CONTROLLING SYSTEMIC RISK IN AN ERA OF FINANCIAL CONSOLIDATION

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Introduction

The structure of the U.S. financial services industry has been transformed during the past two decades. Between 1980 and 1999, the combined forces of new technologies, deregulation and increased competition produced a steady erosion of the legal and market barriers that separated banks from securities firms and insurance companies. For example, sophisticated computer systems and new financial instruments (e.g., commercial paper, junk bonds and asset-backed securities) made it feasible to "securitize" many types of business and consumer debt. As a result, many business firms and consumers who previously relied on bank loans gained access to credit from nonbank sources, including finance companies, mortgage companies and the markets for publicly-traded and privately-placed debt. At the same time, securities brokers, credit card banks and mutual fund companies offered low-cost cash management and investment management services to the general public. In response to these innovations, consumers shifted a rapidly growing share of their investment funds from traditional bank deposits and life insurance policies into mutual funds, variable annuities and other investment vehicles linked to the capital markets.

In combination, these developments caused a dramatic increase in competition and a narrowing of profit margins in the markets traditionally served by banks, securities firms and life insurance companies. Large banks, securities broker-dealers and life insurers responded to these

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trends by pursuing a twofold consolidation strategy. First, to defend existing markets, leading institutions in each sector absorbed traditional competitors. Second, to capture new and diversified sources of revenue, market leaders acquired firms in other sectors.[2]

These consolidation efforts triggered a wave of mergers within and across the banking, securities and insurance sectors. Consolidation in the banking industry was also spurred by (i) new state and federal laws that removed longstanding barriers to geographic expansion, and (ii) more lenient antitrust policies adopted by federal bank regulators and the Justice Department. Between 1980 and 1999, the number of banking organizations fell by nearly half and the market share held by the ten largest banks more than doubled.[3] Three huge bank mergers were announced in 1998, and four mergers of comparable magnitude were agreed to during 1999-2001.[4] As a result of this rapid consolidation, the U.S. banking industry is developing a two-tiered structure. Within the next decade, it seems likely that a small group of ten to fifteen very large banks will control most of the industry's assets, and the remaining competitors will primarily be community-based institutions or specialized niche providers. Similar patterns of

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[2] For discussions of these industry trends, see, e.g, Charles W. Calomiris, U.S. Bank Deregulation in Historical Perspective (Cambridge Univ. Press, 2000) [hereinafter Calomiris, Bank Deregulation], at 334-49; Arthur E. Wilmarth, Jr., The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation and Increased Risks, 2002 University of Illinois Law Review 215 [hereinafter cited as Wilmarth, Transformation], *passim*.

[3] Wilmarth, Transformation, supra note 2, at 250-54 (reporting that (i) the number of independent U.S. banking organizations declined from 12,500 to 6,800 during 1979-99, and (ii) the percentage of banking industry assets held by the 10 largest U.S. banks grew from 23% to 49% during 1984-99).

[4] Id. at 252 (discussing (i) mergers in 1998 involving NationsBank and BankAmerica, Bank One and First Chicago NBD, and Norwest and Wells Fargo, (ii) a 1999 merger between Fleet and BankBoston, (iii) mergers in 2000 involving J.P. Morgan and Chase, and FirstStar and U.S. Bancorp, and (iv) a merger in 2001 between First Union and Wachovia).

consolidation have occurred within the securities and insurance sectors in the United States.[5]

Cross-industry acquisitions also become important during the 1990's, due to favorable rulings issued by federal bank regulators and the courts. By 1999, all of the twenty-five largest U.S. bank holding companies owned securities broker-dealers, and banks had made significant inroads into the insurance business. At the same time, several large securities firms and insurance companies established conglomerates that competed with each other and with banks across a wide range of financial businesses.[6] In 1998, the Federal Reserve Board ("FRB") gave a major impetus to cross-industry consolidation by approving a merger between Citicorp and Travelers. This merger created a huge diversified holding company called "Citigroup," which is generally regarded as the world's leading financial services organization.[7] Proponents of financial modernization hailed Citigroup as the first modern American "universal bank," because it was the first U.S. banking organization since 1933 that could offer comprehensive banking,

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[5] For a detailed discussion of these trends in the U.S. financial services industry, see id. at 254-57, 268-72, 421-28. Similar patterns of consolidation have occurred in the financial sectors of Canada, Europe and Japan. See generally Group of Ten, Report on Consolidation in the Financial Sector, Jan. 25, 2001 [hereinafter Group of Ten Consolidation Report].

[6] For a description of cross-industry consolidation in the U.S. financial services sector since 1980, see Wilmarth, Transformation, supra note 2, at 318-26, 423-28, 431-37.

[7] R. Christian Bruce, Fed Approves Citicorp-Travelers Merger Creating World's Largest Bank Company, 71 BNA's Banking Report 449 (1998). By the second quarter of 2001, Citigroup had total assets of $940 billion and ranked first in the world in terms of both assets and market capitalization. Niamh Ring, Citi Surpasses Deutsche As No. 1 in Asset Size, American Banker, July 6, 2001, at 2; The Business Week Global 1000, Business Week, July 9, 2001, at 75 (tbl.).

At the end of 2001, Mizuho Holdings of Japan moved ahead of Citigroup as the world's largest banking organization in terms of assets. See Veronica Agosta, Japan's Banks Are Again among World's Biggest, Am. Banker, June 18, 2002, at 2 (reporting that Mizuho had $1.3 trillion of assets, compared to $1.05 trillion for Citigroup). However, in mid-2002, Citigroup remained far ahead of all other global banks based on its market capitalization. See The Business Week Global 1000, Business Week, July 15, 2002, at 62 (tbl.).

securities and insurance services to its customers.[8]

The Gramm-Leach-Bliley Act of 1999 ("GLB Act") effectively ratified the Citigroup merger and removed all remaining legal barriers to affiliations among banks, securities firms and life insurers.[9] The GLB Act has encouraged further cross-industry consolidation. During 2000, for example, two major foreign banks acquired U.S. securities firms and another leading foreign bank purchased a U.S. insurance company, while Charles Schwab and MetLife acquired banks.[10]

Advocates of universal banking predict that the new financial conglomerates will produce the following significant benefits: (i) higher efficiency and profitability, as a result of favorable economies of scale and scope, (ii) increased safety and soundness, due to a broader diversification of business lines, and (iii) greater convenience and cost savings for customers,

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[8] Michael Siconolfi, Big Umbrella: Travelers and Citicorp Agree to Join Forces in $83 Billion Merger, Wall Street Journal, April 7, 1998, at A1. Based on an exemption in Section 4(a)(2) of the federal Bank Holding Company Act ("BHC Act"), the FRB allowed Citigroup to offer securities and insurance services beyond the scope of the BHC Act for up to five years after the Citicorp-Travelers merger. In practical effect, the FRB gave Citigroup a five-year license to operate as a universal bank and did not require Citigroup to divest any of its nonconforming securities or insurance activities. See Travelers Group, Inc., 84 Federal Reserve Bulletin 985 (1998).

As used herein, the term "universal bank" refers to a single organization that can engage, either directly or indirectly, in all aspects of the banking, securities and life insurance businesses. See Anthony Saunders & Ingo Walter, Universal Banking in the United States: What Could We Gain? What Could We Lose? 84 (Oxford Univ. Press 1994) (adopting a similar definition of "universal banking").

[9] For general descriptions of the GLB Act, see, e.g., Michael P. Malloy, Banking in the Twenty-First Century, 26 Journal of Corporation Law 787, 793-819 (2000); Michael K. O'Neal, Summary and Analysis of the Gramm-Leach-Bliley Act, 28 Securities Regulation Law Journal 95 (2000).

[10] John Tagliabue, Acquisition Highlights Swiss Flair for Managing Expansion, New York Times, Aug. 31, 2000, at C20 (discussing Credit Suisse's acquisition of Donaldson, Lufkin & Jenrette and UBS' acquisition of PaineWebber); Amy L. Anderson, Sales at Banks A Key Prize In ING Deal For ReliaStar, Am. Banker, May 2, 2000, at 1; Pui-Wing Tam & Randall Smith, Schwab, Going for High-End Clients, Sets $2.9 Billion Stock Accord for U.S. Trust, Wall St. J., Jan. 14, 2000, at C1; Lee Ann Gjertsen, MetLife Has Big Plans for One-Branch Bank, Am. Banker, Aug. 17, 2000, at 1.

based on the concept of "one-stop shopping."[11] Part I of this paper discusses several reasons for doubting whether these optimistic forecasts will be achieved. Big diversified financial providers have produced a largely *disappointing* record over the past two decades. Domestic and foreign financial conglomerates have encountered serious difficulties since 1980, and many of them have abandoned their efforts to establish universal banks. Similarly, mergers among big banks, or between banks and other financial institutions, have generally *failed* to generate substantial improvements in efficiency, profitability, shareholder value or customer service. Thus, the experience of the past two decades provides little support for the rosy projections offered by advocates of universal banking.

Doubts about the claimed advantages of universal banks are buttressed by concerns that financial conglomeration will aggravate the problem of systemic risk in financial markets. Since 1980, major banks, securities firms and life insurers have significantly expanded their involvement in high-risk activities that are closely tied to the capital markets, including leveraged syndicated lending, securitization, equity investments, and underwriting and dealing in securities and derivatives. This growing focus on market-related ventures has made large financial institutions more vulnerable to serious disruptions in the capital markets. In addition, the rising concentration of securities and derivatives activities within a small group of huge financial institutions has created a greater probability that the failure of a leading institution will have serious "spillover" effects. As a consequence, financial conglomeration has increased the

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[11] See, e.g., Senate Report No. 106-44, at 4-6 (1999); James R. Barth, R. Dan Brumbaugh Jr. & James A. Wilcox, The Repeal of Glass-Steagall and the Advent of Broad Banking, 14 Journal of Economic Perspectives 191, 198-99 (2000); Joao A.C. Santos, Commercial Banks in the Securities Business: A Review, 14 Journal of Financial Services Research 35, 37-41 (1998).

likelihood that federal regulators will treat major banks as "too big to fail" ("TBTF") and will also extend federal "safety net" protections to their nonbank affiliates.

As discussed in Part II of this paper, domestic and foreign regulators have responded to the growing risks of financial holding companies by attempting to improve the effectiveness of capital requirements, supervisory oversight and market discipline. However, Part II contends that these regulatory initiatives will not adequately control the risk-taking incentives of financial conglomerates. The new supervisory approaches do not resolve the underlying problems of supervisory forbearance and moral hazard, which are the inevitable corollaries of the current TBTF policy. Moreover, corporate governance scandals at Enron, WorldCom and other major corporations have revealed troubling conflicts of interest affecting securities analysts, investment bankers, accounting firms and credit ratings agencies. Conflicts of interest involving the first two groups have arisen within the new universal banks, thereby indicating that financial conglomeration could subvert the effectiveness of market discipline over both financial and nonfinancial corporations.

Part III proposes a new plan for bank regulation and deposit insurance designed to counteract the perverse effects of the TBTF doctrine. Under this plan, financial conglomerates would be allowed to accept FDIC-insured deposits only within "narrow" banks, which would be barred from making transfers of funds or credit to affiliates (except for lawful dividends out of profits). The FDIC would be strictly prohibited from paying uninsured claims when "narrow" banks fail, thereby insulating the deposit insurance funds from the cost of TBTF bailouts. Drawing on its emergency powers as "lender of last resort" ("LOLR"), the FRB would be primarily responsible for dealing with financial failures involving systemic risk. The FRB would

be obliged to recover the cost of TBTF rescues from financial conglomerates, because those entities are the principal beneficiaries of the TBTF doctrine. Part III(C) discusses six further reforms that are needed to (i) enhance regulatory and market-based controls over the risk-taking incentives of universal banks, and (ii) address conflicts of interest that threaten to undermine the objectivity and prudence of universal banks in extending credit, raising investment capital and providing financial advice.

I. Financial Conglomerates Are Unlikely to Achieve Their Expected Benefits and Will Increase Systemic Risk

A. The Available Evidence Does Not Support the Claimed Advantages of Universal Banks

Empirical studies over the past two decades have generally failed to verify the existence of global economies of scale or scope in large diversified banks, full-service securities firms or multiple-line insurance companies. Most research studies since 1980 have shown that the biggest and most diversified firms in each sector are less profitable and less efficient than their smaller or more specialized competitors. Thus, for example, (i) community banks, midsized regional banks and focused credit card banks have been more efficient and more profitable than the big "money center" banks, (ii) specialized discount brokers have produced higher returns on equity than full-service broker-dealers, and (iii) specialized life insurers have been more efficient than multiple-line insurance companies.[12]

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[12] For evidence of the comparatively poor performance of large diversified financial institutions, see, e.g., William F. Bassett & Mark Carlson, Profits and Balance Sheet Developments at U.S. Commercial Banks in 2001, 88 Federal Reserve Bulletin 259 (2002), at 281, 283, 285, 287 (tbls. A.1.B, A.1.C., A.1.D, and A.1.E.) (showing that, in each year during 1992-2001, the 10 largest U.S. banks had a lower return on assets than any smaller size category of banks); FDIC Q. Banking Profile, 4th Qtr. 2001,

Studies questioning the existence of economies of "super-scale" are supported by the poor track record of large U.S. bank mergers during the 1980's and 1990's. The great majority of those mergers failed to produce the expected synergies and instead resulted in profit shortfalls and long-term losses in shareholder wealth. Several of the biggest combinations during 1996-98 are now widely viewed as costly disappointments or outright failures (e.g., Bank One's mergers with First Chicago NBD and First USA, First Union's acquisitions of CoreStates and Money Store, NationsBank's mergers with Barnett Banks and Bank of America, and Wells Fargo's hostile acquisition of First Interstate). Many analysts perceive similar difficulties with the more recent megamergers between BankBoston and Fleet, and between Chase and J.P. Morgan.[13] In addition to their poor financial results, most big consolidated banks have not fulfilled their

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at 5 (tbl. III-A) (showing that, compared with larger banks, U.S. banks in the size range of $100 million to $10 billion had higher returns on assets and lower levels of charged-off and delinquent loans in 2000 and 2001); Wilmarth, Transformation, supra note 2, at 279-88, 420-34, 437-40 (providing additional data showing the relatively poor performance of large diversified banks, securities broker-dealers and life insurers).

