new approach may view bank safety from the perspective of an equityholder, the regulators' preferences with respect to bank risk-taking may not necessarily be those of the bank's management or its shareholders. Moreover, attempts to implement the regulators' risk preferences through regulatory incentives and penalties imposed upon bank management and shareholders may have some unintended consequences for the banking system. This Part analyzes three examples of recent regulation that illustrate this weakness in the new regulatory approach.

Finally, Part IV considers the future of the new regulatory strategy. If the bank regulators are to play the primary role in controlling risk in the new deregulated banking industry of the future, the regulators must find more effective ways to bring pressure to bear on bank management to control its risk-taking. This in turn will require greatly improved techniques of monitoring and disciplining management performance.

I. THE METAMORPHOSIS OF REGULATION

To recent observers, the bank regulatory system presents something of a paradox. The complexity and detail of bank regulation make banking one of the most intensively and comprehensively regulated industries. moreover, bank regulation has been successful in achieving its primary

16. This Article does not attempt to review in detail all of the statutes and rules applicable to banks, but does develop broad themes that characterize regulatory strategy, providing specific examples where necessary. For a comprehensive analysis of the techniques of traditional bank regulation, as well as regulation of other financial intermediaries, see Clark, The Soundness of Financial Intermediaries, 86 Yale L.J. 1 (1976). Professor Clark divided traditional bank regulation into four categories: anticompetitive regulation (such as restrictions on entry into the banking business and ceilings on interest payable on bank deposits); portfolio regulation (such as restrictions on permissible bank activities and investments); insider misconduct regulation; and reactive regulation (such as deposit insurance). See id. at 26-101.
goal of maintaining the stability of the banking system. Yet, today, bank regulation appears both ineffective and outmoded. Banks have taken advantage of numerous loopholes in the regulatory framework to enter previously forbidden businesses. Market forces ranging from volatile interest rates to international competition in financial services have made anticompetitive bank regulation not only useless to halt innovation but actually counterproductive. Finally, the number of bank failures is increasing each year.

In a sense, both these views of bank regulation are correct. Certainly, many of the traditional tenets of bank regulation, such as limits on the interest payable on deposits, restrictions on the ability of banks to offer certain products and services and strict anti-branching rules, recently have hindered banks in competing for and retaining customers, and occasionally have even contributed to serious financial problems at individual banks. Moreover, these restrictions apparently run counter to the pref-
ferences of most banks, which are actively seeking to compete in new markets, as well as the desires of their customers.

If traditional regulation is economically unsound, anticompetitive and ineffective in preventing innovation, what is surprising is not that deregulation is occurring, but that it took so long to occur. Some observers have explained the longevity of traditional regulation as a form of special interest regulation intended to benefit bank competitors, such as the investment banking industry, or, alternatively, as evidence of the persistence of a highly paternalistic view of banks and their depositors that seeks to shelter them from the consequences of their own risk-taking. Yet neither of these views explains why traditional regulation was not resisted long before now by the banking industry itself, as well as by bank customers. Until relatively recently, there was very little pressure from any source to make banking more competitive.

A better explanation for the survival of traditional bank regulation may be that, until recently, such regulation was successful in maintaining the profitability of the banking industry. Two factors may account for its success. First, by removing any temptation for banks to venture into potentially risky activities and markets, the substance of traditional regulation returned banks to a banking business characterized by stable prof-


25. See, e.g., Rivoir, Banks Take Aim at Money Market Funds, 6 Issues in Bank Reg. 23 (Autumn 1982) (describing bank deposit innovations); see infra notes 120-23 and accompanying text.

26. It is generally assumed that consumer demand is a significant force behind the efforts of banks to diversify their product lines. Undoubtedly, many customers favor "one-stop shopping" for financial products. Yet surveys have indicated that the largest consumers of financial services may not be concerned with obtaining all their financial services from a single supplier. See Bennett, Consumer Demand for Product Deregulation, Fed. Reserve Bank of Atlanta Econ. Rev. 28 (May 1984); see also Sudo, Service Counts Most with Corporate Customers, Am. Banker, Aug. 30, 1988, at 1, col. 2 (survey finds quality of service more important than variety of service in banking relationships).

27. This explanation has been offered for the Glass-Steagall Act. See Macey, Special Interest Groups Legislation and the Judicial Function: The Dilemma of Glass-Steagall, 33 Emory L.J. 1, 15-21 (1984); see also Easterbrook, supra note 12, at 57 (suggesting Glass-Steagall Act should be analyzed as interest group legislation). But cf: Langevoort, supra note 7, at 693 (no historical evidence of this purpose for the Glass-Steagall Act).

28. See, e.g., Clark, supra note 16, at 25-26 (protection of public suppliers of capital from the results of their own risk-taking as motive for regulation of financial intermediaries).

29. See Leavitt, The Philosophy of Financial Regulation, 90 Banking L.J. 632, 647 (1973). Significantly, the banking industry made no serious effort to avoid the regulatory restrictions, although, as demonstrated by recent innovations, evasion would not have been difficult. See Halpert, The Separation of Banking and Commerce Reconsidered, 13 J. Corp. L. 481, 517-18 (1988) (noting infrequency of legal challenges to bank regulation); see also infra notes 133-37 and accompanying text.
its. Second, the form of traditional regulation, consisting of easily administered prophylactic rules, greatly facilitated the regulators’ task of monitoring risk levels at individual banks. The result was a banking industry with high earnings and a low failure rate.

The crisis in traditional bank regulation has come about because the traditional banking business is no longer profitable for many banks. As a result, the primary goal of the bank regulators, to maintain a stable and profitable banking system, can no longer be achieved through the traditional controls. Much of the recent deregulatory effort, as well as certain new regulatory initiatives, are designed to find new sources of profitability for the banking industry as a whole.

A. Traditional Bank Regulation

Analyses of the vast body of statutes and rules that make up traditional bank regulation generally have made three observations. First, much of traditional bank regulation had its origins in the banking crisis of the early 1930s. Second, bank regulation has tended to rely heavily on prophylactic rules that bar banks from particular activities or investments rather than simply to regulate the conduct of those activities. Finally, the principal result of traditional bank regulation has been to confine banks to certain narrowly circumscribed areas of operation that are considered the core business of banking, namely, taking deposits and making loans.

These generalizations about traditional bank regulation are true up to

30. This Part’s attempt to summarize fifty years of bank regulation, as well as its impact on the banking industry, is of necessity very generalized. For a more detailed description of specific regulations, see Clark, supra note 16, at 26-101.
31. For a description of the crisis and related events of the early 1930s that led to comprehensive regulation of the banking and securities industries, see M. Friedman & A. Schwartz, A Monetary History of the United States 1867-1960, at 299-419 (1963).
32. Regulation of banking also has taken place through the regulators’ informal day-to-day supervisory powers over the banking industry, including examinations, monitoring and approval of applications. See supra note 12. Nevertheless, the prophylactic rules provided a check on the discretion of the bank regulators to permit diversification by banks. Moreover, although many of the rules discussed in this Part are statutory, the regulators often formulated their own prophylactic rules in supervising banks. See infra note 43 and accompanying text (regulators set interest rate ceilings for time deposits).
33. There is no real historical reason for considering the loan/deposit business to be the central business of banking. For many periods in banking history prior to the 1930s, banks engaged in a variety of activities. See Symons, supra note 6, at 684-714 (reviewing historical development of bank powers). The source of this traditional, narrow view of banking may have been the economic theory of banking known as the “real-bills” doctrine, which viewed banks chiefly as suppliers of short-term business credit to meet the requirements of trade. For a discussion of the impact of this theory in the United States, see L. Mints, A History of Banking Theory in Great Britain and the United States 9-12 (1945). The “real-bills” doctrine profoundly influenced the drafters of the major banking legislation of the 1930s and probably has informed the popular view of the business of commercial banks. For a history and analysis of the theoretical underpinnings of the banking legislation of the 1930s, see Perkins, The Divorce of Commercial and Investment Banking: A History, 88 Banking L.J. 483 (1971).
a point. Although not all bank regulation dates from the Depression,\(^{34}\) perhaps the best known provisions of banking legislation, the divorce of banking from the securities business (known as the Glass-Steagall Act) and the federal deposit insurance system, were part of the comprehensive banking legislation adopted in 1933.\(^{35}\) Moreover, these two provisions exemplify the form and function of much of traditional bank regulation. For example, the Glass-Steagall Act generally barred banks from engaging in the business of issuing, underwriting, selling or distributing securities, either directly or through affiliates.\(^{36}\) This statutory bar reflected a decision to impose direct regulatory controls on the assets and investments of banks, removing from bank management the discretion to allocate resources among business opportunities. Similar direct controls were imposed on the ability of banks to become affiliated with nonbanking companies,\(^{37}\) to engage in general commercial or financial activities\(^{38}\) or to invest in additional banks across state lines.\(^{39}\)

In addition to regulating the types of assets that banks could acquire, traditional bank regulation sought to protect bank assets for the benefit of the bank’s most significant creditors, its depositors. The most obvious protection is provided by the deposit insurance scheme, which reimburses depositors in failed banks up to $100,000.\(^{40}\) The deposit insurance system does more than simply to provide a guarantee for small deposits.

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\(^{34}\) For example, the nonbanking activities of bank holding companies and their nonbank affiliates were not restricted until the adoption of the Bank Holding Company Act of 1956, Pub. L. No. 84-511, 70 Stat. 133 (codified as amended at 12 U.S.C. §§ 1841-1850 (1982 & Supp. V 1987)). After 1933, bank affiliates were subject to some federal regulation, including a requirement to report nonbanking activities to the Federal Reserve Board. These reports revealed that banks were affiliated with retail clothing corporations, packing companies, newspapers, lumber yards, steamship companies and even churches. See Note, The Banking Act of 1933 in Operation and the Contemplated Modifications, 8 St. John’s L. Rev. 434, 436 (1934).

\(^{35}\) See Act of June 16, 1933, ch. 89, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.). Although the Banking Act of 1933 was passed during the first hundred days of President Roosevelt’s first term, it has never been considered to be New Deal legislation. The separation of commercial and investment banking was not a new idea, but had been proposed several years earlier by Senator Glass. For a description of the origins and purposes of the separation provisions by a key advisor to Senator Glass, see H.P. Willis & J. Chapman, The Banking Situation 84-102 (1934). Moreover, the Act was almost vetoed by President Roosevelt, who disapproved of the federal deposit insurance provisions. See R. Moley, The First New Deal 320 (1966).

\(^{36}\) The basic provision is codified as amended at 12 U.S.C. § 24 Seventh (1982 & Supp. V 1987). In addition, banks are barred from affiliating with organizations “engaged principally” in securities activities, id. § 377, or from having management interlocks with such firms, id. § 78, and organizations engaged in securities activities may not engage in deposit-taking, id. § 378.


\(^{39}\) See Bank Holding Company Act § 3(d), 12 U.S.C. § 1842(d) (1982).

\(^{40}\) See id. § 1813(m)(1).
The Federal Deposit Insurance Corporation also assumes the assets of failed banks and liquidates them for the benefit of unsecured creditors, including uninsured depositors and the insurance fund itself. In addition, whenever feasible, the bank regulators will arrange for the acquisition of a failed bank's assets and liabilities by a healthy bank, thereby preserving the investments of the failed bank's creditors.

Other traditional regulation was designed to protect a bank's assets while it is a going concern. For example, ceilings on the rates of interest payable on bank deposits were intended to ensure a positive spread between the rates that banks could earn on their assets and the rates that they paid on their liabilities. This cushion not only would protect banks from interest rate risk that could lead to failure, but would remove the temptation for banks to make high yielding, high risk loans in order to meet their funding costs. In addition, banks have been subject to periodic on-site regulatory examinations that are intended to identify banks with financial difficulties. Bank examinations traditionally have focused on evaluating loan quality as a way of ensuring that the value of the bank's assets will not fall below its liabilities.

Critics of bank regulation have viewed this emphasis on the regulation and protection of bank assets as a reaction, or perhaps an overreaction,

41. See id. § 1821(c)-(f).

42. If the failed bank has insufficient assets to cover its liabilities, the regulators will provide some amount of financial assistance to permit the acquiring bank to assume the failed bank's liabilities. The regulators will attempt to arrange such an assumption whenever the amount of required federal assistance is less than the cost of paying off the insured depositors out of the insurance fund. See J. Sinkey, Problem and Failed Institutions in the Commercial Banking Industry 36-37 (1979). In addition, in certain cases, the regulators may provide direct financial assistance to failing banks to keep them open. See 12 U.S.C. § 1823(c)(1) (1982). This also has the effect of preserving the investments of the bank's creditors.


44. Because bank assets (primarily loans) tend to reprice more slowly than bank liabilities (deposits), banks are particularly vulnerable during periods of rising interest rates. See Kessell & Clark, *A Study of Expectational Errors in the Money and Capital Markets, 1921-70*, 19 J. L. & Econ. 1, 13 (1976). For example, a bank may sell 90-day certificates of deposit paying 9 percent interest and use the proceeds to fund six-month loans paying 10 percent interest. If, 90 days later, the bank must offer 11 percent on its new certificates of deposit, the bank's cost of funding will exceed what it is earning on its income-producing assets.

45. See M. Friedman & A. Schwartz, *supra* note 31, at 443 (describing this motive for interest rate ceilings).

46. See 12 U.S.C. § 325 (1982) (examination of Federal Reserve member banks by Board of Governors of the Federal Reserve System); id. § 481 (examination of national banks by Comptroller of the Currency); id. § 1820(b) (examination of insured nonmember state banks by FDIC).

to a crisis.\textsuperscript{48} During the early 1930s, the banking system proved to be vulnerable.\textsuperscript{49} The Glass-Steagall Act and similar regulation were designed to protect the banking industry by shielding banks from what were viewed as excessively risky activities, such as investment banking.\textsuperscript{50}

Yet, as so many critics of the Glass-Steagall Act have pointed out,\textsuperscript{51} this response may have been miscalculated. First, as a historical matter, whether the banking industry's problems in the 1930s, or any other time, were caused by participation in investment banking activities is debatable.\textsuperscript{52} Second, it is not so clear that investment banking itself is such a risky activity, either when compared with banking or, more important,

\textsuperscript{48} See, e.g., Jacobs, \textit{Regulation of Deposit-Type Financial Institutions}, in Institute for Contemporary Studies, \textit{Regulating Business: The Search for an Optimum} 17, 18 (1978) (bank regulatory system a response to "aberrant conditions"); Whitesell & Kelly, \textit{Is the Glass-Steagall Act Obsolete?}, 87 Banking L.J. 387, 387 (1970) (Glass-Steagall Act "[c]onceived in a mood of anger and mistrust"); see also Englert, \textit{Bank Supervision in Historical Perspective}, 34 Bus. Law. 1659, 1659 (1979) ("[w]henever the economy is unsettled or out of joint, the bank supervisory structure . . . comes under attack").

\textsuperscript{49} From 1930 through 1932, over 5,000 commercial banks failed; in January 1933 alone, there were 241 failures. See Golembe Associates, Inc., \textit{Commercial Banking and the Glass-Steagall Act} 51 (1982).

\textsuperscript{50} See, e.g., Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., 468 U.S. 137, 144 (1984) (Glass-Steagall Act "responded to the opinion, widely expressed at the time, that much of the financial difficulty experienced by banks could be traced to their involvement in investment-banking activities"). Whether the danger associated with banks' involvement in securities activities was the risk of loss on a speculative securities portfolio, the opportunity for conflicts of interest or the loss of public confidence in the integrity of banks has been debated without resolution. See, e.g., Investment Co. Inst. v. Camp, 401 U.S. 617, 629-34 (1971) (setting forth various possible hazards).


\textsuperscript{52} Prior to the passage of the Glass-Steagall Act, most banks conducted their securities activities through separately capitalized affiliates. For a description of the typical affiliate arrangement, see Note, \textit{Security Affiliates of National Banks: The Legal Aspects}, 33 Colum. L. Rev. 324 (1933). One advantage of this separate capitalization that was noted at the time was that it ensured the affiliate its own supply of funds in the event that the bank was unwilling or unable to advance more money. See Wilkinson, \textit{Bank Security Companies}, 119 Bankers Mag. 927 (1929). Moreover, although many of the most notorious securities affiliates occasionally may have caused the bankruptcy of their customers, they generally managed to protect themselves from losses. A vivid description of the abuses of the securities affiliates is contained in the record of the investigation into stock market practices by the Senate Banking and Currency Committee in the spring of 1933, generally known as the Pecora hearings after the Committee's chief counsel. In one case, a clerk interested in buying United States government bonds was persuaded by a bank securities affiliate to invest in Viennese, German, Greek, Peruvian, Chilean, Rhenish, Hungarian and Irish bonds; when he complained about their decline in value, his broker replied, "Why don't you let me sell you some stock?" See F. Pecora, \textit{Wall Street Under Oath} 85-86 (1939).
when conducted in conjunction with a traditional lending business.\textsuperscript{53} Finally, barring banks from engaging in investment banking does not prevent banks from taking excessive risks in permissible activities such as lending, as is demonstrated by numerous bank failures.\textsuperscript{54}

Nevertheless, to conclude that traditional bank regulation represented an often misguided attempt to eliminate risk from the banking business provides an incomplete picture of the actual purposes and accomplishments of regulation.\textsuperscript{55} Obviously, too much risk avoidance can be counterproductive if banks are relegated to activities from which they cannot earn sufficient profits to cover their liabilities. This, however, was not true of the business of banking, at least until quite recently. In contrast to other financial businesses such as investment banking, commercial banking under the regime of traditional regulation was characterized for decades by stable and consistently high earnings.\textsuperscript{56} Thus, traditional bank regulation did not simply force banks to reduce risk, but actually facilitated the banking industry's return to profitability. In addition, traditional regulation enabled the regulators to monitor risky behavior at

\textsuperscript{53} Portfolio theory suggests that the risk associated with an investment portfolio should be determined not by looking at the riskiness of each investment by itself, but by measuring the degree of correlation between the fluctuations in returns on those investments. If the returns on two investments are positively correlated, they will tend to produce revenues and losses at the same time. If their returns are negatively correlated, poor returns at any given time on one investment should be offset by high returns on the other investment, reducing the variability of earnings of the portfolio as a whole. See Note, \textit{The Conflict Between Managers and Shareholders in Diversifying Acquisitions: A Portfolio Theory Approach}, 88 Yale L.J. 1238, 1240 (1979). It has been argued that underwriting and commercial banking returns are negatively correlated. See, e.g., Note, Restrictions on Bank Underwriting of Corporate Securities: A Proposal for More Permissive Regulation, 97 Harv. L. Rev. 720, 729 (1984). But see infra notes 298-323 and accompanying text (criticizing application of portfolio theory to bank diversification).

\textsuperscript{54} See supra note 20. Some critics argue that protective regulation such as deposit insurance actually has encouraged banks to take excessive risks in their existing businesses, since the costs of failure are borne by the government. See E. Kane, The Gathering Crisis in Federal Deposit Insurance 14-15 (1985) (applying moral hazard argument in deposit insurance context).

\textsuperscript{55} Prevention of risk is not the only explanation that has been given for traditional bank regulation. Fear of concentration of economic power also was a motive for the limits on geographic and product expansion contained in the Bank Holding Company Act. See Glassman & Eisenbeis, \textit{Bank Holding Companies and Concentration of Banking and Financial Resources}, in The Bank Holding Company Movement to 1978: A Compendium 209, 210 (Board of Governors of the Federal Reserve System 1978). Nevertheless, regardless of motive, the real accomplishment of traditional bank regulation was to restore the profitability of the banking industry. Moreover, the demise of traditional regulation has had less to do with any flaws in these expressed or implied motives for regulation than with the diminishing profits of the banking industry operating under regulatory constraints. See infra notes 99-137 and accompanying text.

\textsuperscript{56} For example, between 1960 and 1984, the commercial banking industry's compound earnings growth rate was 9.1 percent, well above the inflation rate for that period, while returns on assets remained remarkably stable. In contrast, during the same period, earnings in the thrift, securities and insurance industries were extremely volatile. See Koch, \textit{The Emerging Financial Services Industry: Challenge and Innovation}, Fed. Reserve Bank of Atlanta Econ. Rev. 25, 27 (April 1984).
individual banking institutions.\textsuperscript{57} These two accomplishments provide not only a motive for the form and content of traditional bank regulation, but an explanation of its longevity.

1. Regulation and Profitability

In view of recent publicity about bank failures and lending problems,\textsuperscript{58} it is difficult to remember that, for the past fifty years, the core banking businesses of deposit-taking and lending generally have been very profitable. Moreover, this profitability did not result from either aggressive risk-taking or constant innovation on the part of bank management.\textsuperscript{59} Rather, bank profitability can be attributed to two developments in the market for bank products: the tremendous influx into the banking system of inexpensive deposits and the ready availability of low-risk, marketable assets in which those deposits could be invested.

In part, the declining market for securities following the stock market crash and subsequent regulation of the securities industry was responsible for the growth of the bank product market. Following economic recovery, savings, particularly those of individuals, flowed back into the securities markets at a slower rate than they flowed into the commercial banks.\textsuperscript{60} Moreover, the increased demand for commercial loans enabled the banks to deploy their new funds profitably. Although rapid loan growth can lead to problems for banks in periods of economic contraction, banks also were able to acquire large quantities of low risk assets such as treasury obligations\textsuperscript{61} and government guaranteed mortgages.\textsuperscript{62} In addition, ceilings on the rates of interest payable on deposits enabled banks to be concerned less with the return on their investments than with

\textsuperscript{57.} See infra notes 87-98 and accompanying text.  
\textsuperscript{58.} See supra note 20.  
\textsuperscript{59.} Studies of the rates and variability of returns in commercial banking relative to other industries confirm that the post-1930s banking business managed to be both profitable and not very risky. A study of the average annual rates of return in banking and manufacturing between 1960 and 1970 found that the banking industry experienced both consistently high rates of return and relatively little variation in rates of return compared with other sectors of the economy, suggesting that the profitability of banking was not due to aggressive risk-taking by banks. See Rhoades, \textit{A Comparative Investigation of Risk and Rates of Return in Commercial Banking and Manufacturing Industries}, 25 Antitrust Bull. 589, 593-609 (1980). The high rates of return in the banking industry were attributed to market power rather than industry innovation. See id. at 609-14.  
\textsuperscript{60.} Prior to 1929, individual investors provided the bulk of capital to the securities markets, which markets shrank after the Depression. For a description of the new issues market before and after 1929, see J. Auerbach & S. Hayes, Investment Banking and Dilligence: What Price Deregulation? 8-107 (1986).  
\textsuperscript{62.} See Tussing, \textit{The Case for Bank Failure}, 10 J. L. & Econ. 129, 136 (1967).
maintaining safe and liquid portfolios.\textsuperscript{63} Thus, a combination of economic conditions and bank regulation enabled the banking business to return to profitability. This very profitability raises a question as to why coercive regulation was needed at all to keep banks in the banking business. In part, the explanation may have been a distrust of the banks on the part of the legislature:\textsuperscript{64} bank management may have been thought either too venal or too incompetent to recognize the advantages of the commercial banking business over more speculative alternatives.\textsuperscript{65} Whether this assessment of bank management had any basis in fact is unclear. For example, even before the Glass-Steagall Act was passed, many large banks were voluntarily abandoning the securities business.\textsuperscript{66} Moreover, after passage of the Act, a number of prominent banks, including J.P. Morgan \& Co., chose to remain in commercial banking rather than in the investment banking business.\textsuperscript{67}

In fact, there are indications that, in the case of the Glass-Steagall Act, the banks derived certain benefits from making their business decision to leave the securities business a matter of legislative directive. Many banks had made substantial investments in their securities affiliates, having set up extensive branch networks staffed by numerous employees to facilitate securities distribution.\textsuperscript{68} When the decline in volume of new securities

\textsuperscript{63} In general, interest-bearing deposits tended to be a less significant source of funds for banks than non-interest-bearing transaction accounts. As of the end of 1947, 73 percent of deposits at commercial banks were demand deposits; over 90 percent of time deposits were low interest passbook savings accounts. See Mitchell, \textit{supra} note 61, at 3. In contrast, by 1970, demand deposits represented only 52 percent of total deposits; by 1980, this percentage had declined to 38 percent. See Golembe Associates, Inc., \textit{supra} note 49, at 13.

\textsuperscript{64} See \textit{supra} note 28 and accompanying text (paternalistic motive for bank regulation).

\textsuperscript{65} To the extent that, prior to the passage of the Glass-Steagall Act, the securities affiliates of large banks routinely used their smaller correspondent banks as outlets for the placement of their securities issues, there may have been some concern to protect less sophisticated local banks. See 75 Cong. Rec. S9,911 (May 10, 1932) (remarks of Sen. Bulkley) (country bank correspondents had been “overloaded with a mass of investments”).

\textsuperscript{66} Three months before the passage of the Act, National City Bank and Chase National Bank, two of the largest bank participants in the securities business, announced the termination of their securities affiliates. Their decisions may have been sparked by the negative publicity surrounding bank securities affiliates as a result of testimony at the Pecora investigation into stock market practices. See \textit{supra} note 52. In addition, following the stock market crash, bank securities affiliates were no longer very profitable. See Perkins, \textit{supra} note 33, at 522-23.

\textsuperscript{67} Morgan was one of the small group of private banks that had dominated investment banking prior to the entry of commercial bank securities affiliates. See J. Auerbach \& S. Hayes, \textit{supra} note 60, at 13.

\textsuperscript{68} See Perkins, \textit{supra} note 33, at 492. The entry of commercial banks into investment banking through securities affiliates coincided with changing practices in the securities industry, including improvements in the rapid retail distribution of securities issues. See J. Auerbach \& S. Hayes, \textit{supra} note 60, at 17-21. The development of huge retail distribution networks not only enabled the new bank securities affiliates to place securities more rapidly, but gave them an advantage in competing for underwriting business with established investment bankers.
issues made these branches unproductive, banks were looking for ways to trim their operations as quickly and painlessly as possible. The mandatory divestment of securities activities required by the Glass-Steagall Act provided banks with an excuse to terminate large numbers of employees in 1933 without incurring negative publicity. 69

In the long run, traditional regulation had other benefits for banks. Regulation excluded numerous potential competitors from entering the core banking business. Although other financial institutions could compete with banks in discrete activities, such as lending 70 or trust services, the line of demarcation between banks and nonbanks under traditional regulation was the ability to take deposits. 71 The power to take deposits, particularly given the protection afforded by deposit insurance and interest rate ceilings, not only provided banks with a cheap source of funding, but also enabled banks to build relationships with potential customers for other bank products, such as lines of credit, mortgages or credit cards. In this sense, the classic definition of the bank product market as a unique cluster of products and services, all of which could be offered only by banks, 72 accurately described the business of banking. 73 Thus, the accomplishment of traditional regulation was not so much to keep banks

69. For example, by the end of 1933, over one thousand employees of Chase Securities Company, a bank securities affiliate, had been fired. See Perkins, supra note 33, at 523-24. A comparison may be drawn to the recent negative publicity following announcements by Citicorp and other bank holding companies of plans to terminate employees in their investment banking operations. See Duffy, Citicorp Cuts Trading Staff in UK by 85, Am. Banker, Jan. 13, 1988, at 2, col. 1 (Citicorp officials deny any connection between layoffs and trading losses suffered in October 1987 stock market crash).

70. Nonbank competitors included consumer and commercial finance companies and, in some lending markets, thrift institutions. In addition, corporations could satisfy their financing needs through the public and private securities markets. Nevertheless, until the development of the commercial paper market in the 1960s, corporations tended to resort to the securities markets mainly for long-term financing, relying on bank loans for more current financing needs. See infra notes 107-11 and accompanying text.

71. For example, section 21 of the Glass-Steagall Act prohibits any securities organization from engaging in the business of taking deposits. See 12 U.S.C. § 378 (1982); see also Bank Holding Company Act § 2(c), 12 U.S.C. § 1841(c) (Supp. V 1987) (defining bank as an entity that takes demand deposits and makes commercial loans or whose deposits are FDIC-insured).


73. Traditional regulation did not prevent banks from offering a relatively diversified package of financial services to their customers. For example, despite the Glass-Steagall Act's restrictions on bank securities dealing, banks were permitted to buy and sell securities for the accounts of customers. See 12 U.S.C. § 24 Seventh (1982 & Supp. V 1987); see also Senate Comm. on Banking and Currency, Operation of the National and Federal Reserve Banking Systems, Report to Accompany S. 1631, S. Rep. No. 77, 73d Cong., 1st Sess. 16 (1933) (under Glass bill, "banks are to be permitted to purchase and sell investment securities for their customers to the same extent as heretofore"). Likewise, the Bank Holding Company Act's restrictions on nonbanking activities did not prevent bank affiliates from offering financial products such as credit cards, investment advice and safe deposit services. See Regulation Y of the Board of Governors of the Federal Reserve System, 12 C.F.R. §§ 225.22(b), 225.25(b) (1988).
in the banking business as to keep competitors out.\textsuperscript{74}

In addition, the regulatory constraints permitted bank managers to operate banks in a risk averse manner.\textsuperscript{75} Regulation not only guaranteed banks a healthy rate of return from investment in particular assets, such as loans and low risk securities, but also removed the necessity to compete by entering new businesses or developing new products. For example, Bank $A$'s management did not have to be concerned that Bank $B$ would decide to offer its corporate customers underwriting services, forcing Bank $A$ to follow suit to retain its own customers. Bank $A$ could count on the fact that Bank $B$ was precluded by law from this innovation. Therefore, banks did not have to make substantial and potentially risky investments in research and development of new products in order to keep competitive in the banking industry. Virtually the only possible use for funds was to make more loans, or buy more government securities. Thus, traditional regulation encouraged asset accumulation rather than entrepreneurial risk-taking.

This management strategy led to the popular generalizations about bankers as conservative, unimaginative and risk averse.\textsuperscript{76} Because the banking business was stable and profitable, the most significant risks to

\textsuperscript{74} A major force for change in the banking industry has been the effort by nonbanks to engage in the very activities to which banks have been confined by regulation. \textit{See infra} notes 100-13 and accompanying text.

\textsuperscript{75} Recent literature has suggested that corporate managers may be more risk averse than their shareholders because of their personal—and undiversified—investments in their firms. \textit{See} Coffee, \textit{Shareholders Versus Managers: The Strain in the Corporate Web}, 85 Mich. L. Rev. 1, 16-24 (1986). This risk aversion should be expected of bank managers, despite the protection afforded by the deposit insurance system. \textit{See supra} note 54. Although deposit insurance and rescues of failed banks may protect most or all bank creditors from losses, shareholders generally lose all or part of their investments in any bank liquidation, failed bank merger or restructuring. \textit{See}, e.g., \textit{FDIC Agrees to Assistance Plan for Texas BHC Subsidiary Banks}, [1987-1988 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 87,057, at 92,923 (Sept. 9, 1987) \textit{[hereinafter First City Rescue]} (financial assistance plan to keep failing subsidiary banks open required reduction of shareholders' interest in the restructured banking organization to less than 3 percent of total equity). As bank directors generally are required by applicable banking laws to make an equity investment in their banking organization, these managers can expect losses in the event of failure. \textit{See}, e.g., 12 U.S.C. § 72 (1982) (requiring national bank directors to own shares in the bank or its bank holding company with a minimum par value of $1,000). Moreover, bank managers are certain to lose their jobs once their bank runs into trouble, regardless of the ultimate regulatory disposition. A liquidation or merger of the bank automatically removes incumbent management; even if the bank remains open, the regulators can commence a proceeding to remove or impose personal liability on bank management. For a description of the regulatory disciplinary powers, \textit{see infra} notes 198-223 and accompanying text. Although some regulatory enforcement powers are of recent vintage, the authority to remove directors or officers for unsafe and unsound banking practices was first given to the regulators by the Banking Act of 1933. \textit{See} Banking Act of 1933, ch. 89, § 30, 48 Stat. 162, 193, \textit{repealed by} Financial Institutions Supervisory Act of 1966, Pub. L. No. 89-695, Title II, §§ 202, 207, 80 Stat. 1028, 1047-50, 1055 (adopting new removal provisions).

\textsuperscript{76} \textit{See}, e.g., Mitchell, \textit{supra} note 61, at 3 \textit{(banking has had “a pattern of traditional services, an imposed molecular structure, and a pedestrian operating technology”). In large part, bankers' conservatism may have been a reaction to the economic crisis of the
the health of the banking industry were insider fraud and mismanage-
ment.\textsuperscript{77} The low rate of bank failure reflects this. From 1943 through
1974, fewer than ten banks failed per year. No banks failed in 1962.\textsuperscript{78}

Given this record, it is not surprising that bank management generally
saw little need to innovate.\textsuperscript{79} Moreover, bank shareholders apparently
exerted little pressure on management to take more risks.\textsuperscript{80} Even if bank
shareholders might have preferred more aggressive risk-taking, their abili-
ty to force their preferences on bank management was blunted by the
fact that, because of the ready availability of deposits, banks rarely had to
resort to the equity markets for funding.\textsuperscript{81} Traditional regulation did not
impose strict minimum equity capital requirements that might have
forced banks to seek new shareholders.\textsuperscript{82} Thus, banks could afford to
keep their equity low compared with total bank resources.\textsuperscript{83}

Bank management's reluctance to innovate is suggested by the rela-

\begin{itemize}
\item \textsuperscript{77} As one observer wrote in 1967, "a bank which fails today on account of bad assets cannot claim that good
assets were not available, or that an unforeseen depression made bad assets out
of a wide range of apparently good ones. The reason is almost certain to be an
error in judgment on the part of the bank's management."
\item \textsuperscript{78} See Huber, \textit{Mandatory Disclosure of Information About Banks}, 6 Ann. Rev. Banking
\item \textsuperscript{79} Of course, there were occasional attempts to resist bank regulation; repeal of the
Glass-Steagall Act was urged as early as 1935. See Langevoort, \textit{supra} note 7, at 698.
Nevertheless, compared with the turmoil of the last decade, the banking industry of the
1940s, 1950s and 1960s was relatively quiescent. See Leavitt, \textit{supra} note 29, at 646-47
(philosophy of banking from the late 1930s through the 1950s was one of “caution, risk
avoidance, and only limited concern for maintenance of a competitive climate”).
\item \textsuperscript{80} Because many banks were privately owned and managed, their shareholders
would not be expected to exert any countervailing pressure on management. As late as
1983, only 18 percent of insured commercial banks were owned by publicly held bank
holding companies, while only 5 percent of insured banks not owned by holding compa-
nies were themselves publicly held. See Federal Deposit Insurance Corporation, Deposit
\item \textsuperscript{81} Theoretically, equityholders in a highly leveraged institution such as a bank may
prefer more aggressive risk-taking than equityholders in a less leveraged firm, because the
debtholders will bear most of any resulting losses. See McDaniel, \textit{Bondholders and Cor-
porate Governance}, 41 Bus. Law. 413, 419 (1986). Nevertheless, in order to be effective,
shareholders' preferences must be felt by management. Traditionally, banks have not had
to raise equity on a regular basis, and regulation such as barriers to interstate banking
and restrictions on affiliation with nonbanking firms has protected banks from the disci-
pline of the takeover market. Thus, management could afford to ignore shareholders'preferences as to risk-taking. For a more complete discussion of the effect of bank regula-
tion on the market for bank equities, see \textit{infra} notes 324-54 and accompanying text.
\item \textsuperscript{82} Prior to 1933, the regulators informally required a capital to total assets ratio of
10 percent or more; after passage of the comprehensive banking legislation, this informal
standard gradually disappeared. See Wall, \textit{Affiliated Bank Capital}, Fed. Reserve Bank of
Atlanta Econ. Rev. 12, 13 (Apr. 1985).
\item \textsuperscript{83} See Peltzman, \textit{Capital Investment in Commercial Banking and Its Relationship to
regulation in bank regulatory strategy, see \textit{infra} notes 173-97 and accompanying text.
\end{itemize}
tively limited number of banking institutions that took advantage of legal means of avoiding restrictive regulation. Although the nonbanking activities of bank holding companies were virtually unregulated until passage of the Bank Holding Company Act of 1956, the relative importance of holding companies actually declined between 1936 and 1956. One explanation may be that commercial banking was simply more profitable than the unregulated activities that could be conducted through holding companies. For example, a study in the early 1970s of the performance of nonbank affiliates of bank holding companies engaged in consumer finance and mortgage banking, two of the most popular nonbanking activities for bank holding companies, found that in both cases the bank holding company affiliates tended to be less profitable than either their independent competitors or their sister banks.

2. Regulation and Failure Prevention

Traditional bank regulation has served another important function that is frequently overlooked. The bank regulatory framework includes an administrative apparatus through which the bank regulators monitor compliance by individual institutions with regulatory standards. Bank regulatory enforcement traditionally has relied less on deterrence through the imposition of penalties for violations than on detection and correction of possible violations before they can result in harm to the bank. This makes sense from the point of view of the bank regulators.

84. See supra note 34.

85. Between 1930 and 1939, only 34 nonbank subsidiaries were formed or acquired by bank holding companies. Between 1950 and 1959, only 290 nonbank subsidiaries were formed or acquired by bank holding companies. See One-Bank Holding Companies Before the 1970 Amendments, 58 Fed. Res. Bull. 999, 1004 (1972). One exception was Transamerica Corporation. See Note, Transamerica—The Bankholding Company Problem, 1 Stan. L. Rev. 658, 658 (1949). Yet even Transamerica's nonbanking operations apparently were not very diversified, consisting of substantial investments in insurance operations and much smaller investments in a metals manufacturer and a fish processing company. See Halpert, supra note 29, at 498.

86. See Talley, Bank Holding Company Performance In Consumer Finance and Mortgage Banking, 52 Mag. Bank Admin. 42, 44 (July 1976). This study covered bank holding company performance from 1973 to 1974, when banks were already beginning to push for greater power to diversify; prior to 1973, too few bank holding companies were engaged in either activity to permit analysis. See id. at 43. Although the consumer finance industry was experiencing narrowing interest margins in the early 1970s, mortgage banking generally was extremely profitable. See id. at 42.

87. This monitoring takes place primarily through on-site bank examinations, see supra text accompanying notes 46-47, and to a lesser extent through mandatory disclosure requirements, which until recently were designed primarily to provide information to the regulators. See 12 U.S.C. §§ 161, 324, 1817(a) (1982) (year-end consolidated reports of income and quarterly consolidated reports of condition must be submitted by banks to their primary federal regulator). For a more detailed discussion of bank disclosure requirements, see infra notes 346-54 and accompanying text.

88. To the extent that statutory penalties for violations of banking law have been provided, they have tended either to be too severe (such as termination of deposit insurance) or to require lengthy judicial or administrative proceedings, thus discouraging their regular use. See infra notes 198-201 and accompanying text.
Violations of bank regulation may lead to bank failure, resulting in tremendous cost to the insurance fund. The bank examination process permits the regulators to uncover problems and violations that can be dealt with through preventive measures.

In view of this goal of preventing violations, the broad prophylactic approach of traditional bank regulation simplified the examination process. Obviously, prophylactic rules may sweep too broadly; for example, in any particular case, a bank’s participation in an underwriting of corporate securities may present no risk at all to either the bank or the banking system. Yet a narrowly tailored rule that prohibits only risky underwriting would force bank examiners to review every bank participation in underwriting to see if it presented any unacceptable risks. In contrast, a sweeping rule that prevents all underwriting avoids the necessity for examiners to scrutinize individual transactions.

Traditional bank regulation not only simplified the monitoring process, but permitted the regulators to channel their efforts and expertise more efficiently. Any diversified enterprise presents problems of central monitoring and control. It is almost impossible for a single manager to comprehend the details of numerous different businesses. This problem is compounded for the bank examiner, who as an outsider must master the firm’s unfamiliar organizational structure as well as understand the day-to-day operations of each one of the firm’s businesses.89 Confining banks to particular activities enabled bank examiners to concentrate on one area, that of loan quality, in which they could develop considerable expertise.90

Finally, restrictive regulation may have assisted the regulators in containing bank problems once they developed. Restrictions on product and geographic diversification limited the ability of a bank to affiliate with a large number of other banks or financial entities, thus avoiding the likelihood of multiple business failures should the bank encounter financial difficulties. Moreover, in a banking system consisting of numerous small banks, one bank’s failure would have less of an impact on the banking system than the failure of a huge diversified financial institution.91

89. The job of the examiner is more complex than even that of the outside auditor. The examiner must assess not only the bank’s current financial position, but also any future risks that may arise out of current activities.

90. In determining bank financial condition, examiners assess banks in five categories: capital adequacy, asset quality, management, earnings and liquidity. See Putnam, Concepts of Financial Monitoring, Fed. Reserve Bank of Atlanta Econ. Rev. 6, 8 (Nov. 1983). Given the difficulty of predicting such variables as liquidity and quality of management, examinations traditionally have focused on assets. See Dince, supra note 47, at 4. Until recently, bank earnings were derived almost exclusively from the investment of deposits in loans. Thus, bad loans could wipe out earnings and capital and, if the bank’s lending problems were publicized, lead to deposit runs that could negatively affect liquidity. Moreover, bad loans generally were viewed as an indication of bad management.

91. This has not always proved to be true. For example, the failure of a tiny Ohio thrift institution, which raised doubts about the solvency of state-sponsored deposit insurance funds as well as the health of local banking institutions, had significant repercussions
the extent that regulation slowed the trend toward financial concentration,\(^\text{92}\) it served the very practical purpose of simplifying the task of dealing with the consequences of bank failure.\(^\text{93}\)

Some critics have disputed the ultimate effectiveness of prophylactic regulation, since it encourages the regulated industry to find ways to evade the restrictions.\(^\text{94}\) When that occurs, regulatory enforcement becomes very complex and expensive, often necessitating legislative redrafting to repair the loopholes.\(^\text{95}\) Yet until recently banks themselves had neither the expertise nor the inclination to breach the regulatory walls.\(^\text{96}\) Rather, the energies of bank management went into asset growth, a trend that was encouraged by regulatory policy.\(^\text{97}\) The regulators’ attention therefore could be directed almost entirely to the tasks of monitoring asset quality and identifying bad management that was the cause of most bank failure.\(^\text{98}\)

### B. Banking in Transition

Under the regime of traditional regulation, the banking business was very profitable for many years. This profitability explains the long success of traditional regulation, and its recent failure. Traditional regulation remained largely unchallenged as long as the regulated business of banking was profitable. When that profitability was threatened, the validity and desirability of traditional regulation began to be questioned.


92. See supra note 55.

93. The liquidation of Penn Square Bank in 1982 was the first deposit payoff of a bank with over $100 million in assets in the history of the Federal Deposit Insurance Corporation. See Gilbert, *Disclosure and Market Discipline: Issues and Evidence*, Fed. Reserve Bank of Atlanta Econ. Rev. 70, 72 (Nov. 1983). When Continental Illinois ran into trouble in 1984, it was so large that neither a deposit payoff nor a federally assisted merger was a feasible alternative, requiring a massive government bailout. See Morris & Weiner, *U.S. Rescues Continental Illinois Corp.*, Am. Banker, May 18, 1984, at 1, col. 2; see also *First City Rescue*, supra note 75, at 92,923 (capital assistance plan for bank holding company with 62 subsidiary banks is second largest financial assistance plan in FDIC history).

94. See Clark, supra note 16, at 34 (making this argument with respect to mechanical price and entry restrictions).

95. See supra note 18 (nonbank banks).

96. See supra notes 75-86 and accompanying text. For example, until the 1970s, banks did not even attempt to test the limits of the Glass-Steagall Act’s brokerage exception by entering the retail brokerage business. See Note, *National Banks and the Brokerage Business: The Comptroller’s New Reading of the Glass-Steagall Act*, 69 Va. L. Rev. 1303, 1311-12 (1983); supra note 73. One explanation may have been that the securities services that banks did routinely perform for customers, such as custodial services and portfolio evaluation, were not very profitable. See Securities and Exchange Commission, *Report on Banks Securities Activities*, 95th Cong., 1st Sess. 86 (Comm. Print 1977).

97. See supra notes 75-76 and accompanying text.

98. See J. Sinkey, supra note 42, at 19 (historically, fraud and mismanagement have been main causes of bank failure).
ble? Although numerous forces were at play, the most important factors had little to do with the banking business itself. The very profitability of the basic banking business of taking deposits and making loans caused nonbank competitors to look for ways to enter the banks' traditional markets. This heightened competition from outside the banking industry led to declining market shares, and, ultimately, declining profitability.99

This competition was felt on both the asset and liability sides of the bank balance sheet. Beginning in the late 1950s, rising interest rates and growing investor sophistication began to affect banks' ability to attract and retain non-interest or low interest-bearing deposits.100 Many depositors switched their funds from demand deposits to interest-bearing time deposits, which increased the cost of deposits for banks.101 In addition, corporate and individual savers began to remove funds from the banking system entirely. The reasons for this disintermediation included the inability of banks to pay market rates of interest on their deposits because of regulation,102 the development of liquid financial instruments such as money market mutual funds that served as deposit substitutes,103 the technological innovations that allowed the rapid movement of money in and out of bank and nonbank financial instruments,104 and the improved money management skills of businesses of all sizes.105 Banks thus had to


100. In particular, large national corporations began to seek ways to economize on their cash balances, which previously had been kept in non-interest-bearing bank accounts. See McKinney, New Sources of Bank Funds: Certificates of Deposit and Debt Securities, 32 L. & Contemp. Probs. 71, 72 (Winter 1967).