Two recent studies have confirmed the superior performance of small and midsized banks. A Ryan Beck study found that, during 1997-2001, U.S. banks with assets of less than $50 billion recorded faster growth in both earnings and stock market value than bigger banks did. A First Manhattan study found that deposits at smaller banks grew at an annual rate of 5% during the same period, while large banks had little or no internal deposit growth. Small and midsized banks have produced higher earnings and have maintained better credit quality, compared to their larger rivals, due in part to their focus on providing lower-risk retail banking services to consumers and small businesses. See Tara S. Bernard, Smaller Looks Better to Some Bank Investors, Wall St. J., Mar. 20, 2002, at B7C; Mara Der Hovanesian et al., For Small Banks, It's a Wonderful Life, Business Week, May 6, 2002, at 83; John Reosti & Katie Kuehner-Hebert, 4Q: What Recession? Small Banks Post Record Profits, Am. Banker, Jan. 25, 2002, at 1.

[13] For a discussion of the generally poor results of large bank mergers during the 1980's and 1990's, see Wilmarth, Transformation, supra note 2, at 272-78. See also John Hechinger, Fleet to Sell Robertson Stephens, Focus on Core Banking Business, Wall St. J., April 16, 2002, at A1 (describing problems resulting from Fleet's merger with BankBoston); Heather Timmons, The Besieged Banker, Bus. Week, April 22, 2002, at 69 (discussing problems created by Chase's merger with J.P. Morgan); Shawn Tully, Risky Business, Fortune, April 15, 2002, at 116 (same).

promises to provide better service and lower prices to customers.[14]

Similarly, large financial conglomerates have achieved little success over the past two decades. The "financial supermarkets" created during the 1980's by American Express, GE, Kemper, Prudential and Sears were all dismantled after generating poor returns. During the 1990's, Bankers Trust, NatWest and Security Pacific sold out to rivals after suffering large losses from risky ventures in the capital markets. In the past five years, ABN Amro, AXA, Barclays and ING either sold off or shrank their investment banking operations after experiencing losses or lackluster earnings. Conseco's purchase of Green Tree, a large subprime lender, produced crippling losses and pushed the insurer to the brink of bankruptcy in mid-2002. The most spectacular disaster occurred at Credit Lyonnais, whose merchant banking unit, Altus Finance, made huge, ill-advised investments in a wide variety of European and overseas firms. The debacle at Credit Lyonnais ultimately forced the French government to finance a $20 billion rescue plan for the bank.[15]

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[14] Arthur E. Wilmarth, Jr., Too Good to Be True? The Unfulfilled Promises Behind Big Bank Mergers, 2 Stanford Journal of Law, Business & Finance 1 (1995) [hereinafter cited as Wilmarth, Big Bank Mergers], at 4-5, 31-41, 87 (contending that big bank mergers have resulted in inferior service and higher prices for consumers and small businesses); Gerald A. Hanweck & Bernard Shull, The bank merger movement: efficiency, stability and competitive policy concerns, 44 Antitrust Bulletin 251, 258-59, 265-81 (1999) (same); Timothy H. Hannan, Retail Fees of Depository Institutions, 1994-99, 87 Federal Reserve Bulletin 1, 8-11 (2001) (reporting that, compared with smaller banks, multistate banks and larger banks charged significantly higher fees on deposit accounts).

Much of the success enjoyed by small and midsized U.S. banks since 1990 has been due to their commitment to personalized service, which has enabled them to attract many consumers and small businesses who were disenchanted with the impersonal, mass-market approach of larger banks. See Bernard, supra note 12: Der Hovanesian, supra note 12; Wilmarth, Transformation, supra note 2, at 254-70.

[15] See Wilmarth, Transformation, supra note 2, at 322-23, 376-78, 425-28; Mary Chung & Lina Saigol, Closure of US Units Meets with Relief, Financial Times (London, UK), Mar. 26, 2002, at 30 (discussing ABN Amro's decision to close its U.S. investment banking operations, and noting that ABN

Three major U.S. banks have encountered similar difficulties after diversifying into new businesses tied to the capital markets. Bank of America's acquisition of Montgomery Securities was an expensive failure, and its other investment banking efforts have not yet produced significant gains. FleetBoston shut down its investment banking unit and sharply reduced its venture capital business after suffering large losses in both areas during 2001 and the first half of 2002. During the same period, J.P. Morgan Chase incurred more than $1.5 billion in losses from its venture capital investments and produced disappointing results from its other capital markets operations.[16]

Five big global banks – J.P. Morgan Chase, Citigroup, Credit Suisse, Deutsche Bank and

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Amro's retrenchment "is the latest sign of European banks recognising the limits of their global investment banking ambitions"); Joseph T. Hallinan, Conseco Reports Enormous Loss for 2nd Quarter, Wall St. J., Aug. 15, 2002, at A2.

Allianz, the giant German insurer, incurred a substantial loss during the first half of 2002, following its acquisition of Dresdner Bank in 2001. Thus, Allianz found itself "paying the price for its expansion into banking, [while] Swiss financial firm Credit Suisse was reeling from problems in its insurance operation." Jill Treanor, Banking Venture Adds Up to a Loss for Allianz, Guardian (London, UK), Aug. 15, 2002, at 22 (stating that Allianz reported a net loss of $350 million during the first half of 2002, due to losses of $1 billion generated by Dresdner's investment banking and corporate lending operations); see also Andrew Cave, Dresdner Losses Will Cramp Allianz Target, Daily Telegraph (London, UK), Aug. 15, 2002, at 36 (same); infra note 17 and accompanying text (discussing serious problems encountered by Credit Suisse during 2001-02).

[16] See Dean Foust, Whipping a Behemoth into Shape, Bus. Week, Jan. 21, 2002, at 64 (discussing Bank of America's failed acquisition of Montgomery Securities); David Boraks, Defections Hinder B of A Equity Plans, Mar. 18, 2002, at 10 (reporting on continued "instability" in Bank of America's investment banking unit); Hechinger, supra note 13 (discussing problems at FleetBoston); Scott B. Nelson, Bank $386M in the Red in the Second Quarter, Boston Globe, July 16, 2002, at D1 (reporting that FleetBoston incurred losses of over $600 million when it closed its investment banking unit); Timmons et al., supra note 13 (discussing problems at J.P. Morgan Chase, including declining revenues from investment banking and $1.3 billion in losses from private equity investments during 2001); Riva D. Atlas, Profit Off at J.P. Morgan Chase, but Outlook Picks Up, N.Y. Times, April 18, 2002, at C4 (reporting that, during the first quarter of 2002, Chase experienced "continued weaknesses in [its] investment banking business" and incurred "further losses of $255 million" from its private equity investments).

UBS – continue to pursue a universal banking strategy. However, all five banks have absorbed significant losses from capital markets activities at various times since the mid-1990's. During 2001 and the first half of 2002, a general slump in the world's equity markets caused sharp drops in investment banking revenues at all five banks as well as the "big three" securities firms (Goldman Sachs, Merrill Lynch and Morgan Stanley). During the same period, Credit Suisse incurred large losses resulting from its expensive and ill-timed acquisitions of Donaldson Lufkin Jenrette (a U.S. securities firm) and Winterthur (a European insurance company). In late 2001, Citigroup decided to spin off its Travelers property and casualty insurance subsidiary, because Travelers (i) failed to produce the expected synergies with Citigroup's other business lines, and (ii) incurred large losses arising out of insurance claims for the terrorist attack on the World Trade Center. In 2002, as discussed below in Part III(C), the investment banking operations of Citigroup and J.P. Morgan Chase were tarnished by allegations of misconduct related to Enron and WorldCom. Thus, the diversification strategies of big universal banks have exposed them to a variety of risks related to disruptions in the financial markets, and the ultimate success of the universal banking model remains in doubt.[17]

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[17] See Wilmarth, Transformation, supra note 2, at 321-26, 373-78, 427-28 (discussing developments affecting all eight institutions through the fall of 2001). For more recent developments, see Timmons et al., supra note 13 (reporting on slumping earnings and growing credit risks at J.P. Morgan Chase); Liz Moyer, 1Q Earnings: Citi's Results Illustrate Limits of Diversity, Am. Banker, April 16, 2002, at 1 (reporting on Citigroup's declining profits from its investment banking unit and its growing credit problems related to Argentina and Enron); Paul Beckett & Jathon Sapsford, Gigantic Headaches: Citigroup's Vast Reach Brings It Trouble from Many Quarters, Wall St. J., July 26, 2002, at A1 [hereinafter cited as Beckett & Sapsford, Citigroup's Headaches] (discussing Citigroup's and J.P. Morgan Chase's exposure to legal problems and reputational risks resulting from their alleged involvement in financial scandals affecting Enron and WorldCom); Pamela Williams, In the Shadow of Enron, Australian Financial Review, Aug. 17, 2002, at 25 (same); Joseph B. Treaster & Riva D. Atlas, Citigroup to Shed Part of Travelers Unit in Stock Sale, N.Y. Times, Dec. 20, 2001, at C9 (discussing Citigroup's decision to spin off Travelers' property and casualty insurance business); Elizabeth Olson, Profit at Credit Suisse Group Plunged 73% Last Year, N.Y. Times, Mar. 13, 2002, at W1 (reporting that

Another reason for the disappointing results of financial conglomeration is that most customers (with the possible exception of very large corporations) have *not* embraced the concept of "one-stop shopping." Consumers, small businesses and midsized firms have expressed a strong preference for spreading their purchases of financial services among several providers. Customer attitudes help to explain why the "financial supermarkets" of the 1980's failed, and why most of the financial success stories of the 1990's were focused providers, such as credit card banks, innovative community banks, discount brokers and mutual fund managers. Specialized financial firms have earned customer loyalty by providing superior service and/or better investment returns at lower cost. The Internet creates new competitive opportunities for specialty firms, because web-based searches increase the ability of consumers and small businesses to locate the most attractive combination of price and service. In contrast to focused providers, large diversified banks and full-service securities firms have consistently charged higher fees and paid lower returns on deposits and other investments.[18]

Credit Suisse's earnings fell sharply during 2001); Elizabeth Olson, Credit Suisse Posts Loss and Will Cut Dividend, N.Y. Times, Aug. 15, 2002, at W1 (describing Credit Suisse's continuing problems during 2002); David Fairlamb, UBS' Mr. Fix-It, Business Week (Int'l Ed.), April 15, 2002, at 44 (stating that, during 2001, profits declined at Deutsche Bank by more than 50% and at UBS by 36%); Erik Portanger et al., Four Large Banks in Europe Post Lower Profits, Wall St. J., Aug. 2, 2002, at A7 (reporting that Deutsche Bank's earnings continued to decline in 2002); Elizabeth Olson, UBS' Drop in Profit Is Less than Forecast, N.Y. Times, Aug. 14, 2002, at W1 (stating that UBS performed better than Credit Suisse during the first half of 2002, but UBS still faced "slipping profits from investment banking and asset management"); Emily Thornton, Wall Street's Lone Ranger, Bus. Week, Mar. 4, 2002, at 82, 85 (stating that Goldman Sachs' profits fell by 25% in 2001 and continued to decline in early 2002); Cheryl W. Munk, Deals & Deal Makers: Merrill Posts Quarterly Loss, and CFO Warns on Future, Wall St. J., Jan. 24, 2002, at C15 (reporting that Merrill Lynch's profits fell by 85% in 2001, reaching their lowest level in 11 years, and the firm faced continuing problems in 2002); Patrick McGeehan, Morgan Stanley Reports a 16% Drop in Earnings, N.Y. Times, Mar. 27, 2002, at C8 (reporting that Morgan Stanley's profits in late 2001 and early 2002 were "hurt by a continuing slide in its investment banking business").

[18] See Wilmarth, Transformation, supra note 2, at 261-70, 293-97, 428-34.

B. The Growth of Universal Banks Will Increase Systemic Risk

The most troubling aspect of financial consolidation is its effect on "systemic risk" (i.e., the risk that the failure of a major financial institution will severely disrupt the financial system and have adverse "spillover" effects on the general economy). Over the past three decades, large U.S. banks have consistently adopted more aggressive strategies as they have grown in size and complexity. Throughout this period, compared with smaller banks, major U.S. banks have operated with higher leverage, less liquidity and a more risky asset-liability mix. This correlation between bank expansion and increased risk is not a uniquely American phenomenon. A recent study concluded that the largest banks in twenty-one developed nations (including the U.S.) engaged in more risky activities and faced a greater probability of insolvency during 1988-98.[19]

The willingness of governments to protect uninsured depositors and payments system creditors of "too big to fail" ("TBTF") banks undoubtedly encourages major banks to assume greater risks. Studies have shown that the TBTF policy confers a significant implicit subsidy on big U.S. banks, because (i) it allows them to pay below-average rates to depositors and other creditors, and (ii) it shields them from effective market discipline, despite their below-average capitalization and above-average risks.[20] Another recent study found a similar link between

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[19] Henry Kaufman, On Money and Markets: A Wall Street Memoir (McGraw-Hill, 2000) [hereinafter cited as Kaufman, On Money and Markets], at 223-31, 242-46, 259-68, 278-86, 306-07; Gianni De Nicolo, Size, Charter Value and Risk in Banking: An International Perspective, Working Paper, April 2001 (available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id+255465>); Wilmarth, Transformation, supra note 2, at 242-44, 300-03, 312-407, 444-45.

[20] For discussions of the TBTF policy and the perverse incentives it creates for risk-taking by major banks, see, e.g., Ron J. Feldman & Arthur J. Rolnick, Fixing FDICIA: A Plan to Address the Too-Big-to-Fail Problem, 12 Region No. 1 (Fed. Res. Bank of Minneapolis, MN), Mar. 1998, at 2, 3-9; Edward J. Kane, Incentives for Banking Megamergers: What Motives Might Regulators Infer from Event-Study Evidence?, 32 Journal of Money, Credit & Banking 672 (2000) [hereinafter Kane, Megamerger Incentives], at 673-74, 691-94; Kaufman, On Money and Markets, supra note 19, at 207-10,

TBTF status and perverse risk incentives among large European banks.[21]

Several commentators maintain that U.S. bank consolidation has substantially increased the risk that a major bank failure could bankrupt the FDIC's deposit insurance fund.[22] Similarly, a recent "Group of Ten" report acknowledged that the growth of large complex banking organizations ("LCBOs") has probably aggravated systemic risk. As the report pointed out, the consolidation of financial assets within LCBOs has (i) increased the complexity of major financial institutions, making it harder for regulators and market participants to comprehend the risks inherent in LCBOs, (ii) produced a higher concentration and correlation of credit risk and market risk among the largest financial institutions, due to their growing domination of the markets for syndicated loans, over-the-counter ("OTC") derivatives and investment banking services, and (iii) created close linkages between banking and nonbanking subsidiaries of

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226-30, 259-68, 278-86; Wilmarth, Transformation, supra note 2, at 300-08, 372-73, 406-07, 444-45.

For recent studies documenting the implicit subsidy provided to big U.S. banks by the TBTF policy, see, e.g., Craig H. Furfine, Banks as Monitors of Other Banks: Evidence from the Overnight Federal Funds Market, 74 Journal of Business 33, 36-40, 47 (2001) (in 1998, banks with more than $10 billion of assets paid significantly lower interest rates on overnight loans than those paid by smaller banks); Hanweck & Shull, supra note 10, at 274-76 (in 1997, big banks paid much lower interest rates on deposits and operated with substantially lower equity capital ratios, compared to smaller banks); Donald P. Morgan & Kevin J. Stiroh, Bond Market Discipline of Banks, in The Changing Financial Industry Structure and Regulation (Fed. Res. Bank of Chicago, IL, 36th Annual Conference on Bank Structure & Competition, 2000), at 494, 504-06 (during 1993-98: (i) public bond markets applied much less stringent discipline to banks with assets of more than $85 billion, and (ii) weaker bond market discipline was especially evident among the 11 big banks that were publicly identified as TBTF in 1984).

[21] Reint Gropp & Jukka M. Vesala, Deposit Insurance and Moral Hazard: Does the Counterfactual Matter?, European Central Bank Working Paper No. 47, July 2001 (available at <www.ecb.int/pub>), at 2-3, 8-12, 17-24.

[22] See, e.g., Robert Oshinsky, Effects of Bank Consolidation on the Bank Insurance Fund, FDIC Working Paper No. 99-3 (available at <www.fdic.gov>); William M. Isaac, Financial Reform's *Unfinished* Agenda, 14 Region No. 1 (Fed. Res. Bank of Minneapolis, MN), Mar. 2000, at 34, 37; Kaufman, On Money and Markets, supra note 19, at 226-30, 237-38, 329-37.

financial holding companies, thereby complicating the problem of resolving the failure of a major bank in isolation from its nonbank affiliates.[23]

Regulators and investors recognize that LCBOs are highly integrated enterprises, despite the corporate veils between their various subsidiaries. Most financial holding companies are centrally managed with the specific goal of coordinating the product offerings of their nonbank subsidiaries with the services of their lead banks (e.g., combining securities underwriting with syndicated lending for the same corporate clients). LCBOs have also increased their reputational stake in nonbank affiliates by promoting unitary "brand names" covering the entire holding company. Financial conglomeration has therefore increased the pressure on *both* managers *and* regulators to protect nonbank subsidiaries of LCBOs.[24] The financial markets fully expect that (i) managers of an LCBO will use its banking resources to rescue troubled nonbank affiliates and

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[23] See Group of Ten Consolidation Report, supra note 5, at 125-46. See also Gianni De Nicolo & Myron L. Kwast, Systemic Risk and Financial Consolidation: Are They Related?, Board of Governors of Federal Reserve System, Finance & Economics Discussion Series, Working Paper 2001-33, June 19, 2001 (available at <www.federalreserve.gov>) (concluding that the rapid growth of LCBOs probably increased systemic risk in the U.S. during 1988-99).

[24] See, e.g., Mark J. Flannery, Modernizing Financial Regulation: The Relation Between Interbank Transactions and Supervisory Reform, 16 Journal of Financial Services Research 101, 103-09 (1999); Lisa M. DeFerrari & David E. Palmer, Supervision of Large Complex Banking Organizations, 87 Federal Reserve Bulletin 47, 51-53 (2001); Anthony Santomero & David L. Eckles, The Determinants of Success in the New Financial Services Environment, 6 Economic Policy Review No. 4 (Fed. Res. Bank of N.Y.), Oct. 2000, at 11, 15, 18-19; U.S. General Accounting Office, Risk-Focused Bank Examinations: Regulators of Large Banking Organizations Face Challenges, GAO/GGD-00-48, Jan. 2000 [hereinafter cited as GAO LCBO Study], at 5, 15, 24, 28-30.

For example, Citigroup recently began to market all of its global corporate and investment banking services under the brand name of "Citigroup Corporate and Investment Bank." Citigroup executives declared that the new brand name would be part of "an aggressive, coordinated advertising and communication plan" that would "bring further clarity to our identity in the marketplace and among our clients." Paul Beckett, So Long, Poker Players: Salomon Is History, Wall St. J., May 23, 2001, at C18 (quoting Michael Carpenter and Sandy Weill). Given this unified branding strategy, Citigroup will undoubtedly feel greater pressure to use the resources of its entire holding company to satisfy future liabilities created by its commercial banking and investment banking subsidiaries.

thereby preserve the LCBO's public reputation, and (ii) regulators will use the federal "safety net" for banks to protect entire financial holding companies whenever such action is deemed necessary to maintain public confidence in the financial system.[25]

Soon after the GLB Act was adopted, a senior official at Moody's Investors Services declared that federal regulators *must* support diversified financial holding companies during "times of extreme financial stress." In his view, the TBTF status of big financial conglomerates is undeniable – it is "like the elephant at the picnic – everyone is aware of it, but no one wants to mention it."[26] Other commentators agree that regulators would probably rescue a failing nonbank affiliate of an LCBO during a severe economic disruption, because (i) the affiliate's default could trigger a contagious "run" by all of the holding company's investors and creditors, and (ii) the

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[25] See Wilmarth, Transformation, supra note 2, at 256, 302-04, 446-50. Walter Wriston, the former chairman of Citicorp, declared that "it is inconceivable that any major bank would walk away from any subsidiary of its holding company. If your name is on the door, all of your capital and assets are going to be behind it in the real world. Lawyers can say you have separation, but the marketplace . . . would not see it that way." Similarly, former FRB chairman Paul Volcker stated that "the practical realities of the market place and the internal dynamics of a business organization under central direction drive bank holding companies to act . . . as one business entity, with the component parts drawing on each other for marketing and financial strength. Certainly the market conceives of a bank holding company and its components in that way. And if market participants tend to consider the bank holding company as an integrated entity, problems in one part of the system will inevitably be transmitted to other parts." S. Rep. No. 100-19, at 9 (1987), reprinted in 1987 U.S. Code Cong. & Ad. News 491, 499 (quoting Messrs. Wriston and Volcker).

The federal "safety net" for banks consists of deposit insurance, protection of uninsured depositors and payments system creditors of major banks under the TBTF policy, discount window advances provided by the FRB as LOLR, and the FRB's guarantee of interbank payments made on Fedwire. See George G. Kaufman & Peter J. Wallison, The New Safety Net, 24 Regulation (Cato Review of Business & Government) No. 2, Summer 2001, at 28.

[26] Christopher P. Mahoney, Commentary, 6 Economic Policy Review No. 4 (Fed. Res. Bank of N.Y.), Oct. 2000, at 55, 57-58. Similarly, Alan Blinder, a former FRB vice chairman, recently acknowledged that "[e]verybody knows that there are institutions that are so large and so interlinked with others that it is out of the question to let them fail." Quoted in Rob Blackwell, 'Too Big to Fail' Deniers Have a Tough Audience, Am. Banker, June 4, 2001, at 1.

collapse of a large financial holding company could set off a systemic "flight to safety" in the financial markets.[27] As discussed below in Part II, this de facto extension of the safety net greatly reduces the ability of regulators or investors to impose meaningful limits on risk-taking by LCBOs.

By authorizing unlimited mergers between banks and securities firms, the GLB Act has also removed the "shock absorbers" that the U.S. financial system contained prior to 1999. The FRB mobilized leading U.S. banks to counteract serious disruptions in the capital markets during the Penn Central commercial paper crisis of 1970, the Hunt Brothers silver crisis of 1980, the stock market crash of 1987, and the Russian debt crisis of 1998. In each case, major banks provided emergency credit that enabled large nonbank firms to avoid bankruptcy or severe distress. Banks were able to serve as standby sources of liquidity and credit on each occasion, because their capital markets activities represented a relatively small portion of their overall operations and did not expose them to devastating losses. Conversely, the securities industry provided an alternative financing channel for U.S. business firms during the recession and banking crisis of 1990-92, because most securities firms did not confront the severe lending problems that plagued major banks at that time. Thus, the legal barriers separating banks and securities firms prior to 1999 reduced systemic risk in the U.S. economy, because those barriers

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[27] Thomas M. Hoenig, Financial Industry Megamergers and Policy Challenges, 84 Economic Review No. 3 (Fed. Res. Bank of K.C., MO), 3d Qtr. 1999, at 7-8, 10-13; Kaufman, On Money and Markets, supra note 19, at 207, 237-38; Remarks by FRB Governor Laurence H. Meyer before a National Bureau of Economic Research Conference, Jan. 14, 2000 (available at <www.federalreserve.gov>) [hereinafter cited as 2000 Meyer NBER Speech], at 1-2; Frederic S. Mishkin, Financial consolidation: Dangers and opportunities, 23 Journal of Banking & Finance 675, 680-81 (1999); Santomero & Eckles, supra note 24, at 15, 18-19; Gary H. Stern, Thoughts on Designing Credible Policies After Financial Modernization, 14 Region No. 3 (Fed. Res. Bank of Minneapolis, MN), Sept. 2000, at 4-5, 24-25.

(i) insulated each sector to a substantial degree from the other's problems, and (ii) allowed each sector to act as an alternative source of financing during periods when the other sector was recovering from serious financial losses.[28]

As an instructive comparison, consider the record of Japan over the past twelve years. In 1990, the Japanese banking system had massive exposures to *both* the real estate market *and* the stock market. Japanese banks had made huge amounts of loans secured by real estate and securities, and they also held extensive portfolios of corporate stocks (primarily because of cross-shareholding relationships within their corporate groups, called *keiretsu*). Beginning in 1990, Japan's real estate and stock markets collapsed, with prices in each sector falling by more than two-thirds. Several major Japanese banks, securities firms and insurance companies failed, and many others were driven to the brink of insolvency. In response, the Japanese government spent more than $1 trillion on economic stimulus programs and budgeted more than $500 billion to rescue its banking system. However, Japan has not been able to revive its slumping economy or restore its battered financial system. Japanese banks cannot provide the credit needed by business firms, because they are burdened with an estimated $1.3 trillion of nonperforming loans as well as heavily depreciated stock portfolios. The government is severely limited in its ability to finance new assistance programs, because Japan's public debt has reached record levels equal

[28] See Remarks by FRB Chairman Alan Greenspan before the World Bank Group and the IMF Program of Seminars, Sept. 27, 1999 (available at <www.federalreserve.gov>) [hereinafter cited as 1999 Greenspan IMF Speech], at 1-3; George G. Kaufman, Designing the New Architecture for U.S. Banking, in Benton E. Gup, ed., The New Financial Architecture: Banking Regulation in the 21st Century (Quorum Books, 2001) [hereinafter cited as Gup, New Financial Architecture], at 39 [hereinafter cited as Kaufman, Banking Architecture], at 44; Wilmarth, Transformation, supra note 2, at 235-37, 371-72.

to more than 130% of its gross domestic product.[29]

Many observers have blamed Japan's failure to resolve its problems on the unwillingness of its political and business leaders to undertake a fundamental restructuring of Japan's financial system and general economy.[30] Resistance to change undoubtedly accounts for a significant portion of Japan's difficulties. However, the role of Japanese banks as dominant providers of business finance, and their exposure to *both* credit risk in the real estate market *and* investment risk in the securities market, are additional factors that account for the severity and protracted nature of the Japanese crisis. The Japanese financial system concentrated business finance, credit risk and market risk within a small group of major banks. The simultaneous collapse of Japan's real estate and stock markets crippled the banks and left no substantial alternative source of financing for Japanese businesses. Accordingly, the Japanese experience provides a clear warning signal about the potential for systemic risk that may already exist within

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[29] See, e.g., Franklin Allen & Douglas Gale, Bubbles and Crises, 110 Economic Journal 236, 236-38, 252-54 (2000) Valentine V. Craig, Japanese Banking: A Time of Crisis, 11 FDIC Banking Review No. 2, at 9, 12-17 (1998); Akihiro Kanaya & David Woo, The Japanese Banking Crisis of the 1990s: Sources and Lessons, Int'l Monetary Fund Working Paper No. 00/7, Jan. 2000 (available at <www.imf.org>), *passim*; Curtis J. Milhaupt, Japan's Experience with Deposit Insurance and Failing Banks: Implications for Financial Regulatory Design?, 77 Washington University Law Quarterly 399, 408-24 (1999); Joe Peek & Eric S. Rosengren, Japanese Banking Problems: Implications for Lending in the United States, New England Economic Review (Fed. Res. Bank of Boston, MA), Jan./Feb. 1999, at 25 [hereinafter cited as Peek and Rosengren, Japanese Banking Problems], at 25-31; Bill Spindle, Japan's Massive Debt Bomb Ticks Ever Louder, Wall St. J., Dec. 11, 2000, at A1; Phred Dvorak & Peter Landers, Is Japan on the Verge of a Contagious Financial Crisis?, Wall St. J., Mar. 14, 2001, at A1; John Grimond, What Ails Japan? A Survey of Japan, Economist, April 20, 2002 (following p. 52), at 3-6; Japan's banks: Surreal, Economist, April 20, 2002, at 74; Bank reform in Japan: Hampered, Economist, July 13, 2002, at 59.