101. Prior to 1960, many banks did not pay any interest on corporate time deposits. Eventually, the need to attract deposits in order to satisfy the increasing demand for loans led the largest banks to compete more actively for funds by selling large denomination negotiable certificates of deposit that paid rates that were competitive with other money market instruments and thus were attractive to corporate and institutional savers in search of liquid investments. For a discussion of the development of negotiable certificates of deposit, see id. at 72-73.

102. See supra notes 43-45 and accompanying text (interest rate ceilings). The interest rate ceilings became a problem for banks during the 1960s and 1970s as interest rates rose, causing the rates on unregulated money market instruments such as treasury bills and commercial paper to exceed the regulated bank rates. See McKinney, supra note 100, at 73-77. Deregulation of interest rates on deposits has removed this impediment to competing for funds, but also has made deposits much more expensive for banks. See supra note 19.

103. These financial instruments were developed in response to investors' demand for investments that were short-term and more liquid than traditional corporate bonds, yet paid higher rates than bank deposits. Money market mutual funds are investment companies that invest solely in short-term corporate and bank liabilities. See J. Auerbach & S. Hayes, supra note 60, at 92-93. By the end of 1983, money market funds had grown to $175 billion. See Hayes, supra note 2, at 52.


105. Even small businesses have become more sophisticated in money management. Demand deposits and currency have steadily declined as a percentage of the total liquid assets held by nonfinancial corporations from 63 percent in 1970 to below 40 percent in 1980. Some of these funds have remained in the banking system, but have been invested in high interest negotiable certificates of deposit. Yet substantial funds have left the
compete with nonbanks for increasingly expensive funds.106

As bank liabilities became more expensive and difficult to obtain, banks faced competition for assets as well. The growth of the commercial paper market in the 1970s,107 coupled with increased competition from foreign banks both in the Eurodollar market108 and in the United States,109 seriously affected the previously stable relationships of banks and their corporate borrowers. Corporations, particularly the most creditworthy, found that they could borrow more cheaply by issuing short-term debt in the domestic or foreign securities markets than by borrowing from banks.110 Thus, the traditionally recognized role of


106. Of course, "core" deposits, consisting of retail demand deposits and low interest accounts, continue to be a relatively stable and inexpensive source of funds for most banks. The advantages of these core deposits led some nonbank financial firms such as Household International to compete directly with banks by setting up so-called "nonbank banks": deposit-taking institutions that, because they did not make commercial loans, were not subject to the Bank Holding Company Act's restrictions on ownership of banks by nonbanking businesses. See supra note 18. Not all such efforts by nonbanks to compete for consumer deposits were successful. See Gross, Financial Companies Follow Spectrum of Strategies in Era of Deregulation, Am. Banker, May 26, 1987, at 32, col. 1 (for some nonbank competitors, attracting retail deposits has proved very expensive).

107. Commercial paper consists of short-term unsecured promissory notes issued by corporations in the public debt markets to satisfy their current financing needs. Unlike long-term public debt, issues of commercial paper are not subject to the registration and prospectus requirements of the Securities Act of 1933, see 15 U.S.C. § 77c(a)(3) (1982), and thus can be placed relatively cheaply and easily. In fact, for high quality issuers, selling commercial paper is often cheaper than obtaining a bank loan, in view of the interest rates that banks must charge to cover their costs of funding and administrative expenses. The commercial paper market has grown from an annual rate of $4 billion in 1960 to $123.7 billion in mid-1983. See Hayes, supra note 2, at 52.

108. Corporate issuers often were able to borrow in the largely unregulated foreign securities markets more cheaply than in domestic markets. In 1984, United States corporations issued $21 billion of debt securities in the Eurodollar market. See J. Auerbach & S. Hayes, supra note 60, at 95. Although the Glass-Steagall Act generally did not bar United States banks from competing for this business through their overseas affiliates, United States banks faced high start-up costs and intense competition. See General Accounting Office, Report to the Chairman of the Subcomm. on Telecommunications and Finance, House Comm. on Energy and Commerce: International Finance—U.S. Commercial Banks’ Securities Activities in London (Sept. 1988).


110. Banks have been able to continue their relationships with some of these borrowers
commercial banks as the chief suppliers of short-term credit to business began to disappear. 111 Although a market for bank loans did exist, the new borrowers often were less creditworthy than traditional corporate customers, because these borrowers were too risky to have access to the commercial paper market. 112 Even in this market, banks faced fierce competition from nonbank lenders that had concentrated on "middle market" and other smaller borrowers. 113

The result of this competition for both bank liabilities and assets has been a gradual decline in profitability, and an increase in risk, in the core banking business. 114 Higher funding costs required banks to charge higher rates of interest on their loans to make a profit. Yet increased competition for the most creditworthy borrowers forced banks to choose between earning very narrow spreads 115 and investing in more risky assets. 116 Moreover, the banking industry's share of the lending market continued to decline. 117

by issuing back-up lines of credit to support their customers' debt issuances in the event of default. Although these lines of credit have generated substantial fee income for banks, the unpredictable nature of the bank's commitment to lend creates potentially serious funding risks. See Johnson & Murphy, Going Off the Balance Sheet, Fed. Reserve Bank of Atlanta Econ. Rev. 23, 26-27 (Sept.-Oct. 1987). Moreover, the most creditworthy issuers do not have to obtain back-up lines of bank credit to sell their debt.

111. See supra note 33 (describing this view of the proper function of banks).

112. As a result of the development of an active secondary market for junk bonds—corporate debt rated below "investment grade"—even these borrowers may be able to sell debt more cheaply than they can borrow from banks. In late 1987, junk bonds were estimated to provide some $157 billion in credit. See Sudo, Analysts See Loan Growth Slowing in '88, Am. Banker, Dec. 29, 1987, at 1, col. 2. The advantage of junk bonds over bank loans is not necessarily lower interest rates. Banks may insist on restrictive covenants in their loan agreements, especially for less creditworthy borrowers. In contrast, most corporate debt today is issued with very few or no restrictive covenants. See McDaniel, supra note 81, at 425-26. Thus, banks seeking to recapture lost borrowers may be forced to relax their own requirements for protective debt covenants, thereby increasing their credit risk.


115. In 1986, adjusted net interest margin, or the difference between interest income and interest expense, fell for banks of all sizes. See Wall, supra note 114, at 25. Two other measures of bank profitability, return on assets and return on equity, also declined, particularly for banks with assets under $25 million. See id. at 27.

116. See Johnson & Murphy, supra note 110, at 24. The large amounts of foreign loans in bank portfolios, many of which account for current loan losses, are in part the result of banks' efforts to find higher yielding investments for their more expensive deposits.

117. In 1982, banks accounted for 23.5 percent of all private sector lending; in 1986, their share was only 16.1 percent. See Clarke, The Limits of Bank Regulation, 6 Ann.
This decline in profitability has put pressure on traditional bank regulation. Traditional regulation had failed to prevent the new nonbank competitors from offering products and services comparable to or better than traditional bank products.\textsuperscript{118} By imposing restrictions on the products and services that banks could offer, however, traditional regulation kept banks from competing with these new entrants on their own terms.\textsuperscript{119}

Thus, traditional regulation itself is often blamed for the decline in bank profitability by restricting the freedom of the banking industry to innovate. Insofar as the industry was able to escape these restrictions, regulation forced banks to seek the most expensive and often the riskiest ways to compete. For example, the inability of banks to offer market rates of interest on their deposits caused them to develop complex instruments such as "sweep" programs, many of which required banks to share fees and customers with nonbank financial firms.\textsuperscript{120} Likewise, banks in search of ways to recapture some of their lost lending profits engaged in "off-balance sheet" activities, such as issuing standby letters of credit to back up issuances of commercial paper\textsuperscript{121} and selling interests in pools of bank assets.\textsuperscript{122} These activities, although profitable in the short run, have created new risks for the banking industry.\textsuperscript{123}

\textsuperscript{118} A frequently cited example is Merrill Lynch's cash management account, which combined the high return on a brokerage account with the ease of withdrawal of the typical bank checking account. For a description of the first cash management account, see M. Mayer, supra note 104, at 34-45.

\textsuperscript{119} For example, under the Glass-Steagall Act, banks have been permitted to engage in some aspects of the securities business, such as privately placing corporate securities. See Federal Reserve Board Staff, Commercial Bank Private Placement Activities 81 (1977) (private placement does not constitute "underwriting or dealing" in securities prohibited by Glass-Steagall). Nevertheless, until recently, banking organizations were precluded from underwriting public issuances of corporate securities or placing commercial paper. See Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., 807 F.2d 1052 (D.C. Cir. 1986) (upholding Federal Reserve Board ruling that commercial paper placement does not constitute "underwriting or dealing" in securities prohibited by Glass-Steagall), cert. denied, 107 S. Ct. 3228 (1987); J.P. Morgan & Co., Chase Manhattan Corp., Bankers Trust New York Corp., Citicorp and Security Pacific Corp., 75 Fed. Res. Bull. 192 (1989) [hereinafter Morgan/Chase/Bankers Trust/Citicorp/Security Pacific] (permitting banks to underwrite and deal in corporate debt securities on a limited basis through affiliates); infra notes 148-55 and accompanying text.

\textsuperscript{120} Under these programs, bank balances were swept into a money market mutual fund maintained by a brokerage firm. The brokerage firm ordinarily received a fee for sponsoring the fund. For a description of sweep programs and other deposit innovations, see Rivoir, supra note 25, at 23.

\textsuperscript{121} See supra note 110.

\textsuperscript{122} This securitization of loans enables banks to transform illiquid loans into a diversified investment vehicle. For a description of securitization, see Johnson & Murphy, supra note 110, at 30-33.

\textsuperscript{123} Off-balance sheet activities such as standby letters of credit create contingent claims against the bank that are unpredictable, thus increasing the bank's funding risk, and that are difficult for the regulators to monitor. See id. at 26.
Although traditional regulation no longer keeps banks profitable, total dismantling of the restrictive regulation has not necessarily been the solution to the profitability crisis. Ceilings on the interest rates payable on deposits became counterproductive once depositors had a choice of competitive instruments with higher yields. Yet eliminating these ceilings, although theoretically permitting banks to recapture some of their deposit market, created the additional problem of increasing the cost of bank funds, exposing banks to new funding risks. It is significant that, despite rate deregulation, commercial banks have still paid rates on their deposits that are below rates offered by competitive money market investments.

Moreover, the picture of banks as eager innovators stifled by regulatory constraints is belied by the bank regulators’ own efforts to encourage industry innovation. The bank regulators did respond to the effect of rising interest rates on banks’ ability to attract deposits by repeatedly raising the ceilings on the rates of interest payable on bank deposits. Moreover, bank diversification into new activities generally has required prior regulatory approval, which, particularly recently, usually has been granted. Legal challenges to new bank powers have pit-

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124. See supra note 19.
125. To the extent that banks relied upon the interest rate ceilings in pricing their assets, too rapid a rise in rates payable on liabilities could have led to serious gap problems. See Black & Williams, Regulatory Response to Financial Innovations, 5 Issues in Bank Reg. 3, 4 (Autumn 1981).
127. See, e.g., Kane, Accelerating Inflation, Regulation and Banking Innovation, 4 Issues in Bank Reg. 7 (Summer 1980) (conflict between industry innovation and regulatory reaction).
128. For example, between 1961 and 1966, the Federal Reserve Board revised Regulation Q four times to respond to increases in rates on treasury bills. See McKinney, supra note 100, at 73-77.
129. Under the Bank Holding Company Act, the Federal Reserve Board must determine whether entry by a bank holding company into a new nonbanking activity is “so closely related to banking or managing or controlling banks as to be a proper incident thereto.” 12 U.S.C. § 1843(c)(8) (Supp. V 1987). Following some approvals of individual applications, the Board may add a particular activity to Regulation Y’s “laundry list” of permissible activities, thereby permitting other bank holding companies to commence the activity without formal application. See 12 C.F.R. § 225.25(b) (1988).
ted competitors such as the securities and insurance industries against the bank regulators. When reregulation has occurred, it has come principally from Congress, which has reversed significant regulatory innovations.

Occasionally, the banking industry itself has resisted innovation. Although banks have been losing customers to nonbank competitors such as securities firms for over a decade, banks have been surprisingly slow to attempt to recapture their lost market even when regulation has not posed a significant barrier to innovation. Most bank management, trained in the traditional banking business, lacked the expertise necessary to develop and market sophisticated new financial products. Resistance to and suspicion of the very rapid changes that have occurred in the financial marketplace slowed bank entry into new activities. Thus, the

Governors of the Fed. Reserve Sys., 839 F.2d 47 (2d Cir.), cert. denied, 108 S. Ct. 2830 (1988) [hereinafter Citicorp/Morgan/Bankers Trust]. The regulators recently approved bank applications to underwrite and deal in various corporate debt instruments on a limited basis, and indicated their intention to permit banks to underwrite and deal in corporate equity as well on a limited basis if certain operating conditions are met. See Morgan/Chase/Bankers Trust/Citicorp/Security Pacific, supra note 119, 75 Fed. Res. Bull. at 192.


See supra note 96 (banks' slow entry into brokerage activities). This reluctance to innovate may have reflected a disinclination on the part of many banks to incur the cost of the regulatory application process and subsequent legal challenges by competitors. For example, Bankers Trust's application to place commercial paper on behalf of customers resulted in two trips through the federal court system, including one hearing before the Supreme Court. See Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., 468 U.S. 137 (1984) ("Bankers Trust I") (holding that commercial paper was a security under the Glass-Steagall Act and remanding for determination whether commercial paper placement constituted prohibited underwriting or dealing); Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., 807 F.2d 1052 (D.C. Cir. 1986), cert. denied, 107 S. Ct. 3228 (1987) ("Bankers Trust II") (holding that commercial paper placement was not prohibited underwriting or dealing under the Glass-Steagall Act).

Some banks have sought to bridge this gap in expertise by hiring experts away from their nonbank competitors to set up new divisions. See, e.g., Albert, Chemical Raids Wall Street to Beef Up Unit that Securitizes and Sells Loans, Am. Banker, Feb. 8, 1988, at 1, col. 2. This in turn has created problems in integrating new personnel and businesses into the traditional banking structure. See infra notes 272-74 and accompanying text.

Some observers have spoken of a so-called "bankers' mindset" that resists change
banking industry actually may have benefited from the slow, piecemeal deregulation that has come about largely through regulatory approvals of individual bank applications.\textsuperscript{136} In fact, some of the most far-reaching attacks on bank regulation have been initiated outside of the banking industry by nonbank competitors.\textsuperscript{137}

Several conclusions may be drawn about the deregulatory process in banking. Although the recent effect of traditional regulation has been to increase bank risk, deregulation, particularly too rapid deregulation, potentially creates its own new threat to bank profitability. Thus, the regulators have had to develop a new strategy to protect the banking industry during the process of transition. The aim of the new regulation is the same as that of the old regulation, to assist the banking industry in finding new sources of profit. The regulators' new strategy will be explored in the next section.

C. The "New" Regulation

Traditional bank regulation was characterized by tight control over and protection of bank assets, primarily loans.\textsuperscript{138} The new regulatory strategy is more difficult to characterize. In part, the new approach is negative, involving the removal of many of the old prophylactic restrictions on bank activities. This new approach is apparent in recent regulatory decisions permitting banks to exploit gaps in the regulatory framework. For example, despite the Glass-Steagall Act's general ban on bank securities activities, the regulators have found ways to permit banks or their affiliates to offer discount brokerage\textsuperscript{139} and even to underwrite certain securities on a limited basis.\textsuperscript{140} This reflects a recognition that banks must be allowed to find new sources of income in order to

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\textsuperscript{136} For a discussion of the dangers of too rapid deregulation of business and suggestions for facilitating regulatory transition, see generally Breyer, Reforming Regulation, 59 Tul. L. Rev. 4 (1984).

\textsuperscript{137} For example, the "nonbank bank" phenomenon, see supra note 18, was begun by nonbank firms that were looking for ways to own or retain deposit-taking facilities. See, e.g., Wilshire Oil Co. v. Board of Governors of the Fed. Reserve Sys., 668 F.2d 732 (3d Cir. 1981) (oil company), cert. denied, 457 U.S. 1132 (1982); Board of Governors of the Fed. Reserve Sys. v. Dimension Fin. Corp., 474 U.S. 361 (1986) (interstate holding company).

\textsuperscript{138} See supra notes 36-47 and accompanying text.


survive. In addition, the new regulatory strategy reflects a different, more active approach to the task of limiting bank risk. Since prophylactic rules that prevent risk-taking are no longer feasible, the new regulation focuses on the proper management of risk by banking institutions. For example, the regulators have approved bank entry into new activities only after imposing very specific conditions on how those new businesses may be conducted. These conditions not only address specific management failures, such as conflicts of interest, but also reflect a new concern on the part of the bank regulators with how banks are being operated by their managers.

This shift in regulatory strategy is not complete. Banks are still subject to considerable restrictive regulation. Nevertheless, evidence of change can be found in two recent developments. First, the bank regulators themselves have been leading the push for further deregulation of banking in Congress. Second, the recent internal restructurings at many banks reflect the substantial changes that are occurring in the operations and management of banking organizations. Although these changes are in part a response to market pressure for improved bank earnings, as will be demonstrated, this industry realignment also has been encouraged by the new regulation.

1. Diversification

Perhaps the most dramatic shift in bank regulation over the last decade has been the extent to which banks have been permitted to diversify their activities and investments. This relaxation of traditional product and geographic restrictions has occurred not only at the congressional level, but also through the regulatory application process. In recent

141. See, e.g., Shumway, supra note 11, at 248 (regulator sees need for additional sources of bank income).
142. For specific examples, see infra notes 165-72 and accompanying text.
143. To the extent much of this regulation is statutory, congressional action is necessary to remove it.
144. See supra note 4. In fact, the regulators occasionally have been criticized for being too soft on deregulation. See, e.g., Mayer, Seidman's Brave New World, Am. Banker, Sept. 11, 1987, at 1, col. 2 (FDIC Chairman criticized for becoming the "point man of a deregulatory drive").
146. See infra notes 329-34 and accompanying text.
147. See infra notes 195-97 and accompanying text.
148. In fact, the last time Congress addressed the issue, it actually tightened restrictions on bank insurance activities. See Garn-St Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, §§ 118(a), 601, 96 Stat. 1469, 1479, 1536 (codified as amended at 12 U.S.C. § 1843(c)(8) (Supp. V 1987)) (preventing bank affiliates from providing insurance as principal, agent or broker except for credit life and disability insurance). Congress repeatedly has considered loosening the Glass-Steagall Act's restrictions on bank securities activities, see supra note 7, but, at the time this Article was prepared, no legislation had yet been passed.
years, banks or their affiliates have been permitted by the regulators to engage in a wide range of new financial activities, such as privately placing securities for corporate issuers, providing portfolio investment advice in conjunction with securities brokerage, renting space to a real estate brokerage firm in exchange for a percentage of revenues and underwriting and dealing in various types of securities. Recently, the regulators have called for further product deregulation at the congressional level.

Thus, the bank regulators generally have been aggressive proponents of liberalized powers for banks and their affiliates. At first, this may seem contrary to the regulators' self-interest. Expanding permissible bank activities makes the regulators' job harder by complicating the monitoring process. Nevertheless, the regulators' new policy has a very practical explanation. The decline in profitability of traditional banking has forced banks to choose between taking increased risks in the banking business in order to improve returns and looking for additional sources of income. As increased bank risk could lead to more bank failures, the regulators' only alternative is to allow banks to explore new businesses as potential sources of profitability.

The regulators' recognition that improved safety and soundness in the

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149. See supra note 129 and accompanying text. In the case of geographic expansion, the most significant developments have taken place at the state level, since the Bank Holding Company Act allows states to authorize entry by out-of-state banks. See Bank Holding Company Act § 3(d), 12 U.S.C. § 1842(d) (1982). Nevertheless, acquisitions by bank holding companies of banks across state lines require approval by the Federal Reserve Board, which must determine whether the state statute's authorization of entry by out-of-state banks complies with the requirements of the Bank Holding Company Act. See, e.g., Northeast Bancorp v. Board of Governors of the Fed. Reserve Sys., 472 U.S. 159, 169-74 (1985) (upholding Board's determination that a state statute limiting entry to banks from a particular geographic region is consistent with the Bank Holding Company Act).

150. See Federal Reserve Board Staff, supra note 119, at 81.


153. See Morgan/Chase/Bankers Trust/Citicorp/Security Pacific, supra note 119, 75 Fed. Res. Bull. at 192 (corporate debt securities); Citicorp/Morgan/Bankers Trust, supra note 130, 73 Fed. Res. Bull. at 473 (commercial paper, municipal revenue bonds and mortgage-related securities). At the time this Article was prepared, the regulators had agreed to authorize banks to underwrite and deal in equity securities on a limited basis in a year if certain operational and managerial requirements are met. See Morgan/Chase/ Bankers Trust/Citicorp/Security Pacific, supra note 119, 75 Fed. Res. Bull. at 209.


155. See supra notes 87-90 and accompanying text.
banking industry will come from product diversification represents a revolution in bank regulatory strategy. As previously described, restricting banks to particular banking activities not only removed the opportunity for banks to enter into unfamiliar and potentially risky ventures, but enabled tight regulatory control of day-to-day bank activities.\textsuperscript{156} Diversification, if handled properly, may permit banks to offset earnings variability in the banking business,\textsuperscript{157} but it also removes a great deal of regulatory authority. The bank regulators no longer can control exactly what businesses banks will enter,\textsuperscript{158} nor will all banks necessarily engage in the same activities. Allowing banks this flexibility to experiment with new activities is essential to achieve the advantages of diversification. Nevertheless, the regulators cannot be sure that all bank management will diversify effectively.

Thus, deregulation of banking activities creates a new risk to the banking system: the risk that banks will not manage their new investments and operations profitably.\textsuperscript{159} Management may misallocate resources among banking and nonbanking activities, leading to a decline in profitability of the bank as a whole. Management may permit conflicts of interest that threaten the operations of one or more parts of the banking organization.

Although these risks are inherent in all diversified enterprises, the potential for harm is particularly serious in banking. Poor management or conflicts of interest that lead to bank failure may impose costs on the entire banking system.\textsuperscript{160} Thus, the bank regulators are still faced with the need to prevent mismanagement of diversified banks.\textsuperscript{161} Unlike the

\textsuperscript{156} See supra notes 90-98 and accompanying text.

\textsuperscript{157} See supra note 53 (risk reducing effect of diversification).