[30] E.g., Craig, supra note 29, at 14-17; Grimond, supra note 29, at 6-11, 15-16; Milhaupt, supra note 29, at 408-24; Michael Williams et al., Day of Reckoning: Wall Street Intensifies Japan's Woes, but They All Trace Back to Home, Wall Street Journal, Mar. 16, 2001, at A1.

U.S. and European LCBOs.[31]

II. Current Regulatory Policies Cannot Adequately Control the Risk-Taking Incentives of Financial Conglomerates

Pursuant to congressional mandates in the GLB Act, federal regulators have followed a four-part strategy to control the risks of LCBOs. First, financial holding companies must conduct securities, insurance and merchant banking activities in separate nonbank subsidiaries that are insulated by regulatory "firewalls" from their affiliated banks.[32] Second, all banks in a financial holding company must be "well capitalized," and regulators must apply "prompt corrective action" ("PCA") to any bank that fails to meet prescribed capital standards.[33] Third, all banks in a financial holding company must be "well managed," and regulators have instituted new supervisory procedures for evaluating the effectiveness of each LCBO's management.[34] Fourth,

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[31] Craig, supra note 29, at 9-14; 1999 Greenspan IMF Speech, supra note 28, at 2; Peek & Rosengren, Japanese Banking Problems, supra note 29, at 26-31; Wilmarth, Big Bank Mergers, supra note 14, at 62-63, 69 n.319; Jacob Schlesinger & Peter Landers, Parallel Woes: Is the U.S. Economy At Risk of Emulating Japan's Long Swoon?, Wall St. J., Nov. 7, 2001, at A1.

[32] Senate Report No. 106-44, supra note 11, at 7-8; O'Neal, supra note 9, at 100-12.

[33] O'Neal, supra note 9, at 104-05, 108, 112 (discussing the GLB Act). For discussions of the PCA regime, see, e.g., George J. Benston & George G. Kaufman, FDICIA After Five Years, 11 Journal of Economic Perspectives 139, 144-49 (1997); U.S. General Accounting Office, Bank and Thrift Regulation: Implementation of FDICIA's Prompt Regulatory Action Provisions, GAO/GGD-97-18, Nov. 1996 [hereinafter cited as GAO PCA Study], at 14-21, 25-27.

[34] O'Neal, supra note 9, at 104-05, 108, 112 (discussing the GLB Act). For descriptions of the new supervisory procedures for LCBOs, see generally DeFerrari & Palmer, supra note 24; 2000 Meyer NBER Speech, supra note 27; Remarks by Governor Laurence H. Meyer at the Int'l Banking Conference of the Federal Fin'l Institutions Examination Council, May 31, 2000 (available at <www.federalreserve.gov>) [hereinafter cited as 2000 Meyer FFIEC Speech]; GAO LCBO Study, supra note 24.

regulators are trying to encourage greater market discipline of LCBOs.[35]

These supervisory initiatives are consistent with a new capital adequacy proposal issued in January 2001 by the Basel Committee on Bank Supervision. The Basel Committee's 2001 proposal recommends a new regulatory framework based on "three pillars" – capital adequacy, supervisory review and market discipline.[36] The Basel Committee's proposal includes two new approaches that have already been adopted by U.S. bank regulators: (i) applying capital requirements on a consolidated basis to the entire financial holding company (including nonbank subsidiaries), and (ii) establishing capital requirements for each LCBO in accordance with internal risk ratings developed by the LCBO's managers and reviewed by bank regulators.[37]

Unfortunately, as shown below, all four elements of the new supervisory program for LCBOs have exhibited serious shortcomings in the past. The program is therefore unlikely to

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[35] See O'Neal, supra note 9, at 109 (stating that, under the GLB Act, a national bank must have at least one issue of outstanding debt securities with a qualified credit rating if the bank plans to establish a financial subsidiary and is one of the 50 largest U.S. banks); Meyer NBER Speech, supra note 27, at 2-6 (explaining supervisory measures designed to enhance market discipline over LCBOs).

[36] Basel Committee on Banking Supervision, Overview of the New Basel Capital Accord, Jan. 2001 [hereinafter cited as 2001 Basel Capital Proposal Overview], at 1, 7, 12-36. In June 2001, responding to widespread criticism of its January proposal, the Basel Committee extended its timetable for adopting and implementing the new capital accord. However, the Committee stressed that "it remains strongly committed to the three pillars architecture of the new Accord." Basel Committee on Bank Supervision, Update on the New Basel Capital Accord, 25 June 2001 [hereinafter cited as 2001 Basel Update]. In July 2002, the Basel Committee made revisions to certain aspects of its proposal, and the Committee also announced its intention to promulgate the new capital accord by the end of 2003, with implementation by bank supervisors scheduled for year-end 2006. Basel Committee on Bank Supervision, Basel Committee Reaches Agreement on New Capital Accord Issues, 10 July 2002 [hereinafter cited as 2002 Basel Revision]. Documents related to the Basel Committee's 2001 proposal are available at <www.bis.org>.

[37] Under the Basel Committee's proposal, only large, sophisticated banks that establish satisfactory internal risk management systems would be permitted to use internal risk ratings to calculate their capital requirements. Smaller banks would be governed by uniform, standardized capital rules established by the Basel Committee. See 2001 Basel Capital Proposal Overview, supra note 36, at 1-2, 7-8, 11-17; 2000 Meyer NBER Speech, supra note 27, at 1-3.

prevent LCBOs from taking excessive risks at the expense of the federal safety net.

A. The Ineffectiveness of Corporate Separation as a Risk Control Device

Supervisory requirements based on the concept of corporate separation are in fundamental conflict with the actual behavior of financial holding companies. As noted above, most LCBOs operate as highly integrated enterprises, based on centralized management policies that disregard structural divisions between corporate subsidiaries. On many occasions, financial holding companies have rescued either their affiliates or their customers in order to protect the reputation of the parent holding company and its regulated financial institutions. In the most serious cases, holding company managers have deliberately breached regulatory firewalls by exceeding the legal limitations on financial support that banks or other regulated financial institution may provide to troubled affiliates.[38]

The GLB Act relies on Sections 23A and 23B of the Federal Reserve Act to prevent abusive transactions between banks and their nonbank affiliates within the new financial holding company structure.[39] However, regulators and analysts have acknowledged that (i) the affiliate

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[38] See supra notes 24-25 and accompanying text. See also, e.g., Helen A. Garten, Subtle Hazards, Financial Risks, and Diversified Banks: An Essay on the Perils of Regulatory Reform, 49 Maryland Law Review 314 (1990) [hereinafter cited as Garten, Subtle Hazards], at 352-54 (describing how (i) Hamilton National Bank failed in the mid-1970's, after its parent holding company caused the bank to disregard affiliate transaction rules and purchase large amounts of low-quality mortgages from its troubled mortgage banking affiliate; and (ii) Continental Bank ignored legal lending limits and extended credit to rescue its options trading subsidiary during the October 1987 stock market crash); William S. Haraf, The Collapse of Drexel Burnham Lambert: Lessons for the Bank Regulators, Regulation (Cato Review of Business & Government), Winter 1991, at 22, 23 (stating that, when Drexel Burnham was threatened with failure in early 1990, it withdrew capital from its regulated securities subsidiaries in excess of regulatory limits until the SEC intervened to prevent further capital transfers).

[39] Board of Governors of the Federal Reserve System, Transactions Between Banks and Their Affiliates: Notice of Proposed Rulemaking, 66 Federal Register 24,186-87 (2001) (explaining that Section 23A places quantitative limits on transactions between banks and their affiliates, while Section 23B requires banks to conduct all affiliate transactions on terms comparable to those used in arms' length

transaction rules under Sections 23A and 23B are complicated and difficult to enforce, and (ii) managerial evasions of those provisions are often subtle and hard to detect. As a result, when a financial holding company or its subsidiaries are under severe financial stress, regulators may fail to discover and prevent a transfer of bank funds or bank credit that violates regulatory limits.[40] Moreover, to avert a systemic financial crisis, regulators may elect to waive affiliate transaction rules so that major banks can help their troubled affiliates. For example, in September 2001, the FRB reportedly suspended the application of Section 23A and urged banks to transfer funds to their securities affiliates for the purpose of averting a liquidity crunch that threatened securities broker-dealers following the terrorist attacks on the World Trade Center.[41]

Federal bank regulators currently appear to give little weight to the notion that corporate separation is an effective risk control device. Regulators understand that large financial holding companies operate based on centralized business strategies and risk management programs that transcend corporate boundaries between affiliates. Accordingly, regulators currently stress the importance of supervising financial holding companies in a *consolidated* manner that cuts across corporate divisions among bank subsidiaries and their nonbank affiliates.[42] Given the banking

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transactions with unaffiliated firms).

[40] Garten, Subtle Hazards, supra note 38, at 380-81 (stating that the "[FRB] has admitted that restrictions on interaffiliate funds transfers frequently have been violated or interpreted creatively by management in times of stress"); GAO Says Banks May Pass Net Subsidy To Their Affiliates, 16 Banking Policy Report No. 18, Sept. 15, 1997, at 7, 8-9 (reprinting letter from GAO Chief Economist James Bothwell to Rep. Richard Baker).

[41] Anita Raghavan et al., Team Effort: Banks and Regulators Drew Together to Calm Markets After Attack, Wall St. J., Oct. 18, 2001, at A1. See also infra note 101 and accompanying text (discussing the FRB's response to the terrorist attacks on Sept. 11, 2001).

[42] See, e.g., DeFerrari & Palmer, supra note 24, at 51-53; GAO LCBO Study, supra note 24, at 5, 7, 14-18, 24-30; Meyer FFIEC Speech, supra note 34, at 5-8.

agencies' current adherence to the concept of consolidated supervision, one can certainly question whether regulators and financial industry lobbyists actually believed in the effectiveness of corporate separation during the 1990's, or whether the separation concept was simply used as a convenient rationale to persuade Congress that the GLB Act's "firewalls" would forestall any risks to the federal safety net.[43]

Recent initiatives by Citigroup and Merrill Lynch provide further evidence that current "firewalls" do not prevent financial holding companies from transferring federal safety net subsidies to their nonbank subsidiaries. During 2000, both companies established "sweep" programs enabling their customers to transfer cash balances from uninsured brokerage accounts at securities subsidiaries into FDIC-insured deposit accounts at affiliated banks. These "sweep" programs permit brokerage customers to make structured transfers into deposit accounts at multiple bank affiliates, thereby evading the $100,000 limit on federal deposit insurance. By 2001, brokerage customers of Merrill Lynch and Citigroup had transferred $75 billion into insured accounts at affiliated banks. Both companies reportedly intend to use their new deposits to help finance the activities of their nonbank subsidiaries.[44]

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[43] See, e.g., House of Representatives Report No. 106-74, at 99-102 (1999) (citing statements by federal regulators and industry representatives claiming that corporate separation and regulatory "firewalls" would insulate FDIC-insured banks from the potential risks of their nonbank affiliates if the proposed GLB Act was adopted). See also Flannery, supra note 24, at 112 n.10 (stating that "many proponents of broad financial conglomerate powers insist that legal separateness will effectively insulate banking activities, without explicitly addressing the question of de facto integration. This omission is particularly noteworthy when it is accompanied by an assertion that regulation should permit conglomerates to take maximum advantage of scope economies among the various product lines – which seems to contradict the promise of de facto separateness!").

[44] See Wilmarth, Transformation, supra note 2, at 448-49 (discussing the new "sweep" programs at Citigroup and Merrill Lynch, which (i) allow Citigroup's customers to obtain up to $600,000 of deposit insurance by making structured transfers to six affiliated banks, and (ii) permit Merrill's customers to obtain up to $200,000 of deposit insurance by making structured transfers to two affiliated

Other financial holding companies have established or are actively considering similar brokerage-to-bank "sweep" programs, due to the significant funding advantage provided by low-cost, FDIC-insured deposits.[45] Thus, financial conglomeration has fostered a growing trend toward transfers of safety net subsidies from bank subsidiaries to their nonbank affiliates. These subsidy transfers – which current federal regulations do not prevent – will reduce the effectiveness of market discipline and encourage greater risk-taking among financial holding companies.[46]

B. Shortcomings in Capital Regulation

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banks). When a spokesman for Merrill Lynch was asked what his company would do with its "newfound low-cost funds," he replied that the company's new deposits would give it "flexibility . . . to finance other parts of our business." Similarly, Citigroup was expected to use the deposits generated by its "sweep" program to help finance loans offered by its consumer lending subsidiary, Associates First Capital. Richard Melville, Deposit Power: Where Merrill, B of A, Citi Agree, Am. Banker, Dec. 18, 2000, at 1 (quoting James Wiggin of Merrill Lynch and reporting on Citigroup's expected use of "sweep" deposits).

[45] See Rob Blackwell, Will Brokers' Sweeps Moves Speed Reform?, Am. Banker, May 2, 2002, at 1 (reporting that Lehman Brothers and TD Waterhouse had instituted brokerage-to-bank "sweep" programs, while Prudential was considering a similar move); Tom Lauricella, Fund Track: Brokerage Firms Stop Money-Fund 'Sweeps,' Wall St. J., May 1, 2002, at C1 (stating that financial holding companies were encouraging brokerage customers to transfer their cash balances to FDIC-insured bank accounts, instead of money-market mutual funds, because diversified financial firms (i) have wide discretion in investing bank deposits, compared to tight legal restrictions on permissible investments for money-market funds, and (ii) can therefore make much higher profits by collecting and investing bank deposits); Matthias Rieker, Banks Seen Missing The Boat by Failing to Generate Deposits, Am. Banker, April 5, 2001, at 2 (citing study by First Manhattan Consulting Group showing that consumer deposit accounts produced 51% of total revenues and 66% of total pretax profits at U.S. banks in 1999); Steven Pearlstein & Peter Pae, Megabank Day, Wash. Post, April 19, 1998, at H1 (citing statement by John McCoy, then chairman of Bank One, that "access to consumer deposits . . . amounted to cheap capital" for big banks).