\textsuperscript{158} To the extent that diversification has come about through the regulatory application process, the regulators have been able to control the types of new activities that banks are entering. As the list of permissible activities grows, however, the regulators have less control over exactly what combination of businesses a bank may choose at any particular time. Any effort to regulate the permissible mix of investments, or to confine banks to particular activities that the regulators believe will be profitable for them, would only interfere with the ability of banks to adjust to market changes, leading to the same problems that banks experienced under traditional regulation. For example, although investment banking has appeared very profitable to banks and bank regulators over the past decade, there are indications that, now that banks are receiving permission to enter that business, returns are dropping. See Neustadt, \textit{Investment Banking Party Ends As Commercial Banks Get Invite}, Am. Banker, Apr. 11, 1988, at 1, col. 2 (study predicts investment banking profits, lower in 1987, will continue to decline until 1991). Therefore, allowing individual bank experimentation with different activities is less costly than legislating a new mix of powers each time that economic conditions change.

\textsuperscript{159} This risk has been described as "operating risk." See Rhoades, \textit{Interstate Banking and Product Line Expansion: Implications From Available Evidence}, 18 Loy. L.A.L. Rev. 1115, 1153 (1985); infra notes 316-21 and accompanying text.

\textsuperscript{160} See supra note 8 (describing reasons for regulatory goal of minimizing consequences of bank failure).

\textsuperscript{161} In addition, the absence of substantial self-regulation in the banking industry, which may in part be due to the industry's limited experience with diversification, increases the need for regulatory intervention. See Miller, \textit{A Regulatory Approach to Dereg-
old prophylactic rules, however, the new regulatory approach has been symptomatic, consisting of narrowly drawn rules and operating procedures that are designed to minimize opportunities for mismanagement.

In part, the regulators have relied on long-standing statutory rules that prevent financial abuses within bank holding companies. For example, section 23A of the Federal Reserve Act limits loans, extensions of credit and certain other financial transactions between a bank and its nonbank affiliates.\footnote{162} Limits on the payment of dividends by a bank to its parent company also prevent banks from diverting funds to nonbank affiliates.\footnote{163} Moreover, banks may not pay excessive fees for services furnished to them by an affiliate.\footnote{164} Such regulation is intended to prevent diversified banking organizations from draining assets from the bank for the benefit of other entities within the organization.

In addition, in approving applications to commence new activities, the regulators have imposed conditions and requirements that affect the operation of the new activity in order to minimize opportunities for conflicts of interest that may jeopardize the bank and its depositors. The regulators' strategy has been to separate, both structurally and operationally, the new activity from the traditional banking business.\footnote{165} This strategy has been referred to as building a "firewall" between banking and nonbanking activities.\footnote{166} Thus, the regulators have required physical separation of banking and nonbanking businesses, including separate incorporation,\footnote{167} separate offices\footnote{168} and separate personnel.\footnote{169} Moreover, the regulators have limited interactions between the separate opera-

\begin{footnotes}
\footnote{162. See 12 U.S.C. § 371c (1982). Although section 23A by its terms applies only to banks that are members of the Federal Reserve System, its provisions have been extended to all nonmember insured banks. See 12 U.S.C. § 1828(j) (1982 & Supp. V 1987). At one time, bank transactions with affiliates were even more stringently regulated. In the original Bank Holding Company Act, banks were prohibited from investing any funds in their holding companies or any affiliate. See Act of May 9, 1956, Pub. L. No. 84-511, § 6, 70 Stat. 133, 137, repealed by Act of July 1, 1966, Pub. L. No. 89-485, § 9, 80 Stat. 236, 240.}
\footnote{163. See, e.g., 12 U.S.C. § 60(b) (1982) (national banks need regulatory approval to pay dividends in excess of net profits plus retained earnings for two preceding years).}
\footnote{165. See, e.g., Citicorp/Morgan/ Bankers Trust, supra note 130, 73 Fed. Res. Bull. at 492 (insulation of nonbank subsidiary, both structurally and operationally, from bank makes it less likely that "adverse effects related to the conduct of the nonbanking activity will affect affiliated banks").}
\footnote{166. See Garsson, Building a 'Firewall': Can It Work?, Am. Banker, Dec. 14, 1987, at 1, col. 2.}
\footnote{167. See, e.g., Citicorp/Morgan/Bankers Trust, supra note 130, 73 Fed. Res. Bull. at 503 (underwriting to be conducted through separate nonbank affiliate); United City
tions, particularly extensions of credit by the bank to its nonbank affiliate\textsuperscript{170} and certain joint marketing of bank and nonbank products.\textsuperscript{171}

Although specific conditions may vary, the strategy of the new regulatory approach is clear. Rather than controlling the types of risks that banks are allowed to take, the bank regulators have encouraged experimentation with new activities in the hope of improving the profitability of banking. At the same time, the regulators have tried to influence how banks will manage their newly diversified businesses by imposing rules intended to minimize the potential for abuses that could adversely affect profitability. Thus, although bank management has been accorded greater discretion to choose bank investments, management's autonomy in operating its businesses actually has been reduced by rules that are designed to prevent mismanagement on a day-to-day basis.\textsuperscript{172}

2. Capital

Initially, regulation of bank capital appears to share the objectives and approach of traditional bank regulation. In the banking industry, capital traditionally has served an insurance function for depositors by protecting them, and the deposit insurance fund, against a decline in the value of the bank's assets.\textsuperscript{173} If the value of a bank's assets declines below its

\textsuperscript{168} See, eg., Citicorp/Morgan/Bankers Trust, supra note 130, 73 Fed. Res. Bull. at 503. Occasionally the regulators have required the nonbanking business to have a different name from that of the bank. See NatWest, supra note 130, 72 Fed. Res. Bull. at 588.

\textsuperscript{169} See, eg., Citicorp/Morgan/Bankers Trust, supra note 130, 73 Fed. Res. Bull. at 503.

\textsuperscript{170} See, eg., Morgan/Chase/Bankers Trust/Citicorp/Security Pacific, supra note 119, 75 Fed. Res. Bull. at 206-07 (prohibiting lending by bank to its underwriting subsidiary); Citicorp/Morgan/Bankers Trust, supra note 130, 73 Fed. Res. Bull. at 503 (preventing bank from extending credit (i) to enhance the creditworthiness or marketability of any securities underwritten by a securities affiliate, (ii) to customers to purchase any such securities, or (iii) to issuers for the payment of principal of or interest on any such securities).


\textsuperscript{172} See infra notes 264-71 and accompanying text.

\textsuperscript{173} See Peltzman, supra note 83, at 1. The term "capital" here is used generally to
capital, then depositors will incur losses, requiring reimbursement from the deposit insurance fund. Thus, a high capital to asset ratio allows the bank more readily to absorb loan losses. In addition, high capital makes the bank examiner's job easier by providing a cushion of protection against possible future losses on risky loans. Since the amount of a bank's capital is easier to measure than the riskiness of its loan portfolio, a large capital component protects against the possibility of examiner mistakes.

Until recently, however, capital levels at most banks were relatively low. In part, the explanation may have been the failure of the bank regulators to impose strict capital requirements. Until the 1980s, the regulators tended to evaluate the capital levels at individual banks relative to their peers, failing to halt the decline in capital ratios for the banking industry as a whole. Moreover, when formal capital to asset ratios were instituted, the regulators' definition of capital included not only equity, but also loan loss reserves and various forms of debt.

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Refer to long-term financial claims on the bank, including equity and long-term debt but excluding deposits. See generally W. Klein & J. Coffee, Business Organization and Finance: Legal and Economic Principles 292 (3d ed. 1988) (defining "capital structure"). As will be seen, "capital" for bank regulatory purposes may have a more specific meaning, including only particular types of capital instruments. Moreover, regulation of bank capital is concerned not only with total levels of capital relative to bank assets (such as loans and investment securities), but also with the relative levels of equity and debt as components of total capital (leverage).

174. See Peltzman, supra note 83, at 3.

175. This particularly has been the case for bank equity levels. In 1980, money center banks' average assets to average equity was 26.9, representing an increase in leverage of 12.3 percent since 1975. Large regional banks (with over $2 billion in assets) were leveraged 17.4 times, and medium-sized regional banks (with less than $2 billion in assets) were leveraged 15.6 times, representing increases in leverage of 5.1 percent and 5.3 percent respectively since 1975. See Walker, Regulating Capital at the Margin, 5 Issues in Bank Reg. 35, 36 (Autumn 1981).

176. See supra notes 82-83 and accompanying text. The regulators did evaluate capital levels in ruling on applications by banking organizations to acquire banks or nonbank affiliates, occasionally denying an application if the acquisition would result in too much additional leverage. See, e.g., Croesus Partners I, Inc., 72 Fed. Res. Bull. 45, 46 (1986).

177. See Wall, supra note 82, at 13.

178. The regulators adopted a two-part definition of capital for banking organizations (including both banks and bank holding companies): primary capital, consisting principally of equity (common stock and perpetual preferred stock) and loan loss reserves, and secondary capital, including limited life preferred stock, subordinated debt issued by banks and unsecured long-term debt issued by bank holding companies. Banking organizations were required to maintain a minimum primary capital to assets ratio of 5.5 percent and a minimum total capital to assets ratio of 6 percent. See 12 C.F.R. Parts 3, 225, 325 (1988).

179. As a result of this broad definition of capital, additions to loan loss reserves to provide for bad loans would not result in a decline in capital for regulatory purposes despite any resulting decline in net worth and shareholders' equity. For example, when Citicorp added $3 billion to its reserves in May 1987 to cover expected losses on its international loan portfolio, its primary capital remained unchanged. See Trigaux & Garsson, Regulators Downplay Possible 'Domino' Effect, Am. Banker, May 21, 1987, at 3, col. 2.

180. See supra note 178.
This broad definition of capital may have served the regulators' purpose of providing a cushion to absorb losses in the event of bank failure before they could be felt by depositors and the insurance fund. Yet traditional capital requirements did not cause banks to reduce risk-taking that could lead to failure and, in fact, may have caused some banks to increase the riskiness of their assets. Increasing capital imposes additional costs on banking organizations in the form of higher dividend or interest charges. In order to fund these increased charges, a bank may be tempted to invest its new capital in higher yielding, riskier assets. In addition, the capital requirements indirectly may have led to an increase in risk in bank holding companies, which issued substantial amounts of debt and thereby increased their leverage to fund their additional investments in their subsidiary banks. Because the principal source of funds to service this holding company debt is the subsidiary bank itself, a highly leveraged bank holding company may be tempted to drain resources from its bank, thereby impairing its operations.

Moreover, the declining profitability of the commercial banking business contributed to the drop in capital, particularly equity, at many banks. As long as banks earned a comfortable spread between the rates of interest earned on their loans and paid on their deposits, the cost of servicing capital was not a burden. As the price of deposits increased, many banks no longer could support high dividend payouts, even when they invested in more lucrative risky assets. Because banks did not depend on equity for day-to-day funding, they had no incentive voluntarily to raise equity capital, particularly when the market for bank equities was depressed.

Recently, capital regulation has assumed new importance, but both the

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181. It has been argued that the protection afforded by deposit insurance itself reduced incentives for banks voluntarily to increase their capital, since at least insured deposits did not have to rely on capital as protection against losses in the event of failure. See Peltzman, supra note 83, at 4.

182. With respect to dividends, the banking organization could choose to reduce its dividend rate. Such a move, however, may have a negative effect on the market for the bank's equity, hindering its ability to raise future capital. See infra note 324 and accompanying text.

183. A survey of New York's six largest bank holding companies at year-end 1986 found that as a group the holding companies had a double leverage ratio of 140 percent. In other words, the holding companies had invested an amount equal to all of their shareholders' equity plus an additional 40 percent in their bank and nonbank subsidiaries. See Forde, The Risk Behind Parent Company Debt, Am. Banker, May 14, 1987, at 1, col. 2.

184. As previously noted, bank dividends are subject to legal limitations that are intended to prevent bank holding companies from taking excessive funds from their subsidiary banks. See supra note 163. To the extent that these restrictions are effective, however, they may leave highly leveraged bank holding companies without sufficient funds for debt servicing.


form and purpose of the requirements are changing. First, the regulators are putting greater emphasis on equity as the primary component of the capital requirement. Second, in applying capital standards to individual banks, the regulators are taking into account the composition and riskiness of the bank’s assets.

This new approach to bank capital regulation views the role of capital as more than simply a cushion of protection for depositors in the event of failure. Either equity or some form of subordinated debt may provide such a cushion. But additional debt imposes burdens on banks that can seriously affect their financial positions as going concerns. Once the interest rate on debt is set, a bank cannot waive or alter its obligation to pay interest even if the bank suffers a decline in earnings. In contrast, it is generally assumed that management will be able to waive dividend payments should the bank encounter financial difficulties. Thus, requiring banks to raise equity, rather than debt, to meet increased capital requirements may lessen the burden of future debt servicing, thereby eliminating a potential risk to bank solvency.

Requiring higher levels of equity capital will have the additional practical effect of forcing banking organizations to raise funds in the public equity market. Ideally, this should have several consequences for banks. In order to sell new stock, banking organizations must compete for buyers in the public securities market with other banking organizations as well as nonbank issuers. This market pressure could force banks to manage their risk-taking more effectively in order to keep their cost of capital low. In effect, the regulators could enlist the equity market to assist it in policing bank risk.

187. The United States bank regulators, in conjunction with central bankers from Europe and Japan, recently adopted new capital guidelines that require a minimum capital to assets ratio of 8 percent, of which 4 percent must be primarily common stock and certain categories of perpetual preferred stock. See Federal Reserve System, Capital; Risk-Based Capital Guidelines, 54 Fed. Reg. 4186, 4186-4221 (Jan. 27, 1989), corrected in, 54 Fed. Reg. 12531 (Mar. 27, 1989) [hereinafter Risk-Based Capital Guidelines].

188. The new capital guidelines assign risk weights to bank assets, ranging from zero percent for essentially riskless assets such as cash and treasury securities to 100 percent for loans to private borrowers. See id. at 4220.

189. See generally Mendelson, The Threat of Corporate Debt, 6 J. Comp. Bus. & Cap. Market L. 149, 155-57 (1984) (negative effects of high leverage on firms). Although, as a legal matter, dividends may be waived more easily than interest payments, the likelihood of an adverse market reaction may make such a decision untenable. See infra notes 324-25 and accompanying text.

190. A study of bank equity to assets ratios in mid-1987 found that 26 major banks had ratios under the 4 percent minimum. See Rehm & Duffy, 26 Big Banks Face Need to Raise Equity: Regulators Seek 4% Minimum Level, Am. Banker, Dec. 11, 1987, at 1, col. 4.

191. For example, the depressed share value of many banking organizations over the past few years may reflect the market’s concern about risky lending practices, particularly in the international sector. See Matthews, supra note 186, at 25, col. 1.

192. At the same time, the regulators may be able to use the equity market’s assessment of banks, as reflected in their share prices, to assist them in identifying risky banks. See infra note 336 and accompanying text.
Alternatively, banking organizations may look for ways to avoid raising new equity. Regulatory capital requirements are measured on the basis of the ratio of the bank's capital to total assets. Thus, each additional dollar of assets, or loans, requires a corresponding increase in capital. One way for banks to avoid the need for additional capital is to restrict asset growth. In the past, capital requirements have provided a reason for the popularity of such bank products as standby letters of credit issued to back up commercial paper. Standby letters of credit produce fee income for the bank but, as contingent claims, do not appear on the bank's balance sheet as assets unless the contingency is realized and the loan is made. Yet since the bank ordinarily will be called upon to lend only in the event of a financial emergency, such as a default by the commercial paper issuer, such a loan may be subject to a significant risk of nonpayment as soon as it is made by the bank. This defeats the aim of the capital requirements to provide some insurance against future loan losses.

The new approach to capital regulation seeks to prevent this particular circumvention of the capital requirements by including in its definition of assets certain off-balance sheet engagements, such as letters of credit. More generally, by taking into account the riskiness as well as the size of a bank's assets, the new capital requirements encourage banks to choose less risky ways to avoid raising new capital. A banking organization that does not want to resort to the capital markets instead may weight its portfolio with more low risk assets, such as cash and government securities, that will not require as much capital as riskier commercial loans. Alternatively, the bank may simply shrink its loan portfolio, more carefully choosing its borrowers and experimenting with alternative sources of income by diversifying into new businesses. To the extent that the new approach to capital regulation may discourage uncontrolled asset growth, particularly loan growth, it represents a profound shift in regulatory attitude toward portfolio management.

3. Fiduciary Responsibility of Bank Management

Although traditional bank regulation consisted largely of formal rules, regulatory enforcement of those rules was surprisingly informal. The

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193. See Johnson & Murphy, supra note 110, at 25.
194. In addition, because the bank's obligation to lend is unpredictable, the bank incurs the risk that it will be unable to fund the loan. See id. at 26.
195. See Risk-Based Capital Guidelines, supra note 187, at 4203-05.
196. See id.; supra note 188.
197. See Duffy, UK's Japanese Banks Focus on Profitability, Am. Banker, Nov. 17, 1987, at 2, col. 2 (strict U.K. capital requirements force banks to concentrate more on profitability and less on asset growth). At a time when lending has become less profitable for banks than in the past, this portfolio restructuring may make sense. In a changed financial environment, however, leaner banks may be unable to compete as effectively in national and international lending markets against large foreign lenders. See Shaw, Capital Adequacy Standards May Increase Risk, Am. Banker, Feb. 10, 1988, at 4, col. 1.
regulators had powerful sanctions at their disposal to punish violations, including termination of a bank's deposit insurance or revocation of its charter, but rarely exercised such so-called "death penalty" powers. Instead, the regulators resorted to less formal means of bringing pressure on bank management, including "jawboning" and voluntary agreements with management, that had the advantage of not requiring formal judicial or administrative proceedings.

In part, the success of these informal techniques was due to the influence of the regulators over the banking industry. The necessity for regulatory approval of the most basic corporate decisions, such as branch openings, acquisitions of banks and entry into new businesses, gave the regulators a potent means of bringing pressure to bear on recalcitrant bank management. Moreover, the threat of severe sanctions, although rarely used, made bank management more willing to acquiesce in the regulators' informal requests for compliance.

Recently, however, as the substance of bank regulation has shifted away from rigid prohibitions toward more flexible rules of conduct such as conflict of interest rules, regulatory enforcement actually has become more formal. In 1966, the regulators requested and received new formal disciplinary powers from Congress, including the authority to issue cease-and-desist orders to compel banks to undertake or to end particular conduct. In addition, the regulators obtained broad powers to remove bank officers or directors who engaged in insider abuse involving personal dishonesty. In 1978, again at the regulators' request, Congress

201. See, e.g., 12 U.S.C. § 93(a) (1982) (termination of national bank charter requires judicial determination that banking law violations have occurred).
203. See Bank Holding Company Act § 3(a), 12 U.S.C. § 1842(a) (1982) (Federal Reserve Board approval required to form bank holding company or for bank holding company to acquire new bank subsidiaries).
205. For example, the regulators could impose conditions on bank management in connection with their approval of an application. See supra note 12.
206. See supra notes 198-200 and accompanying text.
209. As originally formulated, removal required proof that the director or officer had violated a law or regulation, engaged in unsafe or unsound practices or breached his or
gave the agencies additional disciplinary powers, including authority to issue cease-and-desist orders against individual officers, directors and insiders of banks, civil money penalties against banks and bank management for certain legal violations and expanded powers to remove bank management for "willful or continuing disregard" for the safety or soundness of the bank. Recently, the regulators once again have asked for even broader powers.

Despite the availability of these regulatory powers, formal enforcement proceedings have been relatively infrequent. The regulators' reluctance to commence formal proceedings, as well as their recent requests for still additional disciplinary powers, suggest that the existing remedies still may be too severe or may require too high a standard of proof.

In addition, however, the regulators' push for new and more flexible enforcement powers may reflect a change in the way that disciplinary powers will be used to control bank risk. Originally, the enforcement powers were designed primarily to prevent actual cases of fraud and insider abuse within banks. For example, in the past, bank management could be removed only for knowing violations of the banking laws involving personal dishonesty. Because fraud and insider abuse accounted

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213. Id. § 1818(e)(1).

214. At the time this Article was prepared, legislation was pending that would substantially increase both the enforcement powers and penalties. See Financial Institutions Reform, Recovery and Enforcement Act of 1989, S. 413, 101st Cong., 2d Sess. (1989).


216. In Larimore v. Comptroller of the Currency, 789 F.2d 1244 (7th Cir. 1986), the Comptroller issued a cease-and-desist order requiring the bank directors to reimburse the bank for losses resulting from the directors' approval of loans in excess of the bank's legal lending limits. The court held that the Comptroller had no power under its cease-and-desist authority to impose personal liability on bank directors. See id. at 1245. Although a provision of the National Bank Act does permit an action for damages to be brought against bank directors for knowing violations of the lending limits and other banking laws, such an action requires a full judicial hearing, not simply an administrative proceeding. See 12 U.S.C. § 93(a) (1982). Pending legislation would broaden the regulators' authority to fashion more flexible remedies. See supra note 214.

217. See supra note 209; Cobb, supra note 211, at 519-20.
for most of the serious financial problems at banks, the enforcement powers were designed to help prevent bank failure. Yet because fraud is hard to discover even through on-site regulatory examinations, often the bank had failed before the regulators could bring an action for removal of management.

Recent expansions of the regulators' disciplinary authority, such as the broadening of the removal power to include "willful or continuing disregard" for the safety or soundness of the bank, not only make enforcement actions easier to bring, but also reflect the regulators' increasing concern with the skill and quality as well as the honesty of bank management. The broader enforcement powers permit the regulators to police breaches of fiduciary duty that may not involve actual dishonesty on the part of management. Such breaches of fiduciary duty may include negligence, failure to supervise officers or employees and other mismanagement that results in losses for the bank.

This new use of the enforcement powers to police the fiduciary obligations of bank management is consistent with the regulators' recent efforts to monitor more carefully the day-to-day performance of bank directors and officers. As strict regulatory controls are dismantled, managing risk largely becomes the task of individual banks. The enforcement powers can serve the twofold purpose of enabling the regulators to pressure bank management to improve its performance and permitting the regulators to punish or remove bad managers when problems go uncorrected.

II. A CORPORATE FINANCE ANALOGY

The previous Part described some of the recent changes in the strategy of bank regulation. This Part proposes a way to categorize the new regulatory approach and to contrast it with past regulatory strategies. This effort to categorize the recent changes in bank regulation in a comprehensive fashion has two aims. First, identification of the common themes

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218. See supra note 98.
220. See supra note 213 and accompanying text.
221. See, e.g., Brickner v. Federal Deposit Ins. Corp., 747 F.2d 1198, 1203 (8th Cir. 1984) (upholding removal power for breaches of fiduciary duty). Although the FDIC had criticized the bank's extensions of credit to a customer in violation of its legal lending limits, the directors accepted an officer's assurances that the improper lending would cease and took no further steps to correct the problem. The court upheld the FDIC's authority to remove the directors for breach of fiduciary duty although the directors had not acted intentionally to endanger the safety of their bank.
222. For a discussion of the fiduciary duty of bank directors under common law, as well as statutory sources of liability, see Grunewald & Golden, Bank Director Liability Post-FIRA: How to Avoid It, 98 Banking L.J. 412 (1981).
223. To the extent that increased personal liability for mismanagement makes directors insurers of bank safety and soundness, the regulators' new policy may be subject to some criticism. See Hawke, The Limited Role of Directors in Assuring the Soundness of Banks, 6 Ann. Rev. Banking L. 285 (1987); see also infra notes 283-85 and accompanying text.
in the "new" bank regulation illustrates the extent of the shift that has occurred in both the philosophy and the techniques of bank regulation. This change in regulatory strategy is more significant than any individual statutory or administrative change, because it suggests the direction that regulation will continue to take in the future.

Second, identification of the shift in regulatory strategy permits some tentative assessment of how well the new approach is already working and can be expected to work in the future. Certain problems that have emerged in administering the new regulation may be symptomatic of deeper difficulties inherent in the regulators' new approach to managing bank risk. Identifying this approach may assist in grappling with these problems. This Part sets forth a framework for analysis of the new regulatory approach. The next Part describes its limitations.

The shift in bank regulatory strategy may be best understood by reference to basic concepts of corporate finance. Traditional bank regulation, with its rigid controls on permissible bank activities and investments, may be understood as viewing bank safety from the perspective of the corporate debtholder. Because the bank regulators acted as surrogates for depositors, the relationship between a bank and its regulators was essentially that of a corporation and its debtholders. The influence of these powerful debtholders naturally affected the management style and business of the banking industry.

Recent regulatory innovations suggest that the bank regulators are beginning to view bank safety from a different perspective. This new approach is evident not only in the more liberal attitude toward risk-taking, but also in the new emphasis on the quality of management at banks. The new regulatory strategy may be understood as viewing bank safety from the perspective of the equityholder, who is concerned with the profitable and efficient operation of the enterprise as a going concern. Of course, the bank regulators still must be concerned with the need to protect depositors in the event of failure. To achieve this goal, the new regulatory approach focuses on encouraging better risk management within the institution to maintain its profitability as a going concern rather than on risk prevention and protection of bank assets.

A. Shareholders Versus Debtholders

Basic corporate finance theory assumes a conflict of interest between debtholders and equityholders in a typical corporation. This conflict at times may be overemphasized. Both shareholders and debtholders are engaged in the same economic activity of investment and are motivated by the same goal of profit.\(^{224}\) Moreover, the existence of hybrid securities such as convertible debt has made the distinction between equity and debt less clear in the modern corporation.\(^{225}\) Nevertheless, the classic


\(^{225}\) See McDaniel, supra note 81, at 417.
The dichotomy between shareholders and debtholders is still useful in identifying two divergent approaches toward risk management.

In the classic model, the conflict between shareholders and debtholders is most acute with respect to three basic management decisions: risk-taking, asset management and leverage. Typically, the debtholder is less willing to permit the corporation to incur additional risk than the equityholder. Unlike the debtholder, who is entitled to a rate of return that is unaffected by the profitability of the enterprise, the equityholder stands to gain if risky ventures succeed, either through increased dividends or capital appreciation. In contrast, the debtholder prefers ventures that produce enough income to pay the interest on and principal of the debt, but that do not involve a significant risk of loss that could interfere with repayment. Moreover, equityholders can afford to be less averse to risk-taking at individual institutions given their ability to diversify their investments to reduce overall portfolio risk.

In addition, debtholders and equityholders tend to differ as to the proper management strategy concerning the use of the corporation’s assets. In the event of bankruptcy, the debtholder has a prior claim to the assets of the corporation. Therefore, the debtholder prefers the corporation to maintain sufficient assets to be able to cover the debt in the event of failure. This emphasis on a strong balance sheet is of less concern to the equityholder, who is more interested in the immediate distribution of assets in the form of dividends.

Finally, equityholders and debtholders may have different attitudes toward leverage. Typically, the debtholder welcomes a substantial investment in the corporation by equityholders. In contrast, the equityholder prefers new operating capital to come from debtholders,


227. See supra note 53. Many debtholders also can diversify their investments. For bank depositors, who are banks’ most significant debtholders, diversification often is less feasible, particularly for those depositors with small deposits or transaction accounts that are maintained less as an investment than as a convenience or a necessity. Theoretically, the deposit insurance fund itself is relatively diversified, since it is “invested” in all insured banks. Nevertheless, given the potential cost to the banking system of some bank failures, the insurance fund can be viewed as overinvested in particular banks whose failure either poses systemic risks or would bankrupt the insurance fund. As of the end of 1983, the total deposits of thirteen insured commercial banks exceeded the size of the insurance fund. See Working Group of the Cabinet Council on Economic Affairs, Recommendations for Change in the Federal Deposit Insurance System 20 (1985).

228. See B. Manning, supra note 224, at 6-7. Of course, debtholders also are interested in the corporation’s income flow as the source of repayment of their debt during the life of the corporation. See id. at 14. In contrast, the bank regulators’ principal concern is that the bank will have sufficient assets to protect depositors during periods of financial duress, avoiding the need for assistance from the insurance fund. Thus, the classic model of the typical debtholder as primarily interested in maintaining a cushion of assets as protection in the event of bankruptcy, although not entirely representative of the average creditor, is useful to understanding the perspective of the bank regulators.

229. See id. at 15.

230. See id. at 11-12.
which funds can be invested to make profits that will benefit the equityholders, while any losses will be borne mainly by the debtholders. At a certain point, however, the effects of leverage may produce a change in these preferences. For example, debt servicing imposes a fixed cost on the enterprise that, unlike shareholders’ dividends, cannot be waived in the event of declining corporate earnings. Thus, too heavy a debt burden will limit the ability of shareholders either to remove funds from the enterprise in the form of dividends or to draw on internally generated funds for expansion. On the other hand, the cost of servicing some forms of debt may be so much less than the profits that can be generated from those funds that even existing debtholders will prefer the sale of additional debt as a method of raising funds. This may have been true of deposits when they were subject to interest rate ceilings.

In addition, too much leverage may shift the balance of power within the corporation. Although highly leveraged firms typically are thought to be more inclined to take risks than less leveraged firms, this assumes that shareholders’ preferences determine management’s choices. As the investment and risk exposure of debtholders grow, debtholders may insist on a greater voice in day-to-day management. Although the ability of a bank’s principal debtholders, its depositors, to exert this influence may be limited, the bank regulators as representatives of those depositors have sufficient power to demand greater control of management decisionmaking.

B. Bank Regulation from the Debtholder’s Perspective

The previous description of the preferences of the typical debtholder closely fits the strategy of traditional bank regulation. Debtholders are concerned about earnings variability, because they obtain no advantage from windfall profits but are adversely affected by unexpected losses. Therefore, they prefer a strong balance sheet and steady if unspectacular earnings. These preferences are reflected in the approach of traditional bank regulation. The bank regulators sought to preserve bank safety, and thus protect depositors, a bank’s largest group of debtholders, by limiting banks to businesses that had proved to be predictable sources of

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231. See id. at 12.
232. Too much leverage also may prevent a banking organization from receiving the necessary regulatory approval for further expansion by acquisition. See supra note 176.
233. See supra notes 43-44 and accompanying text.
234. See supra note 81.
235. See Williamson, Corporate Governance, 93 Yale L.J. 1197, 1212 (1984). This voice may take the form of representation on the board of directors by a major corporate lender or more stringent restrictive covenants in the loan documentation.
236. Since depositors as a group lack both organization and shared goals with respect to their investments, they will have difficulty negotiating for and monitoring compliance with detailed debt covenants. See Garten, supra note 10, at 245-46.
237. See supra note 226 and accompanying text.
income. New forms of risk-taking by individual banks were discouraged because they presented only downside risk to the regulatory system. If the risk paid off, any resulting profits would not be shared by depositors, the insurance fund or the regulators. On the other hand, any resulting losses could lead to bank failure, requiring a payoff of depositors out of the insurance fund or a regulatory bailout.

Thus, traditional bank regulation consisted of a series of restrictive covenants similar in form and content to a classic bond contract. These covenants restricted bank investments and activities, as well as banks' ability to pay dividends and interest to future investors. In fact, these regulatory covenants were far more onerous than the typical covenants contained in privately negotiated debt instruments, which, particularly recently, tend not to impose controls on investment decisions. The failure of debtholders to demand more restrictive covenants from issuers may be explained by numerous factors, including the inability of debtholders effectively to bargain for and enforce detailed covenants, the liquidity of most debt instruments and the pressure on corporate issuers of debt to free themselves from restrictions that hamper their ability to compete.

These constraints on private bargaining, however, did not affect the bank regulators in their dealings with the banking industry. Unlike ordinary debtholders, the bank regulators could require essentially identical restrictive covenants from all banks, removing competitive inequalities among different institutions. Moreover, regulatory monitoring of

238. See supra notes 59-83 and accompanying text.
239. Insurance premiums are based on a bank's total deposits, see 12 U.S.C. § 1817(b)(1)-(8) (1982), and do not vary with the amount of risk or profits at individual banks.
240. See supra notes 40-42 and accompanying text.
242. See supra note 6.
243. See supra note 163.
244. See supra note 19 (interest rate ceilings).
245. Apart from negative pledge clauses, debt instruments today contain few covenants at all. See McDaniel, supra note 81, at 424-25.
246. See Guttentag & Herring, supra note 226, at 1369.
247. This liquidity, which has resulted from the development of active secondary trading markets for all kinds of corporate debt as well as the shortening of the average maturities of debt instruments, enables investors to protect themselves by liquidating or selling their investments rather than attempting to control risk-taking by contract.
248. The dual banking system may permit some competition among state and federal bank regulators for bank charters (and chartering fees). See Scott, The Dual Banking System: A Model of Competition in Regulation, 30 Stan. L. Rev. 1 (1977). Theoretically, this competition should lead to a relaxation in regulatory restrictions similar to the phenomenon observable with respect to private debt covenants. Nevertheless, although many state banking laws do grant broader powers to state-chartered banks than are available to national banks, the effect of this competition has been blunted by the fact that almost all banking organizations are subject to some federal regulation, such as the Bank Holding Company Act regulating the holding companies and nonbank affiliates of both
bank compliance with restrictive covenants was superior to private monitoring. Thus, traditional bank regulation imposed the types of controls that an individual debtholder might choose to require given adequate bargaining and monitoring power.

In addition, the effects of traditional regulation on the business of banking accorded with the preferences of the typical debtholder. Traditional regulation encouraged asset growth, both by ensuring a steady source of inexpensive funds for lending and by channelling bank investments into loans rather than into nonbanking ventures. Loan growth, coupled with limits on the interest payable on deposits, provided banks with a comfortable stream of income to service their debt and a large cushion of assets in the event of losses. Thus, bank creditors were protected despite extraordinarily high leverage at most banking institutions.

C. Bank Regulation from the Equityholder’s Perspective

The breakdown of traditional regulation has involved more than simply the dismantling of regulatory “debt covenants.” The new focus of bank regulation reflects a shift from the traditional emphasis on risk control to a new concern with risk management at banking institutions. This approach to regulating banks approximates more closely the classic model of the equityholder than that of the debtholder. Although the primary aim of protecting bank safety has not changed, the new regulation reflects a different view of how this goal should be achieved.

Many signs of this new equityholder’s perspective can be found in recent regulatory innovations. The relaxation of regulatory restrictions on permissible bank activities and investments reflects a more positive attitude toward bank risk-taking. Some bank product diversification was necessary to offset declining earnings in the banking industry. Nevertheless, there has been no effort, as there was in 1933, to force banks into a particular investment strategy that the regulators consider to be safe. Instead, there is a recognition that diversification itself may be the best way to limit risk.

In addition, the new emphasis on improving bank earnings reflects a different regulatory approach to the problem of bank failure. The growing expense of paying off depositors in or otherwise disposing of failed state-chartered and national banks. See Rehm, State Banks Wary of Using New Powers, Am. Banker, Apr. 11, 1988, at 1, col. 2.

249. See supra notes 87-98 and accompanying text. Of course, even regulatory covenants have not been completely effective in preventing all prospective changes in risk. Nevertheless, as discussed previously, until recently bank management had little incentive to attempt to violate these restrictions. See supra notes 75-86 and accompanying text.

250. See supra notes 230-33 and accompanying text.

251. See supra note 172 and accompanying text.

252. See supra notes 118-23 and accompanying text.

253. See supra notes 148-58 and accompanying text.
banks has made bank failure a more serious threat than ever. The cost of handling failed banks has led the regulators to look more carefully at how banks are operated as going concerns rather than relying primarily on a cushion of protection for depositors in the event of bankruptcy. Put another way, although the regulators will not directly share in increased bank profitability, strong earnings make failure less likely.

Further evidence of the new regulatory perspective is the regulators' increased attention to the quality of management. New regulatory initiatives have sought to improve corporate governance, both through detailed rules that dictate how specific operations should be conducted to avoid mismanagement and conflicts of interest and through policies intended to expand the traditional fiduciary duty of bank management. Ironically, this new regulation may be even more intrusive than the old static controls, since it involves intimate details of corporate decision-making, such as where to locate new activities within the banking organization and even when to fire incompetent or dishonest managers. Thus, the new regulation seeks to put the regulators into the positions of supermanagers who can impose direct discipline on the business decisions of bank management. Like equityholders, the regulators can punish excessive risk-taking while rewarding properly managed institutions.

Perhaps the best evidence of the new equityholder's perspective is the recent attempt by the regulators to expose bank management to the discipline of the equity market. Efforts to increase the equity levels at banks and bank holding companies are intended in part to reduce excessive leverage in bank capital structures. Forcing banks to raise new equity, however, serves the additional purpose of making banks more sensitive to the risk preferences of the securities market. Moreover, the regulators may be able to rely on the market's assessment of individual banks as reflected in their share prices as a gauge of bank problems and take steps to ensure a reduction in risk-taking, much as corporate managers are expected to do.

254. For the regulators' alternatives for handling failed banks, see supra notes 40-42 and accompanying text.
255. See supra note 227.
256. See supra notes 162-72 and accompanying text.
257. See supra notes 220-23 and accompanying text.
258. See supra notes 167-69 and accompanying text.
259. See supra note 213.
260. A good example of this new regulatory power is the Change in Bank Control Act of 1978, 12 U.S.C. § 1817(j) (1982 & Supp. V 1987), which makes management skill and experience a prerequisite to acquiring control of a bank. Under the Act, the regulators can stop an acquisition if the "competence, experience, or integrity of any acquiring person or of any of the proposed management personnel indicates that it would not be in the interest of the depositors of the bank, or in the interest of the public to permit such person to control the bank." Id. § 1817(j)(7)(D).
261. See supra note 189 and accompanying text.
262. See supra notes 190-92 and accompanying text.
263. See infra note 336 and accompanying text.
III. REGULATORY GROWING PAINS

The recent shift in perspective in bank regulatory strategy from that of a debtholder to that of an equityholder suggests that the bank regulators will play a more active role in managing risk at banking institutions than they did under the old regulatory scheme. Nevertheless, this more dynamic regulatory approach may create new problems for the regulators. First, it is far more difficult to create and administer standards that attempt to affect how a business is governed than simply to impose prohibitions on particular activities. Second, these new standards are likely to intrude on the prerogatives of bank management to an even greater degree than the old regulation.

A. The Problem of Administration

Detailed regulation that attempts to influence the day-to-day operation of a business is often impossible to administer effectively. The sheer complexity of the regulation may lead to misunderstandings and unintentional violations by the regulated industry, requiring clarification through additional rulemaking. For example, early regulatory approvals of bank entry into the securities business were coupled with detailed specifications as to how to achieve the complete physical separation of banking and securities operations in order to avoid conflicts of interest. Banks offering discount brokerage services to their customers were required to use different employees, to establish separate telephone lines and even to maintain separate office entrances for their brokerage and banking businesses. Yet these rules not only proved virtually impossible to enforce, but also were ineffective in preventing tying arrangements, sharing of confidential information and other abuses from taking place. The regulators therefore have been forced to rewrite or even to abandon many of the detailed operating conditions they originally imposed on applicants seeking to enter new businesses.


265. For example, in practice, separation of the brokerage and advisory businesses meant only that clients of a bank's investment advisory subsidiary had to walk across the bank's lobby to have trades executed by its affiliated discount broker. See Gross, Banks Dispense Investment Advice Through Gap in Glass-Steagall Wall, Am. Banker, Aug. 14, 1985, at 1, col. 3.

266. Section 106(b) of the Bank Holding Company Act, 12 U.S.C. § 1972 (1982), prohibits banking organizations from extending credit or providing other services conditioned upon the customer's obtaining an additional service from the banking organization (except when both services consist of bank lending, discount, deposit or trust services), or agreeing not to obtain services from a competitor.

In addition, many new operating requirements proved unsuccessful because they defeated the very purposes for which banks sought to enter new businesses. In approving new securities activities for banking organizations, the regulators originally restricted the sharing of customer lists between banking and securities operations and other efforts to cross-market traditional banking services and new financial products. In theory, these restrictions may protect bank customers from unfair pressure to buy additional financial products from their bank. In practice, however, most banks must rely primarily on their established customer base as a market for their new products. This cross-marketing may be the only way that banks can gain entry into new businesses and may assist banks in attracting and retaining banking customers. Further, consumer preference for joint marketing of financial products has been a driving force for product deregulation. Thus, restrictions on joint marketing actually may stifle the very innovation that product deregulation was designed to encourage.

The more active role that the regulators are seeking to play in managing bank risk has been further complicated by the banks' own efforts to adapt to the greater opportunities and risks afforded by deregulation of banking. Diversification has required banks to develop both new expertise and new management strategies. Initially, banks relied upon hiring outside experts from their nonbank competitors to gain instant expertise in new businesses. Nevertheless, integration of the new specialists with established bank personnel often has proved difficult. Many


269. For example, some of the new businesses that banks have chosen to enter, such as retail discount brokerage, have not proved to be very profitable. To the extent that banks have continued to enter these businesses, they may be primarily attracted by the opportunity to generate additional deposit customers and by other retail cross-selling opportunities. See Hayes, supra note 2, at 54.

270. See, e.g., Bennett, supra note 26, at 28.

271. Although the Federal Reserve Board originally restricted the sharing of customer lists between banks and their nonbank affiliates, such as affiliated brokers, see NatWest, supra note 130, 72 Fed. Res. Bull. at 585, the Board subsequently reversed its position, noting that in many cases banks and their affiliates may be operating in the same markets and soliciting the same customers even without sharing customer lists. See Manufacturers Hanover Corp., 73 Fed. Res. Bull. 930, 932-33 (1987). Thus, any abuses resulting from joint marketing are already a possibility whenever a banking organization engages in nonbank activities. In this situation, sharing customer lists may simply be a matter of convenience.

272. See, e.g., Albert, supra note 134, at 1, col. 2.

273. This particularly has been a problem for the new investment banking personnel, who often have been better paid than traditional lending officers. See Dickey, It's A Bird, It's A Plane . . . It's A Bank?, 5 Bank Expansion Rep. 1, 10 (Oct. 6, 1986).
banks have gone through successive internal reorganizations as they have attempted to merge their new activities more effectively with their traditional banking business.274

This sort of adjustment is to be expected as the banking industry adapts to a new market environment. Yet deregulation is creating similar dislocations for the bank regulators. Bank examiners now must monitor risk by looking not only at loan portfolios, but also at numerous new sophisticated financial products.275 The regulators not only must understand the new risks, but also must arrive at a means of predicting their potential effect on future earnings. Inevitably, an expertise gap may develop between the industry and the regulators.276

A gap may exist in organization as well. Theorists have noted that all business organizations go through successive phases of maturation that are precipitated by crises in management as the organization grows.277 For example, a young entrepreneurial organization ultimately will face a crisis of leadership as management responsibilities grow, leading the organization to institute a more formalized supervisory structure.278 Too much centralization in turn leads to efforts to restore local autonomy.279 As banks have begun to diversify, they have gone through a similar revolution in organizational structure. Many banks are abandoning their traditional compartmentalized structures, reorganizing their operations by product and market.280

The ability of the industry to adapt its structure to new business developments is not shared by the regulatory system. The bank regulatory system has remained highly centralized and focused on individual corporate units. One bank regulator still is responsible for evaluating all risks


275. These products may include standby letters of credit, futures contracts, forward rate agreements, swaps and securitized assets. See Johnson & Murphy, supra note 110, at 25-33.

276. This problem is exacerbated by the high turnover rate among examiners. A recent survey of bank examiners in the Dallas region found that the majority had less than three years' experience. See Federal Financial Structure for Examining Financial Institutions: Hearings Before the Subcomm. on General Oversight and Renegotiation of the House Comm. on Banking, Finance and Urban Affairs, 97th Cong., 1st Sess. 5 (1981) [hereinafter Hearings on Bank Examination Procedures] (statement of Daniel F. Stanton, Deputy Director, General Government Division, General Accounting Office).

277. For an elegant statement of this theory, see Greiner, Evolution and Revolution as Organizations Grow, Harv. Bus. Rev., July-Aug. 1972, at 37. Greiner's five phases of maturation have been applied to banking organizations. See Dickey, supra note 273, at 9-10.

278. See Greiner, supra note 277, at 41-42.

279. See id. at 42-43.

280. See, e.g., Horowitz, Morgan Revamps Corporate Lending Group, Am. Banker, Sept. 26, 1988, at 3, col. 2 (reorganization of corporate lending into industry-specific groups); see also supra note 274 and accompanying text.
within the bank entity, from loan portfolios to securities activities.\footnote{281} This responsibility creates problems for the individual examiner as well as the regulatory system in keeping banks accountable. Banks are becoming too big and diverse to permit the traditional monitoring by periodic on-site regulatory examinations.\footnote{282}

Thus, the recent shift in regulatory strategy has created a dilemma for the bank regulators. To the extent that the new regulatory approach views bank safety from the perspective of an equityholder, such regulation aims to protect the banking system less through contractual limitations on bank risk-taking than through more careful risk assessment and management. Yet, in the absence of static constraints, it is unclear how the regulators can effectively monitor the new risks at banking institutions.