[46] See, e.g., Garten, Subtle Hazards, supra note 38, at 353-64; Kane, Megamerger Incentives, supra note 20, at 689-94; John R. Walter, Can a Safety Net Subsidy Be Contained?, 84 Economic Review No. 1 (Fed. Res. Bank of Rich., VA), Winter 1998, at 1, 10-17. See also Santomero & Eckles, supra note 24, at 18-19 (concluding that "universal banking does present a new way in which government-induced moral hazard can manifest itself . . . [and] can be passed down to nonbank subsidiaries owned by universal banks").

The Basel Committee issued the current international risk-based capital accord in 1988 (the "1988 Accord"). The 1988 Accord establishes capital requirements for banks by assigning loans and off-balance-sheet commitments to four risk-weighted categories based on perceived credit risk. Many commentators have criticized the four "risk buckets" of the 1988 Accord, because they are too broad and imprecise to distinguish among similar types of assets that involve varying degrees of credit risk. For example, a loan to a "blue chip" corporation with a triple-A credit rating carries the same 100% risk weight under the 1988 Accord as a loan to a speculative company with a below-investment grade rating.[47] The 1988 Accord's unsophisticated treatment of credit risk has allowed LCBOs to engage in "capital arbitrage" by (i) using complex derivatives, whose embedded risks are difficult to estimate, as substitutes for conventional financing arrangements, and (ii) structuring securitizations that transfer low-risk assets out of the bank while causing the bank to retain the most risky assets (e.g., residual interests, whose value is often subject to change based on multiple contingencies and assumptions).[48]

The 1988 Basel Accord also did not impose capital requirements to protect against the market risk inherent in derivatives, securities and other trading assets held by banks. In response

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[47] E.g., Allen N. Berger, Richard J. Herring & Giorgio P. Szegö, The role of capital in financial institutions, 19 Journal of Banking & Finance 393, 414-15 (1995); U.S. Gen. Accounting Off., Deposit Insurance: A Strategy for Reform, GAO/GGD-91-26, Mar. 1991 [hereinafter GAO Deposit Insurance Reform Study], at 85-88.

[48] E.g., Robert C. Merton, Financial innovation and the management and regulation of financial institutions, 19 Journal of Banking & Finance 461, 468-70 (1995); Wilmarth, Transformation, supra note 2, at 403-07, 458-59. See also U.S. Gen. Accounting Off., Risk-Based Capital: Regulatory and Industry Approaches to Capital and Risk, GAO/GGD-98-153, July 1998 [hereinafter GAO Risk-Based Capital Study], at 68, 169 (stating that, during discussions with six major banks, "[o]fficials of two banks commented that they are not constrained by regulatory capital requirements, because assets can always be securitized so capital will not have to be held against them, or they can move to riskier assets in each credit risk category to obtain higher returns").

to rapid increases in trading activity at large banks during the 1990's, the Basel Committee promulgated supplemental capital rules for market risk in 1996. Those rules allow qualifying banks to calculate their capital requirements for market risk based on internal models that measure their "value at risk" ("VAR"). The Basel Committee's 2001 proposal would extend this policy of reliance on internal risk management by allowing qualifying banks to use internal risk ratings in determining their capital requirements for credit risk and operational risk.[49]

Unfortunately, past banking crises have shown that capital is a lagging indicator of bank problems. Declines in capital are frequently not recognized or reported by troubled banks until their financial condition has already been undermined. One reason for this time lag is that many assets held by banks (e.g., commercial loans, OTC derivatives and residual interests in securitizations) are not traded on any organized market and are therefore very difficult for regulators and outside investors to evaluate. Accordingly, outsiders frequently are unable to identify problems of asset depreciation at banks until their capital has already been impaired. In addition, managers of a troubled bank have strong personal incentives to postpone writedowns of assets and capital while hoping that their bank's situation will improve before its next supervisory examination or public disclosure to investors.[50]

The PCA regime is designed to strengthen capital regulation by forcing regulators to

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[49] See GAO Risk-Based Capital Study, supra note 48, at 49-53; 2001 Basel Capital Proposal Overview, supra note 36, at 7-10, 17-29; D. Johannes Jüttner, Message to Basle: Risk Reduction Rather Than Management, in Gup, New Financial Architecture, supra note 28, at 207, 208-09, 217-18.

[50] See, e.g., Berger, Herring & Szegö, supra note 47, at 411-16, 425; Jeffrey W. Gunther & Robert R. Moore, Financial Statements and Reality: Do Troubled Banks Tell All?, Economic & Financial Review (Fed. Res. Bank of Dallas, TX), 3d Qtr. 2000, at 30; Joe Peek & Eric S. Rosengren, The Use of Capital Ratios to Trigger Intervention in Problem Banks: Too Little, Too Late, New England Economic Review (Fed. Res. Bank of Boston, MA), Sept./Oct. 1996, at 49 [hereinafter Peek & Rosengren, Capital Ratios] at 50-57.

impose progressively more stringent enforcement measures if a bank falls below the "adequately capitalized" standard or below two lower capital thresholds.[51] However, federal regulators have weakened the effectiveness of PCA by choosing a lenient capital adequacy test. Virtually all banks met this standard when the PCA rules took effect in 1992, even though the banking industry was just emerging from a major crisis.[52] Studies have shown that PCA's "adequately capitalized" test would *not* have identified most troubled banks during the 1980's, and that the standard was also too low to capture most problem banks during the mid-1990's.[53]

The regulators' selection of a lenient capital threshold for PCA raises a serious question about their willingness to return to a policy of supervisory forbearance if they were confronted with a systemic crisis involving the potential failure of several large banks. The recent failure of Superior Bank, a $2 billion institution, creates further doubts about the effectiveness of PCA. Regulators failed to respond forcefully to Superior Bank's problems until its capital was already fatally impaired by losses from high-risk residual interests, which the bank retained after securitizing its subprime consumer loans.[54] Two studies provide additional evidence that

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[51] See Benston & Kaufman, supra note 33, at 144-48; GAO PCA Study, supra note 33, at 14-21.

[52] See GAO Deposit Insurance Reform Study, supra note 47, at 85-87 (contending that the minimum capital requirements imposed by federal regulators in 1992, based on the 1988 Accord, were "too low to adequately compensate for the types of risks that exist in today's highly competitive banking environment"); GAO PCA Study, supra note 33, at 26-28 (stating that more than 98% of all banks and thrifts satisfied the "adequately capitalized" standard at the end of 1992); Benston & Kaufman, supra note 33, at 146-48 (contending that federal regulators set the "adequately capitalized" threshold too low under their PCA rules); Peek & Rosengren, Capital Ratios, supra note 50, at 57 (same).

[53] David S. Jones & Kathleen K. King, The implementation of prompt corrective action: An assessment, 19 Journal of Banking & Finance 491, 493, 498-99, 508 (1995); Peek & Rosengren, Capital Ratios, supra note 50, at 52-56; GAO PCA Study, supra note 26, at 45 & tbl. 3.1.

[54] Benston & Kaufman, supra note 33, at 146-49, 152-56; GAO PCA Study, supra note 33, at 5-7, 25-29, 41-49, 55-56; Statement of FDIC Director John Reich on the Failure of Superior Bank, FSB,

regulatory capital requirements *failed* to eliminate high-risk bank strategies during the early 1990's, especially among larger banks.[55]

The Basel Committee and federal regulators believe that capital supervision for major banks can be improved by shifting from uniform rules to an individualized approach based on internal risk management policies developed by each LCBO.[56] However, determining capital requirements from LCBOs' internal risk models is highly problematic. Bank credit scoring models failed to anticipate the surge in consumer defaults on credit card loans that occurred during 1996-97. Similarly, VAR models developed by J.P. Morgan and other leading banks did not predict the severe trading losses that occurred during the global financial market disruption triggered by Russia's debt default in 1998.[57] Studies have shown that the most widely-used bank models for estimating market risk and credit risk are unreliable, because (i) they are based on

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submitted to the Senate Committee on Banking, Housing and Urban Affairs, Sept. 11, 2001 (available at <www.fdic.gov>) (stating that the failure of Superior Bank "illustrates the limits of [PCA] tools given to the regulators," because PCA sanctions are often ineffective in dealing with unrecognized losses embedded in securitization residuals and other unmarketable assets whose worth depends on a "complex, assumption-driven" valuation process).

[55] See Tina M. Galloway, Winson B. Lee & Dianne M. Roden, Banks' changing incentives and opportunities for risk taking, 21 Journal of Banking & Finance 509 (1997); Armen Hovakimian & Edward J. Kane, Effectiveness of Capital Regulation at U.S. Commercial Banks, 1985 to 1994, 55 Journal of Finance 451 (2000).

[56] The Basel Committee's proposal would allow each qualifying bank, in determining its capital requirements for credit risk, to use internal risk models to estimate (i) the probability of default by borrowers and (ii) the bank's exposure to loss in the event of default. 2001 Basel Capital Proposal Overview, supra note 36, at 8, 17-23; Speech by FRB Governor Laurence H. Meyer before the Institute of Int'l Bankers, May 5, 2001 (available at <www.federalreserve.gov>) [hereinafter Meyer IIB Speech], at 4-5, 7-8.

[57] See Jeremy Berkowitz & James O'Brien, How Accurate Are Value-at-Risk Models at Commercial Banks?, 57 Journal of Finance 1093, 1094-98 (2002) (finding that VAR models for trading activities used by six major U.S. banks failed to anticipate large trading losses that occurred during the global financial disruption of 1998); Wilmarth, Transformation, supra note 2, at 343-50, 373-78, 388-89, 396-97 (discussing shortcomings in VAR and credit scoring models developed by large banks).

faulty assumptions and insufficient data, and (ii) they permit banks to pursue strategies that may prove to be disastrous, because they tolerate a low-percentage risk of catastrophic losses.[58]

A further problem is that regulators may not possess sufficient expertise to understand and critique the internal risk management systems developed by LCBOs. Regulators generally cannot compete with major financial institutions in hiring highly-paid financial "rocket scientists" to design and analyze complex derivatives and other sophisticated risk management tools. Accordingly, regulators may not be able to verify, with a high degree of confidence, the internal risk models and ratings developed by LCBOs.[59]

Bank regulators and bankers also have sharply conflicting motivations in establishing capital standards. Regulators want conservative capital rules that constrain risk-taking and protect the federal safety net, even at the expense of lower bank profits. In contrast, bankers want liberal capital rules that permit higher leverage and a greater ability to exploit federal safety

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[58] See Wilmarth, Transformation, supra note 2, at 343-50, 373-78 (discussing flaws in bank models for market risk); Patricia Jackson & William Perraudin, Regulatory implications of credit risk modelling, 24 Journal of Banking & Finance 1 (2000) (discussing problems with bank models for credit risk); Robert A. Jarrow & Stuart M. Turnbull, The intersection of market and credit risk, 24 J. Banking & Fin. 271, 272-78 (2000) (same); Jüttner, supra note 49, at 208-22 (same).

Two studies conclude that VAR-based capital rules for market risk create a perverse incentive for banks. Those rules penalize a bank whose trading losses exceed its specified VAR on more than 1% of trading days during a 250-day period. However, the rules do not assess any additional penalties based on the magnitude of losses that a bank may incur during those "outlier" days. Because the rules focus on the *frequency* rather than the *magnitude* of trading losses, profit-maximizing banks are tempted to construct risky asset portfolios that have the potential to produce larger gains but also involve a low-percentage risk of catastrophic losses. See Gordon J. Alexander & Alexandre M. Baptista, A VaR-Constrained Mean-Variance Model: Implications for Portfolio Selection and the Basle Capital Accord, Working Paper, July 16, 2001 (available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=275894>); Suleyman Basak & Alexander Shapiro, Value-at-Risk-Based Management: Optimal Policies and Asset Prices, 14 Review of Financial Studies 371, 372-80, 385, 398-99 (2001).

[59] Kaufman, On Money and Markets, supra note 19, at 225-29; GAO LCBO Study, supra note 24, at 7, 48; GAO Risk-Based Capital Study, supra note 48, at 98-99.

net subsidies, because those circumstances create the potential for higher shareholder returns. Bankers therefore have strong incentives to manipulate their internal risk rating systems to reduce their effective capital requirements.[60]

In this regard, it is very troubling that the Basel Committee's 2001 proposal offers LCBOs the opportunity to *reduce* their capital requirements if they establish internal rating systems for credit risk. The proposal essentially guarantees that banks qualifying for the new "internal ratings-based approach" will receive lower capital requirements than banks whose capital levels are determined under the "standardised approach" for credit risk. The Basel Committee thus appears to be inviting LCBOs to develop internal rating systems for the specific purpose of *reducing* their capital.[61] This approach hardly seems consistent with recent evidence indicating that major banks do *not* hold sufficient capital and reserves in light of their inherent risks.[62]

Finally, the new supervisory strategy of basing capital requirements on internal risk

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[60] GAO LCBO Study, supra note 24, at 41-42; GAO Risk-Based Capital Study, supra note 48, at 94.

[61] See 2001 Basel Capital Proposal Overview, supra note 36, at 9 (stating that, as an incentive for banks to develop internal rating systems, the proposal provides "capital incentives [for the internal ratings-based approach] relative to the standardised approach"); 2001 Basel Update, supra note 36, confirming that the proposed new capital accord would give "capital incentives . . . to encourage banks to adopt these more advanced approaches to credit risk"); 2002 Basel Revision, supra note 36, at 3 (indicating that the capital requirements for credit risk and operational risk for a bank using the internal ratings-based approach could decline up to 10% during the new Accord's first year of implementation and up to 20% during the second year of implementation, compared to the bank's previous capital requirements under the 1988 Accord). See also Meyer IIB Speech, supra note 56, at 5, 7-8, 10 (stating that banks with qualifying internal rating systems would have "lower total regulatory capital charges" and could experience "a significant decline in capital requirements relative to current levels").