\textbf{B. The Problem of Risk Control}

In the average corporation, risk monitoring is primarily the responsibility of management and shareholders. Thus, the bank regulators may be more successful in managing risk at banks if they find ways to encourage bank management voluntarily to improve its performance. The regulators already have the authority to bring disciplinary actions against individual bank directors and officers to hold them personally responsible for losses caused by their mismanagement.\footnote{283} Yet personal liability alone will not necessarily persuade bank managers to play a greater role in actively controlling bank risk-taking. Greater liability (and higher insurance rates for director and officer liability policies)\footnote{284} instead may simply discourage qualified managers from accepting positions with banking

\footnote{281} The division of regulatory responsibility is largely based on the nature of the bank's charter. The Comptroller of the Currency is responsible for monitoring all national banks and their subsidiaries, while state-chartered banks are monitored by the state chartering authority and in some cases by the Federal Reserve Board or the Federal Deposit Insurance Corporation. Recently, there have been proposals for more functional regulation, under which, for example, all securities activities of banks would be regulated by the Securities and Exchange Commission.

\footnote{282} The increasing difficulty of comprehensive on-site monitoring of banks has led the regulators to rely more heavily on statistical data reported by the banks themselves to monitor bank safety. \textit{See} Dince, \textit{supra} note 47, at 5-6. Yet since the usefulness of this data depends on the accuracy and completeness of the banks' own reporting, regulatory oversight is dependent on the honesty and skill of bank management. \textit{See infra} notes 283-85 and accompanying text.

\footnote{283} \textit{See supra} notes 207-23 and accompanying text (describing regulatory enforcement powers). Certain statements by the regulators confirm their intention of forcing bank directors to share the regulators' task of actively monitoring the soundness of their banks, particularly when the regulators cannot do so. \textit{See}, e.g., Clarke, \textit{Directors' Responsibilities Echo Those of Regulators}, Am. Banker, Sept. 21, 1987, at 10, col. 1, at 12, col. 4 (board of directors is an "independent source of safety and soundness for the institution and, in turn, the overall banking system").

Moreover, penalizing bank directors may not even serve a compensatory purpose. If mismanagement causes a bank to fail, the resulting costs may be so large that directors' liability can never adequately compensate for the damages. For example, a director's approval of insider loans leads to losses and failure of the bank, requiring a payoff of depositors out of the insurance fund. To compensate for these losses, the director would have to reimburse the deposit insurance fund as well as pay all administrative costs attendant to the bank closing and liquidation. Even then, the failure may have had spillover effects on the community, causing depositors to withdraw their funds from other local banks, leading to their failure. Individual liability can never adequately compensate for these losses that may result from bank failure.

The regulators face similar problems in relying on bank shareholders to bear primary responsibility for monitoring bank risk-taking. Shareholders may have reason to prefer higher levels of risk at individual banks than the regulators are willing to tolerate. Moreover, the regulators have only limited means of bringing direct pressure to bear on shareholders to conform to the regulators' standard of vigilance.286

Thus, the new regulatory approach leaves open the question of who should bear primary responsibility for setting limits to risk-taking at banks: the bank's regulators, its management or its shareholders. This emerging strain in the fabric of the new regulatory strategy can best be illustrated by examining three examples of the new regulation. Although these examples are intended to demonstrate some problems with the new regulatory approach, this Article does not necessarily advocate a return to old-style bank regulation. Nevertheless, these problems raise significant questions as to how effective the new regulatory approach will be in achieving its goal of preserving the soundness of the banking system.

1. Bank Regulation and Portfolio Theory

From the perspective of the equityholder, diversification is an effective way of reducing overall risk in an investment portfolio. If bank safety is seen from this point of view, similar advantages may be expected from diversification of activities within banks. A banking organization would treat its separate subsidiaries and businesses as investments in a portfolio of securities, and seek to maintain a properly diversified portfolio.287 Proper portfolio management should permit banks to improve their overall return by entering more risky businesses without increasing the riskiness of their portfolio as a whole.288

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285. See Hawke, supra note 223, at 287.
286. See infra notes 349-54 and accompanying text.
287. The bank would choose investments whose returns are negatively correlated, permitting cyclical profits in one business to offset declines in another. See supra note 53.
288. See Jessup, Portfolio Strategies for Bank Holding Companies, 152 Bankers Mag. 78, 78 (Spring 1969) (advocating this portfolio approach to bank diversification); see also
Recent changes in bank regulation have encouraged this portfolio approach to bank diversification. Empirical studies of bank holding company diversification have treated new bank activities as individual securities in the holding company's portfolio and have examined the effect of each new investment on the overall risk position of the portfolio. To the extent that these studies have supported arguments that a portfolio of banking and certain nonbanking activities is either less risky or no more risky than a portfolio consisting solely of banking activities, this evidence has served as a basis for a policy of relaxation of product restrictions. Under this model, the inherent riskiness of any particular investment, banking or nonbanking, would be balanced by the presence of other investments.

This view of bank entry into new ventures as an investment in a diversified securities portfolio further is reflected in regulatory requirements that new nonbanking activities be placed in separate affiliates from the bank. This separation encourages banking organizations to treat their different businesses as individual investments in a diversified portfolio. Compartmentalization of activities has long been considered a solution to the problem of conflicts of interest within diversified banking organizations and has been thought sufficient to shield banks from liability for


290. Most studies appear to support the hypothesis that nonbank investments either decrease bank holding company risk slightly or have little impact at all. See Wall, Nonbank Activities and Risk, Fed. Reserve Bank of Atlanta Econ. Rev. 19, 28-32 (Oct. 1986) (reviewing prior studies). Because of existing legal restrictions, however, these studies were not based on actual experience of banking organizations in activities such as securities underwriting or insurance. See Rhoades, supra note 159, at 1149. In fact, some studies of bank holding companies' actual experience with nonbank affiliates suggest that the operations could actually increase risk in some ways. See, e.g., Talley, supra note 86, at 44 (bank holding company subsidiaries tend to be more highly leveraged than independent companies).


292. See Note, supra note 288, at 661 ("because diversification can reduce 'unique risk,' a broadly diversified bank holding company is likely to be more secure than an undiversified one").

293. See supra notes 165-69 and accompanying text. Most proposals for relaxation of product restrictions have suggested that such firewalls be built to separate banking from nonbanking activities. See, e.g., Mandate for Change, supra note 154, at 93,019.

294. Theoretically, diversification may be achieved without placing each separate activity in a different corporate entity. Nevertheless, policies encouraging compartmentalization of activities are designed to minimize the potential for conflicts of interest and mismanagement of operations that could defeat the risk-reducing benefits of diversification. See infra note 299.

295. See supra note 162 (discussing Federal Reserve Act § 23A).
the debts of nonbank affiliates.\textsuperscript{296} Recently, rules that attempt to insulate banks from nonbank affiliates have been proposed as adequate substitutes for traditional restrictions on diversification.\textsuperscript{297}

Thus, application of portfolio theory to banks leads to a view of a diversified banking organization as akin to a mutual fund or other intermediary that makes essentially passive investments in various separate businesses in order to earn a return.\textsuperscript{298} Ideally, the separate businesses should be operated independently, as is encouraged by regulation that has required separate officers, separate physical facilities and occasionally even separate names for bank and nonbank affiliates and that has tightly regulated interaffiliate transactions.\textsuperscript{299} Theoretically, a bank organized in this fashion may be able effectively to reduce risk, but it is doubtful that diversified banking organizations have much in common with a passive investor holding a diversified portfolio of securities. This gap between theory and reality not only casts doubt on the usefulness of portfolio theory in evaluating the costs and benefits of bank diversification, but raises questions as to the ability of the new regulatory approach to ensure the soundness of a diversified banking organization.

The average diversified banking organization differs from the typical equity investor in a number of ways. First, the diversified equity investor is not actively involved in the management of the enterprises in which he or she invests.\textsuperscript{300} In contrast, evidence suggests that, rather than viewing

\textsuperscript{296} The Bank Holding Company Act divided banking organizations into a heavily regulated and protected bank component and a less regulated nonbank component. See Eisenbeis, \textit{How Should Bank Holding Companies Be Regulated?}, Fed. Reserve Bank of Atlanta Econ. Rev. 42, 43 (Jan. 1983). It was assumed that, in the event of the bankruptcy of a nonbank affiliate, a court would be unlikely to hold the separately incorporated and regulated bank liable for its affiliate's debts. See Note, supra note 288, at 661-62.

\textsuperscript{297} See supra notes 161-72 and accompanying text. Many bank regulators have endorsed the notion that regulatory firewalls will permit diversification by banks without increasing the likelihood of bank failure. See, e.g., Garsson, supra note 166, at 1, col. 2.

\textsuperscript{298} See Eisenbeis, supra note 296, at 43.

\textsuperscript{299} See supra notes 162-71 and accompanying text. Interaffiliate financial transactions, including the shuffling of resources among different operations, will not necessarily increase risk in a diversified organization. In fact, the ability to allocate cash flows to the highest yielding operations has been viewed as one of the benefits of the conglomerate form of organization. See O. Williamson, Markets and Hierarchies 147-48 (1975). Nevertheless, regulatory restrictions on interaffiliate financial transactions reflect a view that, in banking organizations, the actual allocation of resources among banking and nonbanking operations often will be inefficient. Once bank management chooses to diversify, it may have strong incentives to use bank funds to support its new activities even if such an allocation of resources will impair the financial condition of the bank. See infra notes 307-10 and accompanying text. Such a diversion of funds could actually defeat the risk-reducing effects of diversification. The new regulatory approach prefers banking organizations to treat their separate operations as almost autonomous, on the model of a mutual fund, in order to achieve the maximum benefits of diversification. Yet this management model (and the resulting positive effects of diversification) may be impossible to achieve.

\textsuperscript{300} If the investor did have a management role in one or more of the companies, his disproportionate stake in the enterprise would interfere with his efforts to diversify. See Coffee, supra note 75, at 17-19.
their subsidiaries as passive investments, bank holding companies actively manage their separate bank and nonbank affiliates as integrated operations.\textsuperscript{301} Most financial services are not isolated "lines of commerce" but are actually interdependent activities.\textsuperscript{302} For example, banks do not necessarily view securities underwriting and lending as completely separate businesses, such as auto repair and shoe sales, that serve different markets and can be conducted independently.\textsuperscript{303} To the extent that bank diversification has been successful, banks have developed products that complement their existing businesses and can be marketed in tandem.\textsuperscript{304} In fact, when banks have operated their new activities completely separately from their traditional banking business, either because of regulation or management choice, their ventures have tended to un-

\textsuperscript{301} Studies of bank holding company operating policies indicate that parent companies tend to exercise extensive managerial control over their subsidiaries, particularly nonbank subsidiaries. For example, the majority of members of the boards of directors of nonbank subsidiaries tend to be officials of the holding company or its lead bank; the holding company tends to have final say over the selection of key officers of the subsidiaries; and the holding company tends to exercise general supervision over such matters as structure, funds management and budgets of its subsidiaries. For a discussion of these studies, see Rose, \textit{Bank Holding Companies as Operational Single Entities}, in The Bank Holding Company Movement to 1978: A Compendium 69, 85 (Board of Governors of the Federal Reserve System 1978). Although these studies were conducted before 1978, more recent research confirms this highly centralized management strategy. \textit{See} Eisenbeis, \textit{supra} note 296, at 43.

\textsuperscript{302} \textit{See} Hayes, \textit{supra} note 2, at 56. Hayes cites investment banking as an example. Securities underwriting, trading and advising are not separate businesses but interrelated activities. Leadership in underwriting can be advertised as evidence of corporate finance skill and used to attract business such as advising clients on mergers and acquisitions, which often involve issuances of securities. Leadership in underwriting in turn may depend on the ability to place securities rapidly, requiring a presence in the secondary trading market. \textit{See id.} at 56-57.

\textsuperscript{303} This is demonstrated by recent bank reorganizations that are designed to integrate investment and commercial banking operations and personnel. \textit{See supra} note 274 and accompanying text.

\textsuperscript{304} For example, as the Glass-Steagall Act's restrictions on securities activities have been relaxed, banks have moved quickly into such areas as underwriting commercial paper and municipal revenue bonds. Although underwriting municipal revenue bonds is not as profitable as corporate underwriting, banks already underwrite general obligation bonds, and thus have a network of personnel and customers in place; moreover, banks can offer a full line of municipal bonds to the public, thereby improving their relationships with securities buyers. \textit{See Forde, Banks Make Steady Progress In Municipal Bond Underwriting}, Am. Banker, Apr. 8, 1988, at 1, col. 3. Likewise, although commercial paper underwriting recently has proved unprofitable for many securities firms, \textit{see} Horowitz, \textit{There's Life After Glass-Steagall For Wall Street, Report Says}, Am. Banker, Dec. 2, 1987, at 3, col. 2 (discussing Salomon Brothers' termination of its municipal bond and commercial paper underwriting business), banks can use commercial paper operations to reestablish themselves with major corporations as domestic short-term lenders. In contrast, banks may have more difficulty competing for equity underwriting business, which is less complementary to their present operations. Existing bank customers gain no real advantage in terms of expertise or access to a broad distribution network by using banks to place their equity, and they may be concerned about possible conflicts of interest. \textit{See} Stone, \textit{Business and Bank Reactions to New Securities Powers}, Fed. Reserve Bank of Atlanta Econ. Rev. 41, 45-47 (May 1984).
derperform their independent competitors.\textsuperscript{305} Thus, successful diversified banking organizations are more likely to manage their banking and nonbanking activities as a single operation than to treat them as separate investments.\textsuperscript{306}

Perhaps the most convincing evidence that banking organizations are not likely to treat their diversified activities as separate investments is the frequency with which regulatory firewalls between separate affiliates have been breached. Despite legal restrictions, banks repeatedly have provided financial support for ailing nonbank affiliates, even when such funding has impaired the financial condition of the bank.\textsuperscript{307} Moreover, in some cases, the bank regulators actually have encouraged banks to bail out weak affiliates.\textsuperscript{308} The fact that these breaches of the firewall continue to occur, occasionally even with the acquiescence of the regulators, demonstrates the interdependence of banks and their affiliates. This interdependence involves more than the joint marketing of products or even the sharing of basic services such as data processing. It also results from a strong public perception of banking organizations as single operating entities. For example, confidence in the bank itself can be shaken by losses at an affiliate.\textsuperscript{309} Because the failure of an affiliate may threaten the solvency of the entire banking organization, the bank always has a strong motive to come to the rescue of an ailing affiliate.\textsuperscript{310}

\textsuperscript{305} Traditionally, merger and acquisition advisory activities have not been profitable for banks, in part because of their lack of experience in securities underwriting and dealing. See Horowitz, \textit{Banks Garner Few Domestic Merger Deals}, Am. Banker, Apr. 7, 1988, at 1, col. 2.

\textsuperscript{306} The fact that banks are willing to pay substantial premiums to acquire nonbank subsidiaries suggests that banks do expect considerable synergy to result from the combination of activities. See Rose, \textit{supra} note 301, at 70.

\textsuperscript{307} For example, the failure of Hamilton National Bank of Chattanooga in 1976 has been attributed to bad loans purchased by the bank from its nonbank affiliate in violation of section 23A. See J. Sinkey, \textit{supra} note 42, at 199-202.

\textsuperscript{308} The extensive involvement by many major banks in the 1970s with real estate investment trusts (REITs) as lenders and advisers caused those banks to lend to their REITs when the REITs were in danger of defaulting on their commercial paper. This lending was encouraged by the bank regulators, who feared the possible spillover effect of a REIT failure on its sponsoring bank. For background on the banks' involvement in the REIT crisis, see id. at 237-55.

\textsuperscript{309} See Rhoades, \textit{supra} note 159, at 1142 (adverse publicity surrounding default by bank holding company on its commercial paper resulted in a run on its subsidiary bank).

\textsuperscript{310} A recent dramatic illustration of how flimsy the firewall can be was the loan made by Continental Illinois National Bank and Trust Company of Chicago to its options trading subsidiary, First Options of Chicago, in violation of the bank's lending limits. The bank's motive was to keep its subsidiary, the largest clearing firm for professional options traders, in compliance with regulatory and exchange capital requirements following the October 1987 stock market plunge. See Ringer, \textit{First Options' Luster Was Tarnished in Hard Week at Futures Exchange}, Am. Banker, Oct. 28, 1987, at 1, col. 2. The incident is noteworthy not only as additional evidence of the readiness of banking organizations to breach firewalls, but also as an illustration of the problems with regulation designed to prevent joint operation of affiliates. First, the options subsidiary legally could have been (and ultimately was) funded directly by the bank's parent, Continental Illinois Corporation, which itself relies for funding on the bank. Thus, despite the firewall, banking organizations can and will find ways to channel funds to a failing operation. Second, given
Another difference between the portfolio investor and the diversified banking organization is the investor's approach to the acquisition and disposition of investments. The portfolio investor constantly reevaluates the risk-return relationship of all investments, disposing of those that no longer fit the portfolio. Acquisition or disposal of product lines or whole subsidiaries is not so simple for the banking organization. Although acquisitions of new businesses have been frequent, particularly recently, banking organizations have been reluctant to dispose of operations, in part due to such factors as regulatory concerns, employee pressure and the costs of divestment. Thus, banking organizations have grown largely through accretion, reluctant to terminate businesses that no longer fit their portfolios.

Even if banking organizations theoretically can reduce risk by diversification, portfolio theory does not take into account what has been called operating risk: the risk that the diversified businesses may be poorly managed. If management of a diversified banking organization fails to provide efficient operating policies for or adequate supervision of individual operations, any risk-reducing effect of diversification may be lost. The bank regulators do attempt to evaluate management's skill and performance before they will approve acquisitions of new banks and non-banks. Nevertheless, this screening has not always predicted the management problems that tend to arise in newly diversified enterprises.

Studies of diversified banking organizations have suggested that the bank subsidiaries of bank holding companies tend to be more aggressively managed than independent banks, having higher leverage and holding greater proportions of high yielding, high risk assets.
preference for greater risk may simply reflect the advantages of diversification. Yet further studies have indicated that the new nonbanking businesses of bank holding companies are not necessarily being operated profitably. A study of returns on equity for bank holding company affiliates between 1976 and 1984 found that the median return for nonbank subsidiaries tended to be far below the return for bank subsidiaries, particularly for smaller banks. Other studies have found that the nonbank affiliates of bank holding companies have underperformed their independent competitors. This evidence suggests that bank holding company management of nonbank subsidiaries has not been very successful, making the increased risk in the bank even more troubling.

Finally, regulation designed to force banks to manage their different enterprises like portfolio investments may have some unintended consequences. As some bank economists have pointed out, compartmentalized regulation that divides banking organizations into a heavily regulated bank component and a less regulated nonbank component has led banks to shift activities out of the bank into nonbank affiliates. This in turn actually increases operational interdependencies by making the bank more reliant on its affiliates for necessary services. Forcing banks to place functionally related activities in separate entities leads to the same dilemma: either new ties will be developed among different affiliates as they find ways to coordinate the sharing of customers, information and services, or duplication will increase operational expenses for each individual entity. Thus, the goal of independent operation of banking and nonbanking activities may be self-defeating.

If banking organizations are unlikely to treat their diversified activities as investments in a diversified portfolio, the portfolio approach to risk management is of limited usefulness. Because banking organizations cannot or will not diversify as effectively as portfolio investors, any risk-reducing effects of diversification may not be a sufficient substitute for regulation of bank risk-taking. Moreover, diversification itself may cre-

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320. See Wall, supra note 290, at 26.
321. See Talley, supra note 86, at 42.
322. See Eisenbeis, supra note 296, at 44-45.
323. Ironically, separately operated affiliates also complicate regulatory monitoring of diversified banking entities. Because of the difficulty of examining large diversified banking organizations, the regulators increasingly have looked at the policies, procedures and controls at the holding company level as an indication of the quality of the entire operation. See Hearings on Bank Examination Procedures, supra note 276, at 83 (statement of Charles E. Lord, First Deputy Comptroller of the Currency). Truly autonomous management of holding company subsidiaries instead would necessitate separate examination of each affiliate.
ate new problems of risk control and management both for banking organizations and for the regulatory system.

2. Bank Regulation and Market Discipline

Several reasons may account for increased attention to bank capital levels as other regulatory restraints are dismantled. Bank capital always has been viewed as providing a cushion of protection against bank failure. The recent emphasis on equity as a more significant component of the capital requirement discourages the use of debt as a means of raising capital in order to protect banking organizations from the added cost of servicing large quantities of debt. If a bank runs into trouble, it can skip its regular dividends. In contrast, interest payments impose a regular fixed charge on the bank.

As a practical matter, however, a banking organization may be unwilling to skip dividends, particularly if it expects to raise new capital in the public equity markets. Any cut in the dividend rate may be read as very negative news by the market, leading to lower share prices and higher capital costs. Thus, equity does not necessarily provide banking organizations with greater flexibility than debt. In the long run, particularly if bank equity prices are depressed, raising new equity may prove costly for many banks, actually increasing their risk levels.

Alternatively, the new emphasis on capital may be designed to force some restructuring of bank balance sheets. Banks faced with high capital requirements are likely to shrink their assets in order to avoid the need to raise new capital. Ideally, this may lead to leaner, more efficiently operated banking organizations. Nevertheless, asset size alone says very little about profitability. Some banks may be more profitable in the traditional lending business than in ventures that produce fee income but do not result in asset growth. Again, increased capital requirements do not necessarily result in a reduction in bank risk.

324. Moreover, if there is any chance that this negative news also will affect depositors, causing them to withdraw their funds from the bank, the regulators will be reluctant to require dividend cuts.

325. Issuing equity can be very expensive for a bank. Citicorp paid Merrill Lynch $29 million to place $1 billion in new bank equity in late 1987. Moreover, Citicorp paid out over $300 million in dividends on its common stock in 1987. Thus, in three years, Citicorp will have returned to shareholders almost the entire $1 billion in new capital. See Ohman, High Cost of Capital May Mean Lost Income for Bank Shareholders, Am. Banker, Mar. 4, 1988, at 4, col. 1.

326. See Shaw, supra note 197, at 4, col. 1.

327. See id. at 4, col. 3 (shrinkage of U.S. banks could lead to competitive disadvantage in world markets).

328. The need to raise additional equity has prompted some banking organizations to sell off profitable operations. Manufacturers Hanover Corporation sold its profitable consumer finance subsidiary to raise capital following losses in 1987. Although, in the short run, the sale may improve the banking organization's capital position, in the long run, it means the loss of a major source of earnings as well as a valuable national retail distribution network. See Horowitz, Hanover Puts Consumer Unit Up for Sale, Am. Banker, Mar. 4, 1988, at 1, col. 4.
Increased capital requirements have another, more significant consequence for bank regulation. Any substantial increase in equity capital requirements will force most banking organizations to raise new capital in the public securities market. This in turn will subject banking organizations to the scrutiny and discipline of the equity market. Ideally, shareholders will favor better managed banks, while poorly managed banks will have trouble raising capital. Moreover, large numbers of new shareholders should help to alter the balance of power in highly leveraged banking institutions. The more shareholders that are exposed to risk, the more discipline they may be expected to exert on bank management.