[62] See Wilmarth, Transformation, supra note 2, at 242-44, 300-01, 382-88, 445 (describing analysts' and regulators' concerns about inadequate levels of capital and reserves at many large banks).

management systems creates the difficult problem of how to deter LCBOs from deliberately or negligently reducing their capital below a level necessary to ensure their solvency. A few years ago, the FRB considered a "precommitment" approach, under which LCBOs would commit to maintain adequate capital based on internal risk models and would pay fines if their capital allocations were later shown to be inadequate to cover their actual risks. However, the FRB never formally adopted the "precommitment" approach, and analysts questioned whether regulators would actually be willing to impose large enough penalties to deter LCBOs from manipulating their internal risk calculations. As critics noted, major banks are most likely to suffer capital shortfalls during periods of severe economic strain, and regulators would understandably be reluctant under those conditions to enforce large fines that might threaten the solvency of troubled LCBOs.[63] Unfortunately, the Basel Committee's 2001 proposal does not offer a "precommitment" approach or suggest any other mechanism for deterring LCBOs from using overly-aggressive internal rating systems to create a new form of capital arbitrage.

C. Current Limitations on Supervisory and Market Discipline

Bank supervision and market discipline share a common goal of discouraging banks from taking excessive risks. Recent studies have shown that examinations by regulators and market discipline by investors, analysts and credit rating agencies play complementary roles in

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[63] See Jackson & Perraudin, supra note 58, at 11-12; GAO Risk-Based Capital Study, supra note 48, at 110-11. In 1996, the New York Clearing House conducted a one-year test in which 10 major banks each precommitted an amount of capital for market risk based on their internal risk models. None of the 10 banks incurred trading losses that exceeded its precommitted capital during the one-year test period. However, it is noteworthy that (i) the precommitted capital amounts were *less* than the levels that would have been required under the existing capital rules for market risk, and (ii) the test occurred during a period of relative calm in the financial markets. While the test was too short to provide a reliable evaluation of the precommitment approach, it did suggest that LCBOs are likely to *reduce* their capital levels if they are permitted to rely on internal risk models. See GAO Risk-Based Capital study, supra note 48, at 112-13.

restraining risk-taking by banks. It appears that differing oversight methods used by regulators and market observers enable each group to discover proprietary information about banks that is not readily available to the other group.[64]

Nevertheless, both bank regulators and market participants have often failed to identify problems at major financial institutions until those institutions were already seriously or fatally injured. For example, federal regulators, credit rating agencies and investors did not recognize severe weaknesses at many large banks during the 1980's (including Continental Illinois and Bank of New England) until those banks were dangerously close to failure.[65] Federal regulators also failed in 1998 to perceive the grave threat that Long-Term Capital Management ("LTCM") posed to leading banks and securities firms, as well as the financial markets generally, until the hedge fund revealed its perilous condition to the FRB-NY.[66] Credit rating agencies did not anticipate the failure of several large insurance companies in the early 1990's, the Orange County bankruptcy in late 1994, the defaults of several subprime consumer finance companies in 1997,

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[64] E.g., Allen N. Berger, Sally M. Davies & Mark J. Flannery, Comparing Market and Supervisory Assessments of Bank Performance: Who Knows What When?, 32 Journal of Money, Credit & Banking 641 (2000); Robert DeYoung et al., The Information Content of Bank Exam Ratings and Subordinated Debt Prices, 33 Journal of Money, Credit & Banking 900 (2001); Board of Governors of the Federal Reserve System, Staff Study 172, Using Subordinated Debt as an Instrument of Market Discipline, Dec. 1999 (available at <www.federalreserve.gov>), [hereinafter cited as FRB Staff Subordinated Debt Study], at 5, 12-15.

[65] Benton E. Gup, Market Discipline and the Corporate Governance of Banks: Theory vs. Evidence, in Gup, New Financial Architecture, supra note 28, at 187 [hereinafter cited as Gup, Market Discipline], at 195-99; Richard E. Randall, Can the Market Evaluate Asset Quality Exposure in Banks?, New England Economic Review (Fed. Res. Bank of Boston, MA), July/Aug. 1989, at 3 *passim*.

[66] See Wilmarth, Transformation, supra note 2, at 358-61, 370-71.

or the collapse of Enron in late 2001.[67]

In the international arena, the IMF, bank regulators, credit rating agencies and investors all failed to anticipate the onset, severity and contagious effects of the Mexican peso crisis of 1994-95 and the Asian and Russian crises of 1997-98.[68] Similarly, regulators, banks and investors did not comprehend the potential risk exposures of major U.S. banks to those foreign crises. John Reed, the former co-chairman of Citigroup, recently admitted that major banks failed to foresee several major shocks to the global financial system during the 1990's, notwithstanding their costly investments in risk management. He candidly acknowledged that leading banks "don't do very well in managing risk in the financial sector."[69]

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[67] See Frank Partnoy, The Siskel & Ebert of Financial Markets?, Two Thumbs Down for the Credit Rating Agencies, 77 Washington University Law Quarterly 619, 661-62, 665 (1999) (describing the poor record of credit rating agencies in predicting large financial defaults during the 1990's); Amy Borrus et al., The Credit-Raters: How They Work and How They Might Work Better, Business Week, April 8, 2002, at 38 (reporting that the major credit rating agencies did not assign Enron a below-investment-grade rating until four days before Enron declared bankruptcy in Dec. 2001).

[68] See, e.g., Jeffrey E. Garten, Lessons for the Next Financial Crisis, 78 Foreign Affairs No. 2, Mar./April 1999, at 76, 76-83; Reuven Glick, Thoughts on the Origins of the Asian Crisis: Impulses and Propagation Mechanisms, in The Asian Financial Crisis: Origins, Implications and Solutions (William C. Hunter et al., eds., Kluwer Academic Pub. 1999) [hereinafter Asian Financial Crisis], at 33, 33-38, 47-51; Gup, Market Discipline, supra note 65, at 199-201; Jüttner, supra note 49, at 215-17; Kaufman, On Money and Markets, supra note 19, at 281-86; Karin Lissakers, The IMF and the Asian Crisis: A View from the Executive Board, in Asian Crisis, supra, at 3, 4-7. See also David Marshall, The Crisis of 1998 and the Role of the Central Bank, 25 Economic Perspectives No. 1 (Fed. Res. Bank of Chi., IL), 1st Qtr. 2001, at 2, 7 (stating that "[t]he Asian crisis was completely unforeseen by financial markets").

[69] Tom Fernandez, Reed Warns: Banks Not Equipped for Crisis, Am. Banker, Feb. 14, 2001, at 2 (quoting John Reed). See also Gup, Market Discipline, supra note 65, at 199-201 (discussing the inability of investors to predict large bank failures and financial crises during the 1980's and 1990's); Hovakimian & Kane, supra note 55, at 451 (stating that "the nation's 100 largest banks lost almost one-fourth of their market capitalization during the third quarter of 1998," thereby indicating that "risk-modeling systems for managing bank and taxpayer loss exposure are less effective than advertised"); Osman Kilic, David Tufte & M. Kabir Hassan, The 1994-95 Mexico Currency Crisis and U.S. Bank Stock Returns, 16 Journal of Financial Services Research 47, 57-59 (1999) (concluding that the Mexico peso crisis was "surprising to traders" and caused significant volatility in the stock prices for big banks that had major lending exposures to Mexico); supra note 65, infra notes 71-72 and accompanying text

Three primary factors appear to explain these repeated failures in supervisory and market discipline of LCBOs. First, major banks have become more complex and harder to evaluate by regulators and the financial markets over the past three decades. Second, all of the three leading institutional sources of market discipline for LCBOs – securities analysts, external auditors and rating agencies – have been compromised by conflicts of interest. Third, while market discipline is frequently *ineffective* in predicting the onset of financial crises, it can be *indiscriminate* in punishing firms *after* a financial crisis begins. As a consequence, federal regulators have consistently opposed any strong form of market discipline for LCBOs. Instead, regulators have followed market stabilization policies that, in practical effect, reduce the incentives for investors to monitor the soundness of large financial firms.

1. The Growing Complexity and Opacity of Financial Conglomerates

Major banks have increased their opacity to regulators and the securities markets by (i) increasing their lending exposures to below-investment-grade companies and subprime consumers, (ii) securitizing their assets, and (iii) expanding their dealing and trading activities in securities and OTC derivatives. Syndicated bank loans and OTC derivatives are privately-negotiated, customized financial agreements whose terms and potential financial impact are largely unknown to outsiders. OTC derivatives, residual interests from securitizations and other complex financial instruments enable banks (i) to place highly-leveraged bets on the direction of interest rates, currency rates and market prices for commodities, bonds and stocks, and (ii) to make rapid changes in their risk exposures. As a consequence, it is very hard for regulators and

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(citing studies finding that investors failed to anticipate serious problems at large U.S. banks during 1975-94).

market participants to evaluate the financial condition of major banks in a timely manner. LCBOs are also creating complex correlations among interest rate risk, credit risk and market risk as they combine traditional lending operations with investment banking and insurance activities. Neither regulators nor market participants are well positioned to assess the potential dangers of these new risk correlations.[70]

Three recent studies demonstrate the relative opacity of major banks to the financial markets. The first study concluded that investors did not anticipate either dividend cuts or supervisory enforcement actions at seventeen big "money center" banks during 1975-92. Public disclosures of these events (i) caused sharp, immediate declines in the stock prices of the subject banks, and (ii) had significantly negative contagious effects on the stock prices of other money center and regional banks.[71] The second study found that public reports of Bankers Trust's legal problems in 1994, which arose out of its OTC derivatives business, triggered a sharp decline in the stock prices of Bankers Trust and thirteen other banks that were leading dealers in OTC derivatives.[72] Thus, both studies indicate that the financial markets did not recognize the potential risk exposures of major banks until their problems were publicly disclosed.

A third study determined that, during 1983-93, Moody's and Standard & Poor's had

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[70] Flannery, supra note 24, at 101-09; Garten, Subtle Hazards, supra note 38, at 337-42, 346-51, 361-71, 382; Kaufman, On Money and Markets, supra note 19, at 71-83, 281-86, 329-37; Meyer FFIEC Speech, supra note 34, at 1, 5-6; Santomero & Eckles, supra note 24, at 15, 18; Alfred Steinherr, Derivatives: The Wild Beast of Finance 252-65, 274-84 (John Wiley & Sons, 1998); GAO LCBO Study, supra note 24, at 5, 15, 24, 28-30.

[71] Myron B. Slovin, Marie E. Slushka & John A. Polonchek, An anlysis of contagion and competitive effects at commercial banks, 54 Journal of Financial Economics 197 (1999).

[72] Joseph F. Sinkey, Jr. & David A. Carter, The reaction of bank stock prices to news of derivatives losses by corporate clients, 23 Journal of Banking & Finance 1725 (1999).

greater disagreements in their bond ratings for banks and insurance companies than for any other type of firm. In addition, the rating agencies' disagreements over bond ratings for banks *increased* after 1986, notwithstanding the efforts of Congress and bank regulators to restrict the scope of the TBTF policy. Donald Morgan, the study's author, concluded that the largest banks became *less* transparent to credit rating agencies after 1986, due to the growing focus of major banks on trading in securities, OTC derivatives and other financial instruments. Rating agencies apparently found it difficult to assess the risks inherent in bank trading positions that changed rapidly and without timely notice to market participants. The high concentrations of loans held by big banks also increased their opacity, because rating agencies could not readily measure the creditworthiness of the borrowers.[73]

2. Conflicts of Interest among Institutional Sources of Market Discipline

The effectiveness of each of the primary institutional sources of market discipline – securities analysts, external auditors and credit rating agencies – has been significantly undermined by conflicts of interest. For example, securities analysts became much more lenient in their evaluation of LCBOs and other large, publicly-traded corporations during the stock market boom and merger frenzy of the 1990's. During that period, most of the leading securities analysts were employed by either the "big three" Wall Street firms or the investment banking subsidiaries of universal banks. Analysts employed by investment banks had powerful incentives to issue "strong buy" recommendations for the stocks of major corporations, because (i)

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[73] Donald P. Morgan, Rating Banks: Risk and Uncertainty in an Opaque Industry, Fed. Res. Bank of N.Y., Staff Reports No. 105, May 2000 (available at <www.ny.frb.org>). See also Morgan & Stiroh, supra note 20, at 504-06 (finding additional evidence that major U.S. banks are relatively "opaque" to bond investors and rating agencies).

corporate managers viewed analysts' recommendations as a crucial factor in deciding whether to establish or maintain business relationships with particular investment banks, (ii) analysts received large bonuses when they helped their investment banking colleagues in securing underwriting and merger deals, (iii) managers of mutual funds and pension funds gave higher ratings to analysts who issued favorable reports on popular stocks held by the funds, and (iv) investment banks fired several prominent analysts who issued critical evaluations of leading banks or other big corporations.

By early 2002, federal and state regulators identified conflicts of interest among analysts as a major reason for the public's loss of faith in the securities markets. Regulators issued new rules and administrative orders designed to reduce those conflicts of interest. However, some commentators have questioned the effectiveness of the new rules, noting that (i) most analysts continue to be employed by Wall Street firms or universal banks, and (ii) the new rules leave substantial holes in the "Chinese wall" that supposedly insulates analysts from the influence of investment bankers. Accordingly, skeptical observers have warned that the objectivity of analysts can still be subverted by the dominant "deal culture" at their employers.[74]

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[74] For discussions of the conflicts of interest and client pressures affecting securities analysts, see Wilmarth, Transformation, supra note 2, at 468-69; Gretchen Morgenson, Pressuring Analysts: Hard Habit to Break, N.Y. Times, Aug. 11, 2002, § 3 (Money & Business), at 1; Gretchen Morgenson, Requiem for an Honorable Profession, N.Y. Times, May 5, 2002, § 3 (Money & Business) at 1; Susan Pulliam, Deals & Deal Makers: Analysts to Tell Congress that Skepticism Gets Them Abuse, Wall St. J., Mar. 19, 2002, at C1; Emily Thornton et al., Trying to Build a Wall on Wall Street, Business Week, April 29, 2002, at 40; Marcia Vickers, How Corrupt Is Wall Street?, Business Week, May 13, 2002, at 36.