Recent changes suggest that banking organizations are becoming more sensitive to market pressure. Improvements in bank disclosure and analysis indicate that banks are beginning to respond to market preferences. For example, announcements of write-offs of bad loans and major internal restructurings may have been designed in part to improve the banks' image in the market, particularly among analysts. Further, evidence suggests that the market for bank stocks has been a relatively accurate reflector of bank financial condition.

329. These improvements have come about in part as a result of regulatory pressure, see, e.g., 12 C.F.R. § 350.3(b) (1988) (FDIC requires bank Call Reports to be made available to the public upon request); Financial Accounting Standards Board, Proposed Statement of Financial Accounting Standards: Disclosures About Financial Instruments (Exposure Draft Nov. 30, 1987) (proposing to require disclosure in financial statements of market values of all financial instruments), and in part as a result of voluntary efforts to satisfy financial analysts, see Wooden & Paluszek, Disclosure Needs of Financial Analysts: Large Bank Holding Companies, Fed. Reserve Bank of Atlanta Econ. Rev. 77, 79 (Nov. 1983) (describing recent improvements in disclosure).

330. Over the past decade, banking organizations have received greater attention from financial analysts as well as rating agencies. See Stillinger, Sensitivity, Art, and the Shifting Ground of Bank Monitoring, Fed. Reserve Bank of Atlanta Econ. Rev. 42 (Nov. 1983); see also Hicks, Downgraded Ratings Keep Banks Out of Credit Markets, Am. Banker, Feb. 23, 1988, at 6, col. 1.

331. Bank of Boston's announcement in late 1987 that it would write off $200 million of its Latin American loans was viewed as a positive step by the market, ending uncertainty as to the extent of the bank's international debt problems. See Berg, Bank of Boston in Big Write-Off of Latin Loans, N.Y. Times, Dec. 15, 1987, at A1, col. 1; see also Fraust, Citicorp's Debt Move Lifts Stock, Am. Banker, May 21, 1987, at 1, col. 4 (decision to add $3 billion to loan loss reserve ended rumors about international debt problems, leading to stock price rise). Such a move by one bank may force competitors to follow suit to satisfy the fears of the market, even if those competitors are less able to absorb the resulting losses. Thus, the first bank to disclose may thereby obtain a competitive advantage. See Forde, Regionals Follow Bank of Boston in Increasing Loan-Loss Reserves, Am. Banker, Dec. 17, 1987, at 2, col. 1; see also Duffy, Citicorp Move Triggers Drop in British Bank Stocks, Am. Banker, May 21, 1987, at 2, col. 1 (Citicorp's addition to loan loss reserves casts doubt on financial position of other banks with substantial Latin American exposure).

332. See supra note 274 and accompanying text.

333. See Matthews & Neustadt, supra note 145, at 1, col. 4 (bank analysts advocated recent industry restructurings).

334. See Matthews, supra note 186, at 25, col. 1 (decline in share prices of money center banks reflects concern over international debt).
Greater reliance on the stock market to discipline bank risk-taking is consistent with the new regulatory strategy, which views bank safety from the point of view of the equityholder. In addition, it provides a solution to the regulators’ dilemma of how to police risk at diversified banking institutions. The market could assist the bank regulators in two ways. First, shareholders could bring pressure to bear on bad bank management which, in order to improve its share price and lower its cost of capital, would improve its performance. Second, if the market could be counted on to react to changes in bank risk, the regulators could use the market as an indicator of potential problems at banks, thereby targeting their resources.

Nevertheless, it is unclear whether the discipline of the equity market is either attainable or even desirable as a regulatory strategy. Infrequent trips to the equity market may not be enough to expose banking organizations to market discipline. Even with increased capital requirements, banks will continue to generate most of their operating funds from deposits, or, in the case of bank holding companies, the sale of commercial paper, and will raise capital only to the levels required by the regulators. Moreover, banks still may find ways to avoid having to raise new equity in the public securities market, particularly when the market prices of bank stocks are depressed.

More fundamentally, even if the discipline of the equity market could be felt, the risk preferences of bank equityholders may not accord with those of the regulators. Portfolio theory suggests that the ability of equityholders to diversify their investments among different bank and non-bank stocks will enable them to tolerate more risk in any individual investment than an undiversified investor. In contrast, the goal of bank regulation, to prevent losses to the banking system as a result of bank failure, makes the regulatory system overinvested in particular banks.

335. The regulators have considered attempting to encourage similar discipline by the deposit markets by reducing or altering deposit insurance coverage. See, e.g., Federal Deposit Insurance Corporation, supra note 80, at III-11. Such a change, however, could have the unintended effect of increasing depositors’ already strong incentives to participate in sudden and devastating bank runs, which would have no real disciplinary effect on bank management. For a discussion of these and other problems with attempting to force depositors to discipline banks, see Garten, supra note 8, at 129-63. To date, no major changes in deposit insurance coverage have been made.


337. If these sources of funds are sensitive to equity levels, banking organizations may still find that they must voluntarily increase their equity in order to obtain funding. Yet evidence suggests that other indicators of bank financial performance such as dividends, earnings and loan loss rates may be more significant to bank investors than leverage. See Gilbert, supra note 93, at 73.

338. See supra note 186 and accompanying text. In some cases, banks may be able to meet the capital requirements by issuing stock to management or insiders or to employee stock option plans.
whose failure poses systemic risks.\textsuperscript{339} As undiversified investors, the regulators cannot afford the degree of risk-taking by a banking organization that may be preferred by the bank's diversified shareholders.

Another problem with shareholder discipline is that, unlike the regulators, shareholders need not make a long-term investment in their bank. A shareholder may tolerate excessively risky behavior at a bank as long as its risky ventures are profitable, because he or she can sell the stock as soon as problems begin to arise. In contrast, the regulators' long-term commitment to the bank requires the regulators to take a longer view of bank risk. A bank that today is earning a return of 12 percent on a portfolio consisting solely of ten-year loans will make a profit so long as interest rates on its liabilities remain at 11 percent. Yet in evaluating this bank, the regulators must consider what will happen if interest rates rise above 11 percent in eight or nine years. In contrast, the average shareholder today does not expect to be holding the stock even five years from now.\textsuperscript{340}

The volatility of the equity market also creates the danger of possible overreactions to information. Bank disclosures often prompt dramatic price swings that seem out of proportion to either the seriousness or the timeliness of the news. For example, rumors of continuing international debt problems at some money center banks lead to declines in the stock prices of all large multinational banking organizations. One bank announces a substantial addition to its loan loss reserves; its share price soars, although the write-off of the loans will result in large losses and represents only a portion of the bank's total international loans. The stock prices of other banks decline further, as the market waits to see if these banks will make similar announcements.

Although this scenario is hypothetical, concern about international debt has led to similar sudden stock price movements based on rumors, predictions and actual announcements.\textsuperscript{341} The sensitivity of the market for bank stocks may be due in part to the elusive quality of much of bank disclosure. Credit quality, liquidity and other determinants of bank financial condition are very hard to quantify.\textsuperscript{342} Because the equity mar-

\textsuperscript{339} See supra note 227.

\textsuperscript{340} Some observers have suggested that bank subordinated debt may be a more effective source of discipline on bank risk-taking than equity, because such debtholders tend to have a longer commitment to the bank and are more risk averse than equityholders. See, e.g., Gilbert, supra note 93, at 73; Horvitz, A Free Market Approach to Saving Troubled Banks, Am. Banker, Dec. 10, 1987, at 4, col. 1. Nevertheless, a recent study found risk premiums on bank subordinated debt to be unrelated to traditional accounting measures of bank performance and only weakly related to private-sector bond ratings, casting doubt on the effectiveness of these debtholders' discipline. See Avery, Belton & Goldberg, Market Discipline in Regulating Bank Risk: New Evidence from the Capital Markets, 20 J. Money, Credit, and Banking 597, 608-09 (1988).

\textsuperscript{341} See supra note 331; see also Matthews, supra note 186, at 25, col. 1 (blaming share price erosion of money center banks on concern over future international debt problems).

\textsuperscript{342} See Stillinger, supra note 330, at 43 (bank analysis must allow considerable latitude for the exercise of individual judgment). A recent accounting proposal to require
ket often overreacts to news about banks, a policy that forces banks to be more sensitive to the equity market may create a new risk to the banking system. For example, sudden negative publicity following announcement of large loan losses may prevent a banking organization from raising capital in the public equity market. Yet the bank’s inability to raise capital may cause it to violate the minimum capital requirements. At this point, any regulatory action to force the bank to increase capital will only lead to further negative publicity, compounding the bank’s problems in raising new equity.\textsuperscript{343}

These unintended consequences of shareholder discipline raise a question as to the regulators’ motive in attempting to facilitate greater market discipline of banking institutions. It is unclear whether the regulators actually trust the equity market to exert effective control over risk-taking at banks, or whether their real aim is to force the preferences of the regulators as to risk-taking on both banks and their shareholders. The difference between these goals can be illustrated by the new bank capital requirements. Although forcing banks to increase equity theoretically exposes bank management to the discipline of the securities market, the adequacy of capital is tied to the types and riskiness of assets in the bank’s portfolio.\textsuperscript{344} If a bank limits its future investments to United States treasury securities, no additional capital will be required, allowing the bank to avoid the expense and uncertainty of an equity offering.\textsuperscript{345} Although a portfolio of government securities may not be attractive to shareholders in search of high returns, bank management and existing shareholders may be persuaded to reduce the riskiness of the bank’s portfolio rather than to incur the expense of raising additional capital.

The regulators’ often ambivalent attitude toward disclosure also has reflected a desire to use disclosure as a weapon to enforce regulatory standards rather than simply to inform the market. For example, the regulators repeatedly have suggested the need for special disclosure of regulatory enforcement actions\textsuperscript{346} brought against banks.\textsuperscript{347} In many

banks to disclose information about credit risk and market values of their financial instruments has been criticized by observers on the ground that the banks themselves cannot determine the risk-adjusted cost or market value of many of their own products. See Weiner & Forde, Plan to Force Banks to Disclose Risk is Criticized, Am. Banker, Dec. 2, 1987, at 2, col. 1; \textit{supra} note 329.

\textsuperscript{343.} A similar problem could arise if a bank were forced to cut its stock dividend as a result of losses. See \textit{supra} note 324 and accompanying text.

\textsuperscript{344.} For a description of the risk-based capital requirements, see \textit{supra} notes 187-97 and accompanying text.

\textsuperscript{345.} United States treasury securities are accorded a weight of zero in determining total assets for application of the capital to assets ratio. See Risk-Based Capital Guidelines, \textit{supra} note 187, at 4214.

\textsuperscript{346.} See \textit{supra} notes 207-23 and accompanying text (describing regulatory enforcement powers).

\textsuperscript{347.} See, e.g., 12 C.F.R. § 350.4(b) (1988) (FDIC may require disclosure of enforcement actions in annual disclosure statements to be made available to shareholders, customers and the public “where the FDIC deems it in the public interest”). For banks and bank holding companies subject to the periodic disclosure requirements of the securities
cases, this disclosure may provide no real new information to the market, except to indicate the regulators' concern. If the regulators bring an action to force a bank to increase capital, the equity market is already aware of and presumably has taken into account the low level of capital at the offending institution.

Under these circumstances, disclosure of the enforcement action may have several possible effects. Initially, the shock value of the special disclosure may focus the market's attention on the bank in question. This may lead to a negative reaction on the part of bank shareholders. If the bank subsequently takes steps to raise its capital, however, the market may be reassured.\textsuperscript{348}

In addition, the disclosure may have an effect on other banks with low levels of capital. Announcement of the enforcement action against one bank may affect the market's perception of all similarly situated banks, since shareholders will anticipate similar enforcement actions against other institutions. In order to prevent a negative market reaction, other banks may voluntarily take steps to increase capital. Thus, the ultimate effect of the disclosure is to persuade bank management to take steps to comply with regulatory preferences in order to avoid the necessity for such disclosure.\textsuperscript{349}

Nevertheless, experience demonstrates that regulatory attempts to force bank management and shareholders to become risk averse can have unintended effects. The market for bank equities does not always react in ways that the regulators might expect. For example, the regulators traditionally have resisted disclosing their own internal examination data and ratings of banks for fear of a negative market reaction.\textsuperscript{350} Yet the occasional accidental release of this information has not had a significant effect on the market for bank stocks.\textsuperscript{351} Presumably, equityholders were

\begin{itemize}
  \item[348.] For example, in 1984, the Comptroller announced that two large banks, Bank of America and First Chicago, had entered voluntary agreements to increase their capital and correct other deficiencies; according to the Comptroller, this disclosure was designed to reassure the market that the banks' problems had been identified and were being corrected. See \textit{Garsson & Trigaux, Comptroller Steps Up Pressure on Big Bank Capital Adequacy}, Am. Banker, Nov. 19, 1984, at 17, col. 1.
  \item[349.] This was the only possible motive for some regulatory disclosure policies, such as the FDIC's publication of the identities of certain depositors who placed funds through money brokers in banks that subsequently failed. See \textit{Brokered Deposits in Weak Institutions Strain Insurance Fund According to FDIC}, [1984-1985 Transfer Binder] Fed. Banking L. Rep. (CCH) \| 86,189 (Mar. 11, 1985).
  \item[350.] Although the regulators have the authority to publish their examination reports if the bank fails to comply with their recommendations, see 12 U.S.C. \S\ 481 (1982 & Supp. V 1987) (national banks); \textit{id.} \S\ 1828(F) (insured state-chartered banks), this seldom occurs. Without regulatory permission, a bank may not disclose its own examination data. See, e.g., 12 C.F.R. \S\ 7.6025 (1988).
  \item[351.] See, e.g., \textit{Murphy, Disclosure of The Problem Bank Lists: A Test of The Impact},
\end{itemize}
already aware of the difficulties experienced by the banks in question, or discounted the disclosure, making their own risk assessments. Thus, the actual market effect of special selective disclosure may not be sufficient to have any real deterrent effect on bank management and shareholders.\textsuperscript{352}

Therefore, neither capital requirements nor selective disclosure necessarily will cause shareholders to accept the preferences of the regulators as to bank risk-taking. Although increasing shareholder discipline may have the beneficial effect of putting pressure on overly cautious bank management to improve its performance, the regulators' strategy may backfire if banks are pressured by the market to achieve rapid earnings growth in order to appeal to shareholders. A regulatory policy that forces bank exposure to the market may cause banks to take too many new risks too quickly.

Ironically, one way to pressure shareholders to become more averse to risk would be to combine increased capital requirements with a return to the historical assessability of bank shares.\textsuperscript{353} This assessability gave shareholders an additional financial stake in their banks, causing them to be more risk averse. As a practical solution to the problem of risk control in diversified banks, however, assessability of bank shares has obvious drawbacks. It is likely that equityholders would react by simply avoiding bank stocks altogether.\textsuperscript{354} Without some incentives for bank shareholders to become more risk averse, however, reliance on the equity market to set limits to bank risk-taking may be misplaced.

10 J. Bank Research 88, 89 (Summer 1979) (study of stock price movements following publication of regulators' internal problem bank lists found no significant market reaction to disclosure of the lists).

352. The regulators' occasional attempts to use disclosure to have a positive effect on the market also have failed. For example, one week before the federal financial assistance plan for Continental Illinois was announced, the Comptroller's office issued a press release intended to reassure the market, stating that it was unaware of any significant changes in the bank's operations that would serve as the basis for rumors as to the bank's impending failure. See Continental Hearings, supra note 24, at 273. This announcement did not stem the deposit run on the bank by large depositors.

353. Until the 1930s, shareholders of national and most state banks were subject to double liability up to the par value of their shares to satisfy creditors in the event of bankruptcy. See United States v. Knox, 102 U.S. 422, 425 (1880). Because of problems of collection and the small amount of equity relative to total deposits, this double liability afforded only limited protection to depositors. See Note, Branch, Chain, and Group Banking, 48 Harv. L. Rev. 659, 669 n.77 (1935). Following creation of the federal deposit insurance system, provisions for double liability gradually were repealed. See Vincens, On The Demise of Double Liability of Bank Shareholders, 75 Banking L.J. 213, 214-15 (1958).

354. Since many banks today are wholly owned by bank holding companies, an assessability requirement would have to apply to holding company shareholders. Cf. Anderson v. Abbott, 321 U.S. 349, 355 (1944) (applying statutory assessment on insolvent bank shares to holding company shareholders). In fact, the regulators' policy of requiring bank holding companies to provide financial support for their subsidiary banks in the event of financial problems may already serve as a form of assessment on bank shares for bank holding companies and their shareholders. The results of this policy, however, have not been entirely satisfactory. See infra notes 355-67 and accompanying text.
3. Bank Regulation and Problem Banks

The contradictions inherent in the new regulatory approach are perhaps best illustrated by the problem of bank failure. From the viewpoint of a diversified equityholder, losses resulting from the failure of any one investment may be adequately offset by profits made on other investments. Thus, "looting" profitable investments to bail out unprofitable investments may be counterproductive, potentially weakening the healthy enterprises.

Although the new regulatory strategy does attempt to maintain a firewall between a diversified banking organization's investments in order to prevent such looting, this policy presents theoretical and practical problems in the case of the impending failure of a bank. Although the regulators recognize that banking organizations today are diversified entities, ultimately, the regulators are concerned about protecting the traditional deposit-taking component of the diversified company, not its nonbanking operations. Thus, the regulators' attitude toward diversification as somewhat ambivalent. The regulators welcome diversification so long as it strengthens the banking organization as a whole, thereby protecting its banking operations. Once banking operations are threatened, however, the regulators' priority is the future of the bank, not the health of the entire organization.

The contradiction inherent in this regulatory approach is suggested by the regulators' attitude toward interaffiliate transactions in a diversified bank holding company. Rules governing such transactions prevent the use of bank funds to assist nonbank affiliates, but are not concerned with the possible abuse of nonbank affiliates for the benefit of the bank. A recent regulatory proposal for bank product deregulation suggested as a benefit of diversification that nonbank affiliates could be sold to raise capital for the bank during times of adversity. Moreover, the Federal Reserve Board recently reaffirmed its position that bank holding companies are expected to serve as a source of "financial and managerial strength" to their subsidiary banks by ordering a bank holding company with thirty-two subsidiary banks to inject $1.2 million in new capital into one failing bank subsidiary. When the bank holding company

355. See supra notes 293-99 and accompanying text. As previously noted, in some cases, shifting funds from profitable to unprofitable operations may be in the long term interest of a diversified organization if such allocation of funds improves overall performance. See supra note 299. Nevertheless, transferring funds between operations leads to distortions if the sole justification is to prop up inefficient and ailing operations.

356. See supra note 162 and accompanying text (discussing Federal Reserve Act § 23A).

357. See Mandate for Change, supra note 154, at 93,019. Section 5(e) of the Bank Holding Company Act permits the Federal Reserve Board to require a bank holding company to terminate nonbanking activities or divest nonbank subsidiaries if they constitute a serious risk to the financial safety, soundness or stability of a subsidiary bank. See 12 U.S.C. § 1844(e) (1982).

refused, pointing to agreements with its own creditors that prevented additional investment in its subsidiaries, the Board brought a disciplinary action against the bank holding company charging it with unsafe and unsound practices.\textsuperscript{359}

The regulators' policy of requiring bank holding companies to serve as a source of financial and managerial strength to their subsidiary banks presents a philosophical conflict with the regulators' other policy of encouraging compartmentalized portfolio management of diversified banking organizations. The latter policy contemplates management of subsidiaries as independent profit-making operations; the former requires management of the diversified operation with the goal of ensuring a flow of funds to the bank. Moreover, proper management of a diversified portfolio may mean that unprofitable operations are sold or shut down. Yet if the unprofitable operation is a bank, the regulators may require the banking organization to divert resources from more productive businesses to keep the ailing bank solvent.\textsuperscript{360}

These two regulatory policies involve more than simply a conflict in management philosophy. In practice, banking organizations are far more integrated than the portfolio approach to bank diversification suggests. Thus, banking organizations are likely to channel funds to rescue a troubled affiliate as a result of both operational interdependencies and public perception of a banking organization as a single entity.\textsuperscript{361}

Nevertheless, by encouraging a different managerial approach, the new regulatory strategy actually may lessen the ability and willingness of banking organizations to stand behind their subsidiary banks. Geographic and product diversification creates more demands on and opportunities for use of financial resources, particularly as new activities may involve extensive start-up costs. A banking organization's resources no longer will be devoted exclusively to its banking operations.

In addition, recent bank regulatory initiatives have encouraged both the shrinking of traditional bank assets\textsuperscript{362} and the movement of activities

\textsuperscript{359} See Mandate for Change, supra note 154, at 93,026 (Hawkeye Bancorporation). The Board ultimately withdrew its complaint, but issued a policy statement confirming that a bank holding company "should stand ready to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity." See Board of Governors of the Federal Reserve System, Policy Statement on the Responsibility of Bank Holding Companies to Act as Sources of Strength to Their Subsidiary Banks, 4 Fed. Banking L. Rep. (CCH) ¶ 43,055A (Apr. 24, 1987).

\textsuperscript{360} In one recent case, the bank regulators attempted to force a bank holding company to contribute $400 million derived from the sale of its nonbank subsidiaries to increase capital at its failing bank subsidiaries. See Klinkerman, US Balks as MCorp Seeks to Shield Assets, Am. Banker, Oct. 13, 1988, at 1, col. 2.

\textsuperscript{361} See supra notes 307-10 and accompanying text. This suggests that ordinarily a banking organization will have strong incentives to bail out its subsidiary banks as well as other important affiliates.

\textsuperscript{362} See supra notes 326-28 and accompanying text (effect of more stringent capital regulation).
out of banks into separate nonbank affiliates.\textsuperscript{363} These developments render any single bank subsidiary a relatively less important part of the entire banking organization than in the past. Management may find it increasingly hard to justify directing a disproportionate amount of the organization's total resources to any individual bank subsidiary, particularly if the banking operations are not a significant source of profits for the entity as a whole.

Therefore, diversification and more efficient portfolio management, both of which are encouraged by the new approach to bank regulation, may mean that less, not more, resources will be devoted to strengthening banking operations. Two additional developments may exacerbate this trend. First, because diversification permits greater risk-taking in individual investments, banks in diversified banking organizations may be operated in a riskier manner, a phenomenon that already has been noted.\textsuperscript{364} Thus, the banking operations of today's diversified banking organization may be inherently riskier than they used to be, creating a greater possibility of financial difficulty and failure. Second, efforts to increase capital in banking organizations introduce into the banking system an enlarged group of equityholders who are interested in the profitability of the entire banking organization. Equityholders will resist use of the banking organization's earnings to prop up a single troubled bank subsidiary.\textsuperscript{365}

The conflict in regulatory strategy may be most pronounced when a bank subsidiary fails. It is generally assumed that a bank's failure will have spillover effects on affiliated banks in the form of bank runs, and even on nonbank affiliates, which tend to have business and other ties to the bank. Moreover, the loss of a bank subsidiary could deprive the banking organization of a major source of income. Yet the new regulatory strategy aims to minimize these organizational interdependencies.\textsuperscript{366} Ideally, for a diversified bank holding company with strong firewalls between affiliates, the failure of one bank subsidiary may not even threaten the rest of the organization. On the other hand, extensive funding of a failing bank subsidiary by its holding company or its other bank or non-bank affiliates could impair the financial stability of the entire enterprise. In this case, the bank holding company may be better off liquidating the bank rather than draining resources from healthy operations. In view of

\textsuperscript{363} See \textit{supra} notes 322-23 and accompanying text (effect of compartmentalized regulation).

\textsuperscript{364} See \textit{supra} notes 318-19 and accompanying text.

\textsuperscript{365} Holding company debtholders also have reason to resist the use of holding company assets to protect bank debtholders. See Klinkerman, \textit{supra} note 360, at 14, col. 4 (large bank holding company debtholders likely to sue bank holding company management if corporate assets are transferred to failing bank subsidiaries).

\textsuperscript{366} If the bank and nonbank affiliates do not share services, customers or even names, both operational interdependencies and public perception of the affiliation may be reduced, minimizing spillover effects. Moreover, a strongly capitalized bank holding company is less dependent on bank stock dividends for its own funding. See \textit{supra} notes 183-84 and accompanying text (risks of double leveraging).
management's fiduciary duty to its shareholders, this may be the only feasible alternative.\textsuperscript{367}

Thus, banking organizations actually may be more willing to accept bank failure than the regulators. For the regulators, a decision to liquidate a bank is not so simple: they must consider the cost to the insurance fund and the effect on depositors and other banks, which lead the regulators to avoid bank closings. Yet a regulatory policy of forcing banking organizations to support their failing bank subsidiaries not only goes against the logic of the regulators' new strategy, but can lead to financial strain on the entire operation. In that case, maintenance of this policy ultimately may require the regulators to deal with the consequences of failure of an entire banking organization, not just a single subsidiary bank.

IV. THE FUTURE OF THE NEW BANK REGULATION

The new approach to bank regulation that has been described in this Article leaves two unanswered questions. First, it is unclear who will bear primary responsibility for managing risk in deregulated banking institutions, the bank regulators, bank management or bank shareholders. Second, it is unclear how the bank regulators can ever control risk-taking in the large diversified banking organizations of the future.

These problems will not be solved by returning to traditional strategies of regulation. Initially, neither Congress nor the bank regulators are likely to restore the formal system of controls that once characterized bank regulation. In view of the momentum for further deregulation of banking, the regulators simply will not be able to halt bank diversification and growth. Moreover, developments in the markets in which banks operate have made traditional regulatory techniques anachronistic. Thus, all observers of bank regulation today are to some degree deregulators. They differ only as to the desirability and efficacy of the new regulatory techniques, such as firewalls and capital requirements, in controlling bank risk in a deregulated banking environment.

The growing pains that the bank regulatory system currently is experiencing suggest a need not to return to traditional regulation, but to rethink the approach of the new regulatory strategy. Traditional regulatory techniques that mandated a particular investment policy for the banking industry deprived banks of the flexibility needed to adapt their business to an altered financial market. Yet recent regulatory initiatives that attempt to impose specific operating requirements on a deregulated banking industry ultimately may create similar problems. For example, the model diversified banking organization consisting of independent, separately operated banking and nonbanking components

\textsuperscript{367} Cf. Eisemann & Budd, \textit{Bank Holding Company Capital Planning Approaches}, 4 Issues in Bank Reg. 27, 28 (Summer 1980) (concluding that parent organization is unlikely to come to the rescue of an ailing subsidiary).
may not in fact prove to be either the most profitable or the safest way for all banks to enter new businesses. More important, regulation that mandates this particular structure hampers the ability of banks to make alterations within their organizations in response to internal crises or future changes in the banking business.

The most significant lesson to be learned from the failure of traditional regulation may be that future regulation must permit banks sufficient flexibility to develop different operating policies in response to continuing market changes. This suggests that attempts to legislate a new structure for a deregulated banking industry may be unsuccessful. Rather, regulatory reform requires some rethinking of the role that bank regulation itself should be playing in the governance of modern banking organizations. If direct regulatory controls over the structure and business of banks are unworkable, then more effective regulatory strategies for managing bank risk must be developed.

This Part suggests two possible visions for the bank regulation of the future. One alternative would be to complete the process of deregulation of the banking industry, leaving responsibility for determining the organizational structure, business and risk posture of individual banks to their managers and owners. In this deregulated banking environment, regulation would continue to serve only two functions. First, regulatory efforts could be devoted to facilitating market discipline through improved public disclosure and accounting requirements. Second, the regulators presumably would continue to play some role in handling bank failure when it occurred.

An inevitable consequence of this minimal regulatory approach is that it is likely to result in more frequent bank failures. Such a result may be tolerated or even welcomed by the securities market. Bank shareholders are likely to be less risk averse than bank regulators. Moreover, as banks are forced to adjust to a deregulated banking environment, failure initially may serve to eliminate poorly managed or weak banks.

Nevertheless, it is unclear whether the bank regulatory system can tolerate the dislocations caused by more frequent bank failures, particularly the resulting drain on the resources of the deposit insurance system. If individual bank failures create additional risks for solvent institutions, for example, by leading to deposit runs at healthy banks, any substantial increase in the number of bank failures may pose a threat to the safety and soundness of the banking system, defeating the goal of the new regu-
Even if individual failures do not have serious spillover effects on solvent banks, too many bank failures are likely to threaten the solvency of the insurance fund. The only solution then may be to reinstitute some form of protective regulation in order to shield banks from risk-taking that may cause their failure. Thus, unless deposit insurance itself is eliminated or curtailed, which is very unlikely, some form of regulatory control over bank risk-taking is inevitable.

Therefore, the regulators will continue to play a significant role in determining how risk is managed at modern banking organizations, particularly during any transitional period following the dismantling of traditional regulatory controls. As previously noted, however, the regulators' attempts to manage bank risk in deregulated banking organizations create problems of regulatory monitoring and control of diverse and complex institutions. Obviously, the regulators cannot expect to engage in day-to-day administration of banking operations. Attempts to serve as the "shadow management" of the banking industry will be unsuccessful.

Although the regulators cannot hope to direct the day-to-day affairs of a bank, they can become a more powerful constituency within the banking organization. Like bank shareholders, the regulators can bring pressure to bear on bank management to control its risk-taking. Moreover, the same techniques that are used by shareholders to influence management policy are also available to the regulators. Shareholders rely on two powerful weapons to make management more responsive to their preferences: their decision to supply or withhold capital from particular organizations, depending on their assessment of management, and their

371. See supra note 8 (describing goals of bank regulation).

372. Recent financial difficulties experienced by the thrift insurance fund have raised questions as to the ability of the federal deposit insurance fund to absorb losses from massive bank failures. See McTague, FDIC Chief to Answer League Critics: Seidman Will Face Group's Convention To Rebut Claims that Fund is Shaky, Am. Banker, Oct. 31, 1988, at 1, col. 3 (FDIC Chief denies that fund is near bankruptcy).

373. In the past, concern over the adequacy of the insurance fund has led to increased regulatory oversight and control of banks. For example, regulatory intervention to keep failing banks open through federally assisted mergers or direct assistance, although criticized as undermining market discipline of bank management, has been justified as the only way to prevent exhaustion of the deposit insurance fund as a result of large or numerous bank failures. See Isaac, supra note 11, at 203. Other solutions to the deposit insurance crisis likewise would give the regulators new and extensive authority over the affairs of banks. Any form of risk-based premium structure for deposit insurance would require new regulatory powers to investigate and compel disclosure of information relating to bank management. Moreover, in setting individual risk ratings, the regulators would be sending a powerful signal to the market that could affect banks' ability to obtain funding or even their solvency. See id. at 207-08; Garten, supra note 10, at 247 n.26.

374. Even proponents of deregulation support retention of deposit insurance. See supra note 11.

375. See supra notes 264-86 and accompanying text.

376. See Clarke, supra note 283, at 10, col. 2.
power to remove or replace management for poor performance. The bank regulators have devoted considerable effort to enhancing shareholders' ability to exercise these powers by improving bank disclosure and forcing banks to resort more frequently to the capital markets to raise new equity. Yet these shareholders' techniques for disciplining corporate management also may be the regulators' most effective weapons in controlling bank risk-taking.

Effective employment of these tools, however, will require some improvement in bank regulatory technique. The ability to exert effective pressure on bank management requires careful monitoring of management performance. The bank regulators repeatedly have attempted to improve shareholder monitoring of bank risk-taking. Regulatory monitoring must be at least as good as that of private analysts and the securities market if the regulators are to exert any influence over bank policy. In view of the increasing cost and diminishing usefulness of traditional on-site examinations of diversified banking institutions, the regulators may have to rely increasingly on private sector analysis to assist them in gathering and assessing comparative information about banking organizations.

In addition, the regulators must improve existing incentives for bank management to respond to regulatory preferences with respect to risk-taking. Unlike shareholders, the regulators do not supply funds directly to individual banking organizations, but certain forms of regulatory "capital" traditionally have been significant to bank management. Because bank acquisitions and many other corporate decisions have required explicit regulatory approval, banks seeking to expand their operations have had reason to cultivate the good will of the regulators. Moreover, the regulators' broad discretion to decide applications for expansion has enabled the regulators to engage in some creative conditioning in applying regulation to individual banks. For example, the regulators' authority to take into account a bank's financial and managerial resources in ruling on an application has permitted the regulators to condition approval on the applicant's undertaking to raise its capital or otherwise to improve its performance.

Thus, the regulators already have the ability to reward or penalize

377. Shareholders may exert this power through election of the board of directors or, more frequently, through takeovers, which enable shareholders who are dissatisfied with management performance to register their disapproval by tendering their shares to a rival bidder. In addition, shareholders may penalize bad management by suing their directors for money damages for breach of their fiduciary duty to the corporation. See W. Klein & J. Coffee, supra note 173, at 178-79.

378. See supra notes 326-36 and accompanying text (capital requirements).

379. See supra notes 329-34 and accompanying text.

380. The regulators intend to make greater use of outside auditors to assist them in gathering information. See, e.g., Rehm, FDIC to Urge Outside Audits for Banks It Insures, Am. Banker, Jan. 6, 1988, at 3, col. 2.

381. See supra note 12 (describing this conditioning power).

382. See supra note 176 and accompanying text.
management performance through flexible application of their supervisory authority. Ironically, as deregulation proceeds, this authority may be diminished. If remaining regulatory controls on bank investments are removed, banks no longer will have to apply formally to the regulators before engaging in new activities.

The check on bank management traditionally provided by the approval process provides a strong justification for retaining the requirement for prior regulatory approval at least of major corporate decisions such as acquisitions of new affiliates and changes in control. In reviewing applications, the regulators should concentrate on management quality and performance record, using their authority to deny or conditionally to approve an application as a means of disciplining bank management. Although management quality is difficult to evaluate, the regulators can look at such objective factors as past earnings record, stock price performance and the existence of effective internal control mechanisms. These are the same factors that shareholders look to in predicting a company's future performance.

Use of the application process to discipline management may be criticized as a crude and arbitrary means of exerting influence on management policy. Banks may easily avoid the discipline simply by deciding not to expand their operations. Nevertheless, although most banks may resort to the application process infrequently, they must take into account the possibility that they may require regulatory approval of an application at some future time. Thus, it is in the interest of management to be responsive to the regulators' preferences in order to bank some reg-

383. Banking statutes already require the regulators to evaluate management quality in deciding applications for major acquisitions. See supra note 317.

384. The existing approval process is complicated by the fact that a banking organization's decision to expand banking or nonbanking operations may require approval by a different regulatory supervisor—applying different statutory standards—depending on which specific corporate entity within the banking organization is to be used for expansion. For example, new nonbanking activities may require the approval of the Federal Reserve Board if they are to be conducted by a nonbank subsidiary of a bank holding company; if they are to be conducted by the bank, they may be regulated by the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation or a state banking supervisor, depending on the charter or insured status of the bank and its membership in the Federal Reserve System. See supra note 248. The danger of conflicting or inconsistent supervisory standards may provide a reason for requiring banking organizations to expand their activities through nonbank subsidiaries of a bank holding company to ensure that a single supervisory authority (in this case, the Federal Reserve Board) will be able to control the application process. Such a requirement, however, will not entirely solve the problems created by the existence of competing supervisory authorities, each of which would still have authority to approve corporate decisions other than expansion into new nonbanking activities. This suggests the need for closer coordination among the different bank regulators in developing consistent supervisory standards for banks. More generally, the existing division of authority among bank regulators based on corporate form—state bank, national bank, bank holding company—will only hamper regulatory efforts to improve supervision of the restructured and diversified banking organizations of the future. See supra notes 275-82 and accompanying text.
Moreover, the effectiveness of this discipline depends entirely on the ability or willingness of the regulators rigorously to exert their authority in deciding applications. Countervailing factors, such as the need to arrange a merger of a troubled bank or fear of possible negative publicity for the bank following denial of its application, may cause the regulators to be unduly lenient in evaluating management quality in individual cases. These individual considerations may impede the development of clear and predictable standards for granting or denying applications.

Nevertheless, some flexibility in administering standards is desirable in the creative conditioning process, since it permits the regulators to negotiate with individual applicants and tailor solutions designed to address their specific problems. For example, the regulators might be willing to tolerate below-average performance by a bank that has exhibited its commitment to improve by replacing management and developing new operating procedures. At a minimum, bank management will be aware that, to be successful in the application process, it cannot simply ignore past problems, but must take some affirmative steps to improve its performance.

In addition to their ability to withhold or supply regulatory capital,

385. The discipline exerted by the capital markets on corporate management also may be indirect. Many corporations rely on internally generated funds for most of their financing needs and resort directly to the capital markets infrequently. Nevertheless, management still cannot afford to ignore the securities market's reaction to its performance. If the market value of the corporation's stock drops too far, the company may become the target of a takeover by an outsider that believes that it can improve the firm's market value by better management. Similarly, bank management that deliberately avoids the regulatory approval process will be hampered in its ability to expand the bank's operations and adjust to new competitive forces. This in turn may lead to negative shareholder reaction and a possible takeover.

386. The regulators can avoid actually denying an application by requiring applicants to meet with them informally to discuss the application before it is formally filed; if the applicant cannot or will not meet the regulators' conditions and does not want to risk a denial, it will not file an application.

387. For example, the regulators' record in enforcing the Community Reinvestment Act of 1977, 12 U.S.C. §§ 2901-2905 (1982), which requires the regulators in acting on an application for expansion to take into account the applicant's record in helping to meet the credit needs of the local community, has been criticized by some observers as overly cautious and ineffective. One explanation may have been a lack of consensus as to what banks should be doing to serve local credit needs. But see Bank of Boston Corp., 75 Fed. Res. Bull. 35, 37 (1989) (describing typical elements of effective CRA programs). In contrast, the regulators have had long experience in assessing and setting minimum standards for bank financial and management performance.

388. In its recent approval of corporate securities underwriting powers for bank affiliates, the Federal Reserve Board has required each applicant to develop operational and management procedures, such as computer, audit and accounting systems and internal risk management controls, which must be examined and approved by the Board before the new underwriting activities may be commenced. See Morgan/Chase/Bankers Trust/Citicorp/Security Pacific, supra note 119, 75 Fed. Res. Bull. at 206. Requiring bank management to develop its own internal control procedures in this case may be a better way to manage any new risks that may arise out of underwriting activities than for the regulators to impose detailed new structural and operating requirements. The regulators
the regulators, like shareholders, have the power to penalize management directly for poor performance. The regulators can remove or impose direct penalties on bank managers for actual fraud or negligence in operating a banking institution. Nevertheless, it is generally agreed that the regulatory enforcement powers have not been used frequently or effectively enough to have had much of a deterrent effect on bank risk-taking. Too often, enforcement actions have been brought only after the bank has failed, too late to have any influence on bank management policy.

Simply increasing the number of enforcement actions that are brought against bank management, however, may not necessarily improve management performance. The limited effectiveness of current enforcement powers actually may be due in part to the very breadth of existing disciplinary authority. The enforcement powers permit the regulators to punish broadly defined conduct, such as "continuing disregard for the safety or soundness of the bank," the scope of which is determined by the regulators themselves. Moreover, unlike the approval process for regulatory applications that encourages negotiation between the bank and the regulators, the enforcement process is adversarial, resulting in the imposition of potentially serious penalties on management such as removal from office or personal liability. In light of the severity and unpredictability of the enforcement powers, too frequent exercise of the powers may simply discourage candidates from becoming bank directors or officers rather than encouraging greater care in managing banks.

generally could require banks to demonstrate effective internal operating policies and an adequate performance record as a condition to approval of any application.

389. See supra notes 198-223 and accompanying text.
392. See Brickner v. Federal Deposit Ins. Corp., 747 F.2d 1198, 1202 (8th Cir. 1984) (FDIC has discretion to define breach of fiduciary duty for purposes of the removal statute).
393. The regulators' apparent preference for flexible solutions may account for the infrequent use of the formal enforcement powers as opposed to jawboning and other informal techniques of persuasion. See supra note 201 and accompanying text. Yet these informal techniques have been criticized as ineffective in correcting management problems before they lead to bank failure. See, e.g., House Comm. on Government Operations, Combating Fraud, Abuse, and Misconduct in the Nation's Financial Institutions: Current Federal Efforts Are Inadequate, H.R. Rep. No. 1088, 100th Cong., 2d Sess. (1988) (finding efforts by regulators to detect and prevent fraud, abuse and misconduct to have been inadequate).
In addition, the different risk preferences of the regulators and bank shareholders may subject bank management to conflicting duties. For example, the regulators may deem a decision by management of a diversified banking organization not to support an ailing bank subsidiary to be an unsafe or unsound practice warranting an enforcement action against management. Yet a decision to support the subsidiary could be harmful to the banking organization as a whole, prompting complaints and possibly even a derivative action against the directors by its shareholders. Moreover, any penalty imposed by the regulators on the banking organization, such as removal of its directors, could lead to disruption of its operations and negative market reaction, resulting in injury to its shareholders. Thus, aggressive use of the disciplinary powers could result in significant interference with the operations of the bank.

These problems with the regulatory enforcement powers suggest the need for changes in their interpretation and use if they are to be effective in disciplining bank management. Initially, the regulators must develop clearer standards for exercise of their powers, for example, by clarifying what conduct by bank management will be considered to amount to a breach of fiduciary duty sufficient to justify removal. Clearer standards not only will assist potential targets of enforcement actions, but also may solve the problems that the regulators are facing in attempting to use their enforcement powers to improve the quality of management at banking organizations rather than simply to punish past legal violations or dishonesty. In the latter case, the problem conduct is easily identifiable: for example, the bank official embezzled funds from the bank or made improper insider loans. Such conduct is usually both illegal under existing banking laws and a clear breach of the official's duty of loyalty to the bank under common law fiduciary duty principles. Thus, the basis of an enforcement action is easy to articulate and prove.

It is much harder to base an enforcement action on mismanagement that may not violate any specific statute or common law rule but that still poses a threat to the safety of the bank. For example, management's risky and imprudent lending practices by themselves may not violate any specific banking law or even constitute a breach of fiduciary duty to the bank's shareholders. Yet this conduct may be the very sort of mismanagement that the bank regulators wish to discourage before it results in losses for the bank. In order to bring pressure to bear on bank management, however, the regulators must be able to articulate what lending practices are so imprudent as to fall below the regulatory standard of care in managing banks. For example, the regulators may apply certain minimum requirements as to proper loan documentation, levels of loan

395. See supra notes 358-59 and accompanying text (Hawkeye Bancorporation).
396. See supra notes 217-23 and accompanying text.
397. In fact, shareholders may have no reason to complain about these excessively risky practices if they have not yet resulted in financial problems for the bank. See supra notes 339-40 and accompanying text.
concentrations in particular industries or geographic regions and loan approval procedures.

This suggests the need for the bank regulators to develop their own standards of fiduciary duty for bank management that can be used as a basis for the enforcement powers and that will provide bank management with better guidance as to what duties it owes to the regulators. In addition, clearer standards will permit management to decide how best to balance its duties to the regulators against the demands of other constituencies, particularly its shareholders. Inevitably, the requirements of the regulators as to risk management may occasionally conflict with the preferences of shareholders who may prefer more aggressive risk-taking. Nevertheless, these conflicts need not present insurmountable problems for bank management. In practice, bank management already must balance the conflicting interests of multiple constituencies, including shareholders and debtholders, depositors, who because of the special nature of their investment may have completely different interests from the bank's other creditors, customers and the community. The regulators are simply an additional powerful constituency whose demands must be taken seriously by bank management. 398

This broadening of regulatory standards for exercise of disciplinary authority must be accompanied by more narrowly tailored remedies. If the enforcement powers are to be used to improve management performance, the penalties must be designed to protect rather than to cause further injury to the banking organization. For example, if a bank employee embezzles funds from the bank, the most appropriate remedy may not be to remove or penalize the bank's directors. If it was impossible for the directors either to discover or prevent this employee's actions, penalizing or removing the directors will do little to encourage better management performance. Moreover, removing the directors may leave the bank without effective leadership in a time of crisis. On the other hand, if the directors had failed to set up any internal control mechanisms designed to prevent employee fraud, then an enforcement action against the directors may force them to take steps to minimize opportunities for future embezzlement. Thus, by fashioning more narrowly tailored penalties, the regulators can minimize the negative effects of regulatory enforcement actions on banks and their shareholders.

These suggestions for regulatory reform are by no means exhaustive, but are designed simply to illustrate a possible new strategy for bank regulation in managing a deregulated banking industry. Clearly, future bank regulation must rely less on direct rules of conduct and more on flexible risk management, which may vary with individual bank and economic conditions. Thus, rather than attempting to develop new substantive rules to control risk in diversified banks, the regulators should focus

on improving techniques of monitoring individual bank risk and exerting pressure on bank management. This may be the most valuable lesson of the new equityholder’s perspective on bank regulation.

CONCLUSION

Deregulation has required the bank regulators to develop new strategies of regulation that are designed to control risk in modern banking organizations. The shift in regulatory strategy that has accompanied bank deregulation may be characterized as a fundamental change in approach toward bank risk-taking from that of a typical bank debtholder to that of an equityholder. The new equityholder’s perspective on bank risk recognizes the need to enhance bank profitability through diversification, but leaves open the question of how to ensure that banks will manage their new risks effectively. This dilemma may impede the future progress and success of bank deregulation.