In May 2002, the Securities and Exchange Commission ("SEC") approved new rules proposed by the National Association of Securities Dealers ("NASD") and the New York Stock Exchange ("NYSE"), which seek to reduce conflicts of interest among securities analysts. The NASD and NYSE rules (i) require analysts to disclose any personal financial interest in the companies they analyze, (ii) prohibit analysts from receiving compensation directly tied to investment banking fees paid by such

Lawmakers and regulators also focused on conflicts of interest among external auditors. Since the mid-1990's, leading accounting firms have failed to prevent a distressingly large number of publicly-traded corporations from issuing fraudulent financial statements. This trend culminated in the stunning collapses of Enron, Adelphia and WorldCom, which each declared bankruptcy after disclosing massive fraud in their financial reports covering several years. Investigations of these corporate scandals indicated that the professional independence and diligence of external auditors had been compromised by their extensive consulting work for audit clients. Critics charged that the aggressive solicitation of consulting deals by accounting firms

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companies, and (iii) require each research report to disclose whether the analyst's employer has received investment banking fees from the subject company during the past year or expects to receive such fees during the next three months. Rachel McTague, SEC Gives Nod to Markets' Analyst Rules; Changes Aimed at Boosting Independence, 34 Securities Regulation & Law Report (BNA) 749 (May 13, 2002). Less than two weeks after the SEC's action, the New York Attorney General settled an enforcement action against Merrill Lynch. The settlement agreement imposed a $100 million civil penalty and compels Merrill Lynch to adopt policies for securities analysts that are similar to the guidelines contained in the new NASD and NYSE rules. Kip Betz, Merrill Lynch Settles N.Y. Charges Over Analyst Conflicts, Will Pay $100M, 34 Securities Regulation & Law Report (BNA) 841 (May 27, 2002).

For commentaries questioning whether the foregoing regulatory initiatives are sufficient to remove conflicts of interest and ensure unbiased recommendations by analysts, see, e.g., Gretchen Morgenson, Good Deal for Merrill; How About Investors? Settlement May Not Easily Change a Culture that Created Conflicts, N.Y. Times, May 22, 2002, at C1 (cautioning that "cultures as enduring as Wall Street's are rarely overhauled with a single stroke"); Randall Smith, New NASD Rule Limits Analysts at 'Bake-Offs,' Wall St. J., June 6, 2002, at C1 (quoting Prof. Jay Ritter's view that, despite the new NASD rules, "[e]conomic fundamentals haven't changed . . . [and] the issuing company is still going to be told, 'We've got the No. 1 ranked analyst, and we don't ignore clients that we take public.'"); Randall Smith & Aaron Lucchetti, Heard on the Street: How Spitzer Pact Will Affect Wall Street, Wall St. J., My 22, 2002, at C1 (stating that the new NASD and NYSE rules, as well as the Merrill Lynch settlement, would *not* require "a complete separation of research and [investment] banking," because analysts could continue to "[w]rite research on investment-banking clients," and investment bankers could still "promis[e] research coverage as part of pitching for business"); Cleaning up global banking: The repentant banker, Economist, Aug. 24, 2002, at 53 (questioning whether it is feasible to insulate analysts from the conflicts of interest inherent in Wall Street firms).

had eroded their commitment to ensure the accuracy of audited financial statements.[75]

Congress responded by adopting the Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act contains several provisions designed to ensure the independence of external auditors for publicly-traded companies, and the Act also establishes a new public oversight board to supervise accounting firms. However, it remains to be seen whether new accounting rules and professional standards will guarantee the accuracy and transparency of audited financial statements for publicly-traded companies. Since 1980, accounting rules have generally failed to keep pace with the increasing complexity of business structures, financial strategies and "risk management" tools (including OTC derivatives) used by LCBOs and other major corporations.[76]

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[75] See, e.g., John A. Byrne et al., Special Report: How to Fix Corporate Governance, Business Week, May 6, 2002, at 68; Nanette Byrnes et al., Accounting in Crisis, Business Week, Jan. 28, 2002, at 44 (reporting, inter alia, that the percentage of accounting industry fees derived from consulting work increased from 31% in 1993 to 51% in 1999); Ianthe J. Dugan et al., On Camera: People at Anderson, Enron Tell How Close They Were, Wall St. J., April 15, 2002, at A1; Jonathan D. Glater, Lone Ranger of Auditors Fell Slowly Out of Saddle, N.Y. Times, April 20, 2002, at C1; Lynn E. Turner, Just a Few Rotten Apples? Better Audit Those Books, Wash. Post, July 14, 2002, at E1; Special report: Company accounts: Badly in need of repair, Economist, May 4, 2002, at 66 [hereinafter cited as Economist Accounting Report].

[76] For discussions of the political background of the Sarbanes-Oxley Act of 2002, see, e.g., Michael Bologna, Senate Unanimously Passes Landmark Accounting Bill, 97-0, 34 Securities Regulation & Law Report (BNA) 1200 (July 22, 2002); Keith Perine, Regulation Is Back in Vogue, 60 CQ Weekly 2018 (July 27, 2002); Adam Wasch, President Bush Signs into Law Broad Accounting Reform Legislation, 34 Securities & Regulation Law Report (BNA) 1303 (Aug. 5, 2002).

The Sarbanes-Oxley Act includes provisions that (i) prohibit external auditors of publicly-traded companies from providing certain types of non-audit services contemporaneously with an audit, (ii) impose a one-year ban on the ability of a former audit firm employee to accept employment as a senior officer of an audit client, (iii) require rotation every five years of the lead audit partner and reviewing audit partner for each audit client, (iv) establish the Public Company Accounting Oversight Board as a new self-regulatory organization with authority to supervise, inspect and investigate external auditors of publicly-traded companies, and (v) ensure greater independence of the Financial Accounting Standards Board ("FASB") from the accounting profession. See John T. Bostelman et al., Enactment of Broad Accounting, Corporate Governance Reform Act Brings New Prohibitions, Requirements for Executives and Auditors, 34 Securities & Regulation Law Report (BNA) 1281, 1287-89 (Aug. 5, 2002).

Some observers contend that the independence and reliability of credit ratings have also declined as the major rating agencies gained power to grant de facto "regulatory licenses" to bond issuers. Rules issued by federal and state regulators since 1975 have greatly limited the ability of banks, mutual funds and insurance companies to purchase debt securities that do not carry investment-grade ratings from "Nationally Recognized Statistical Ratings Organizations" ("NRSROs"). As a consequence, bond issuers pay substantial fees to NRSROs in order to obtain investment-grade ratings that are the functional equivalent of "regulatory licenses" to sell bonds to institutional investors. The SEC has exclusive power to designate rating agencies as NRSROs, and mergers have reduced the number of NRSROs to only three (Standard & Poor's, Moody's & Fitch).[77]

Professor Frank Partnoy maintains that the licensing powers granted to NRSROs have "fundamentally changed the nature of the product rating agencies sell. Today, issuers are paying

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For commentaries suggesting that new accounting rules may not be sufficient to ensure the accuracy and transparency of financial statements issued by LCBOs and other major corporations, see, e.g., Speech by FRB Governor Susan S. Bies before the Institute of International Bankers, June 10, 2002 (available at <www.federalreserve.gov>); Ken Brown, Creative Accounting: How to Buff a Company, Wall St. J., Feb. 21, 2002, at C1; Ken Brown, Heard on the Street: Auditors' Methods Make It Hard to Catch Fraud by Executives, Wall St. J., July 8, 2002, at C1; Steve Liesman, Heard on the Street: Many Accounting Practices, Not Just Enron's, Are Hard to Penetrate, Wall St. J., Jan. 23, 2002, at C1; Rachel McTague, President, Lawmakers Express Outrage at WorldCom News as SEC Brings Suit, 34 Securities Regulation & Law Report (BNA) 1065, 1067-68 (July 1, 2002) (citing congressional testimony by Professors John Coffee and Bala Dharan); Henny Sender, Heard on the Street: Call Up the Reserves: WorldCom's Disclosure Is Warning for Investors, Wall St. J., July 3, 2002, at C1; Economist Accounting Report, supra note 75.

[77] Partnoy, supra note 67, at 623-24, 681-83, 688-703. See also Kip Betz, Credit Ratings Agencies Consider Amending Monitoring Processes to Improve Timeliness, 78 BNA's Banking Report 342 (Feb. 25, 2002); Borrus et al., supra note 67; Ben White, Do Rating Agencies Make the Grade? Enron Case Revives Some Old Issues, Wash. Post, Jan. 31, 2002, at E1; Lawrence J. White, The Credit Rating Industry: An Industrial Organization Analysis, N.Y.U. Center for Law & Business, Working Paper No. 01-001, April 20, 2001 (available at <http://papers.ssrn.com/paper.taf?abstract_id=267083>), at 5, 10-14, 23-24.

rating fees, not to purchase credibility with the investor community, but rather to purchase a license [to sell bonds] from the regulators."[78] Due to their governmental immunity from outside competition, the three NRSROs receive lucrative fees from bond issuers and do not risk irreparable harm to their reputations when they issue erroneous ratings. In Professor Partnoy's view, the ratings of NRSROs have become "lagging indicators of credit quality" because their "oligopolistic" market position weakens their incentives to invest in improving the timeliness and accuracy of their ratings.[79]

At the same time, the crucial gatekeeping role of rating agencies has subjected them to increased pressures from bond issuers and institutional investors to provide positive ratings.[80] Given this situation, some commentators have criticized the Basel Committee for proposing that

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[78] Partnoy, supra note 67, at 703.

[79] Id. at 659 (quoting Prof. Bruce Lehmann); id. at 651-54, 659, 681-82, 703 (contending that NRSROs operate under "oligopolistic" conditions that enable them (i) to earn "abnormal profits" by charging large fees to bond issuers for "regulatory licenses," and (ii) to make modest investments in their credit review operations, including the payment of below-average salaries to their analysts); White, supra note 76, at 10-19, 23-25 (reaching similar conclusions). See also supra notes 65, 67-68 and accompanying text (noting that credit rating agencies have often failed to predict the onset of financial crises or the collapse of major banks and other large corporations).

[80] See Partnoy, supra note 67, at 659, 662. For example, in January 2002, Moody's released a proposal to change its credit rating practices by (i) making more rapid changes in ratings and (ii) giving more weight to market signals such as stock and bond prices. In response to this proposal, many institutional investors and bond issuers urged Moody's *not* to increase its reliance on market signals or to make frequent, unannounced changes in its ratings. These critics argued that Moody's proposed changes would increase the "volatility" of its ratings and could lead to more disruption and higher bond prices in the capital markets. After receiving these negative comments, Moody's said that it would "consider a significantly scaled back project" for increasing the timeliness of its rating changes. Moody's retrenchment provides suggestive evidence of the susceptibility of credit rating agencies to pressure from their "constituents" – viz., institutional investors and bond issuers. See Betz, supra note 76, at 342 (quoting Fran Laserson, a Moody's vice president); Borrus et al., supra note 67, at 40 (reporting that Moody's was "flooded with complaints by institutional investors" after issuing its January 2002 proposal); John Dooley, Credit Markets: Moody's Planned Overhaul of Its Ratings Process Includes Effort to Limit Volatility, Shorten Reviews, Wall St. J., Feb. 13, 2002, at C16 (reporting on opposition to Moody's proposal among institutional investors).

bank regulators should rely on credit ratings of borrowers in determining capital requirements for credit risk under the "standardised approach." These analysts fear that the use of credit ratings as a bank supervisory tool will increase pressures on rating agencies – from borrowers, banks and even regulators – to provide favorable ratings. Such pressures are likely to be especially intense during times of financial stress, when highly-leveraged companies need access to new credit and banks are hard-pressed to increase their capital. Thus, supervisory reliance on credit ratings could make them even less reliable as an objective measure of credit risk.[81]

3. Additional Limitations on the Effectiveness of Market Discipline as a Risk Control Device for Universal Banks

a. The Inconsistency of Market Discipline

The reliability of market discipline as a risk control device for LCBOs is open to further question, because financial markets often seem to be *ineffective* in predicting the onset of economic crises and *indiscriminate* in punishing risky firms *after* crises occur. Recent studies have shown that market discipline fluctuates in its intensity, with more relaxed monitoring in good times and more stringent oversight during periods of financial stress. The varying intensity of market discipline reflects the tendency of investors to act with excessive optimism during an expansionary "bubble" and to panic when the "bubble" bursts. For example, during the mid-1990's, financial institutions and other investors from developed nations disregarded potential warning signs and made huge investments in Latin America, Asia and Russia. However, when

[81] See, e.g., Howell E. Jackson, The Role of Credit Rating Agencies in the Establishment of Capital Standards for Financial Institutions in the Global Economy, in Regulating Financial Services and Markets in the 21st Century (Eilis Ferran & Charles A. E. Goodhart, eds., Oxford Univ. Press, 2001); White, supra note 76, at 1, 31-32; Rating agencies: Badly overrated, Economist, May 18, 2002, at 69.

subsequent events revealed the full risks of those investments, investors engaged in frenzied "flights to safety" that had a devastating impact on developing economies. The crises of the 1990's, like earlier "boom-and-bust cycles" in domestic and foreign economies since 1970, show how difficult it is for market participants and regulators (i) to avoid an excessive expansion of credit and speculative activities during the "bubble" phase of an economic boom, and (ii) to prevent a liquidity crisis in the financial markets and a sharp contraction in credit after the "bubble" bursts.[82]

The information technology and telecommunications sectors experienced a similar "boom-and-bust cycle" in the United States and Europe during 1996-2002. Investors bid up the stocks of high-technology companies to stratospheric levels during the bull market of the late 1990's. During the same period, banks, securities firms and venture capital funds provided lavish debt and equity financing to high-technology firms, including many start-up ventures. By the spring of 2000, it became evident that (i) the "new economy" would not continue to grow at the rapid pace of the 1990's, and (ii) firms in the information technology and telecommunications sectors would fall far short of their optimistic forecasts for revenues and earnings, due in large part to their creation of operating capacity that far exceeded customer demand for their services. As market participants recognized the magnitude of these adverse developments, share prices for

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[82] See, e.g., Cyclicality and Regulation: Remarks by FRB Chairman Alan Greenspan at the Conference on Bank Structure and Competition, Fed. Res. Bank of Chi., IL, May 10, 2002 (available at <www.federalreserve.gov>); Allen & Gale, supra note 22, at 236-40, 247-54; Ben Bernanke & Mark Gertler, Monetary Policy and Asset Price Volatility, 84 Economic Review No. 4 (Fed. Res. Bank of K.C., MO), 4th Qtr. 1999, at 17, 17-21; Roberto Chang & Andres Velasco, A Model of Financial Crises in Emerging Markets, 116 Quarterly Journal of Economics 489 (2001); Kaufman, Banking Architecture, supra note 28, at 46-47; Kaufman, On Money and Markets, supra note 19, at 68-83, 201-25, 270-325; Robert J. Shiller, Irrational Exuberance 44-68, 96-168, 203-33 (Princeton Univ. Press, 2000). See also supra notes 65-68 (citing numerous instances in which market participants failed to anticipate financial crises during the 1980's and 1990's).

high-technology companies plummeted and the markets for initial public offerings ("IPOs"), bonds and bank loans virtually shut down for those firms. Between March 2000 and July 2002, the bursting of the stock market "bubble" erased an estimated $7 trillion of investor wealth. The stock market's collapse reflected a generalized loss of investor confidence, which was aggravated by revelations of fraudulent schemes and grossly inflated earnings at many of the high-flying corporate "stars" of the 1990's. At the same time, bondholders and banks faced potential losses of hundreds of billions of dollars as a result of bankruptcy filings and threatened defaults by high-technology borrowers. At the end of July 2002, equity markets were stuck in a painful slump, and corporate borrowers faced much tighter credit conditions from banks and the bond markets.[83]

Thus, market discipline does *not* exert a consistent restraining force on managerial risk-taking. Investors are vulnerable to periodic cycles of euphoria and panic, due in part to their uncertainty about the direction of the economy and the soundness of financial intermediaries.[84]

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[83] For discussions of these developments, see, e.g., Franklin Allen, Do Financial Institutions Matter?, 56 Journal of Finance 1165, 1168-71 (2001); Shiller, supra note 82, at 3-68; Riva D. Atlas, A Torrent of Loans Becomes a Trickle, N.Y. Times, July 21, 2002, § 3 (Money & Business), at 1; Anthony Bianco, The Angry Market, Business Week, July 29, 2002, at 32; Rebecca Blumenstein et al., Downed Lines: Telecom Sector's Bust Reverberates Loudly Across the Economy, Wall St. J., July 25, 2001, at A1; E.S. Browning & Gregory Zuckerman, Market Medicine: What Stock Investors Need: First, Trust in Firms' Numbers, Wall St. J., July 17, 2002, at A1; Rich Miller et al., A New Credit Crunch, Business Week, Feb. 18, 2002, at 32; Steven Pearlstein, Fiber-Optic Overdose Racks Up Casualties, Wash. Post, May 2, 2002, at A1; Heather Timmons, Less Credit Where Credit Is Due, Business Week, July 22, 2002, at 68; Emily Thornton, Wall Street: The Big Chill, Business Week, Oct. 22, 2001, at 120; Vickers, supra note 74, at 38; Special report: The telecoms crisis: Too many debts, too few calls, Economist, July 20, 2002, at 59.

[84] For recent discussions of psychological factors that may contribute to investor euphoria and panic, see, e.g., David Hirshleifer, Investor Psychology and Asset Pricing, 56 Journal of Finance 1533 (2001); Shiller, supra note 82, at 44-68; 135-68; Andrei Shleifer, Inefficient Markets: An Introduction to Behavioral Finance (Oxford Univ. Press, 2000).

Cycles of investor sentiment are evident in the banking industry as well as the general economy. Studies of recent banking crises in the United States and Latin America have shown that investors and depositors (i) failed to restrain risk-taking by bank managers until a financial crisis revealed that some banks had already suffered severe harm, (ii) typically reacted to a crisis in the short term by punishing *all* banks exposed to the crisis, with only a limited degree of discrimination among banks with differing risk exposures, and (iii) applied a more effective and discriminating form of discipline only *after* the worst period of the crisis had passed.[85] Benton Gup has summarized the historical record of market discipline as a risk control device as follows:

> [B]ank regulators hope that market discipline will aid them in their task of bank supervision. This chapter questioned the effectiveness of market discipline. The track record of market discipline examined here suggests that it usually occurs after a significant incident, and that it does little to prevent misbehavior. . . . If market discipline means survival of the fittest, it works. If market discipline means controlling behavior, it does not appear to be effective.[86]

Notwithstanding this cautionary evidence regarding the limitations of market discipline, several prominent analysts have argued that a mandatory subordinated debt program for LCBOs would effectively control managerial risk-taking and supervisory forbearance. Under this

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[85] Randall, supra note 65, at 4, 7-18 (finding that equity investors failed to perceive serious problems at 40 large U.S. banks during the 1980's until serious damage had already occurred); John S. Jordan, Insiders' Assessments of the Stock Market's Pricing of New England Bank Stocks, 1988 to 1991, New England Economic Review (Fed. Res. Bank of Boston, MA), July/Aug. 1997, at 3 (concluding that (i) while equity investors punished the stocks of failing banks most severely, they aggressively sold the stocks of *all* publicly-traded New England banks during the banking crisis of 1989-91, and (ii) insiders of New England banks that ultimately survived recognized the market's overreaction and made substantial purchases of their own bank's stock); Maria S. M. Peria & Sergio L. Schmukler, Do Depositors Punish Banks for Bad Behavior? Market Discipline, Deposit Insurance, and Banking Crises, 56 Journal of Finance 1029, 1030-31, 1048-50 (2001) (finding that, during 1981-97, depositors in Argentina, Chile and Mexico failed to anticipate banking crises, engaged in generalized panics (with little attention to "bank fundamentals") *during* crises, and applied effective discipline based on "bank fundamentals" only *after* the worst period of each crisis had passed).

[86] Gup, Market Discipline, supra note 65, at 202.

approach, LCBOs would issue subordinated debt on a frequent and continuing basis in order to satisfy a designated portion of their capital requirements. Proponents of market discipline contend that holders of subordinated debt have strong incentives to restrain risk-taking by LCBOs, because (i) subordinated debtholders face a greater risk of loss and (unlike equity holders) do not receive potential gains when bank managers pursue speculative strategies, (ii) in contrast to deposits, subordinated debt issues have relatively long maturities that prevent their holders from engaging in sudden "runs," and (iii) based on the FDIC's record of dealing with large failing banks since 1984, subordinated debtholders would feel more exposed to loss than holders of uninsured deposits.[87]

Supporters also believe that a mandatory subordinated debt program would discourage LCBOs from taking excessive risks if regulators took supervisory action based on "yield spreads" between (i) the interest rate paid on each LCBO's subordinated debt and (ii) prevailing interest rates for either risk-free Treasury bills or low-risk corporate bonds. The weakest form of discipline would occur if regulators had discretion to use high yield spreads as a "warning signal" that warranted more stringent supervisory oversight. A more stringent form of discipline would occur if high yield spreads operated as automatic "triggers" that compelled regulators to impose sanctions under the PCA regime. Another strong form of discipline would apply if regulators prohibited LCBOs from issuing subordinated debt with yield spreads that exceeded a specified limit. Under this third approach, LCBOs that could not issue qualifying subordinated debt would have to shrink their assets to remain in compliance with capital rules or would face PCA

[87] See FRB Staff Subordinated Debt Study, supra note 64, at 2-3 (summarizing arguments in favor of mandatory subordinated debt programs).

sanctions for noncompliance. Proponents of mandatory subordinated debt generally favor the last two approaches, because they would minimize regulatory discretion and reduce the potential for supervisory forbearance.[88]

The effectiveness of a mandatory subordinated debt program depends, in substantial part, on the reliability of yield spreads as an accurate measure of bank-specific risk. Unfortunately, several studies have questioned, on at least three grounds, whether yield spreads can accurately and consistently distinguish between the relative risks posed by banks. First, yield spreads on bank subordinated debt have shown the same recurring pattern of relaxation and constraint that occurs more generally in the financial markets during "boom-and-bust" cycles. For example, credit markets maintained relatively low differentials between the yield spreads on subordinated debt issued by low-risk and higher-risk banks during recent periods of relative stability in the banking industry (e.g., the mid-1980's and 1992-96). In contrast, during recent periods of significant stress in the banking industry (e.g., 1988-91 and 1997-98), yield spreads widened considerably between subordinated debt issued by low-risk and higher-risk banks. Thus, investors exerted stricter discipline against more risky banks only *after* their underlying problems had been revealed by adverse economic conditions.[89]

A second problem is that yield spreads between bank subordinated debt and either

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[88] For prominent examples of mandatory subordinated debt proposals, see, e.g., Charles W. Calomiris, Building an incentive-compatible safety net, 23 Journal of Banking & Finance 1499, 1510-14 (1999); Douglas D. Evanoff & Larry D. Wall, Subordinated debt as bank capital: A proposal for regulatory reform, 24 Economic Perspectives No. 2 (Fed. Res. Bank of Chi., IL), 2d Qtr. 2000, at 40, 43-46.

[89] See Bd. of Governors of Fed. Res. Sys. & U.S. Treas. Dept., The Feasibility and Desirability of Mandatory Subordinated Debt, Dec. 2000 (available at <www.federalreserve.gov>) [hereinafter Federal Subordinated Debt Study], at 24-25, 27-28, 54-56; FRB Staff Subordinated Debt Study, supra note 64, at 16-24, 44, 48, 56-58.

Treasury bills or low-risk corporate bonds are "noisy" measures of relative bank risk, because those spreads reflect not only bank-specific risks but also general economic conditions and systemic problems in the financial services industry. A third difficulty is that yield spreads are significantly affected by the age and size of subordinated debt issues and the size of the issuing bank. Recent studies have shown that investors apply significant discounts to older or smaller issues of subordinated debt (due to concerns about liquidity), and also to debt issued by midsized banks that are believed to lack protection under the TBTF doctrine. Given these complications, many observers have warned that additional empirical studies must be performed before yield spreads can be used with confidence in evaluating the comparative risks of banks.[90]

Perhaps the greatest potential risk of a mandatory subordinated debt rule is the likelihood that it would aggravate the impact of a banking crisis on the broader economy. As indicated above, proponents of a mandatory program want regulators to respond to high yield spreads with strict sanctions for troubled LCBOs. Thus, for example, if an LCBO could not issue subordinated debt with acceptable yield spreads, regulators would compel the bank to shrink its assets and, potentially, could appoint a receiver for the bank under the PCA regime. Unfortunately, banks generally find it very difficult to issue equity capital or subordinated debt at precisely the time when they need it most desperately – i.e., during a severe economic downturn that produces widespread business failures and causes significant loan losses for banks. If troubled banks are compelled to increase their capital ratios during a serious recession, their most

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[90] See, e.g., Robert R. Bliss, Market discipline and subordinated debt: A review of some salient issues, 25 Economic Perspectives No. 1, Fed. Res. Bank of Chi., IL, 1st Qtr. 2001, at 24, 25, 29-37; Diana Hancock & Myron L. Kwast, Using Subordinated Debt to Monitor Bank Holding Companies: Is It Feasible?, 20 Journal of Financial Services Research 147 (2001); Federal Subordinated Debt Study, supra note 89, at 24-30; FRB Staff Subordinated Debt Study, supra note 64, at 46-49, 56-58.

likely response will be to cut their lending drastically if they cannot sell new issues of stock or subordinated debt. Bank retrenchments in lending and (in the worst case) bank failures will disrupt credit relationships with borrowers, thereby aggravating the economic downturn that triggered bank capital problems in the first place. During the early 1990's, for example, a rapid rise in nonperforming bank loans and the imposition of higher capital requirements forced many banks to curtail their lending, resulting in a prolonged "credit crunch."[91]

Advocates of mandatory subordinated debt recognize that their proposal's most troublesome feature is its inherent tendency to amplify business downturns. As a safety valve, proponents have suggested that supervisory assistance or waivers could be granted during economic crises to prevent severe disruptions in credit flows.[92] This concession indicates that strict market discipline creates very difficult tradeoffs between the benefits of eliminating moral hazard and the risks of undermining financial stability. As discussed in the next section, bank regulators have consistently chosen to stabilize markets and grant forbearance whenever a financial crisis has threatened to set off a generalized panic among investors and creditors.

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[91] See Gary Gorton & Andrew Winton, Liquidity Provision, Bank Capital, and the Macroeconomy, Working Paper, Oct. 9. 2000; FRB Staff Subordinated Debt Study, supra note 64, at 35-36, 63-66. For discussions of the "credit crunch" that occurred in the U.S. banking industry during the early 1990's, see, e.g., Robert T. Clair & Paula Tucker, Six Causes of the Credit Crunch, Economic Review (Fed. Res. Bank of Dallas, TX), 3d Qtr. 1993, at 1, 5-10; Joe Peek & Eric Rosengren, Bank regulation and the credit crunch, 19 Journal of Banking & Finance 679 (1995); Ronald E. Shrieves & Drew Dahl, Regulation, Recession, and Bank Lending Behavior: The 1990 Credit Crunch, 9 Journal of Financial Services Research 5 (1995); Larry D. Wall & David R. Peterson, Bank holding company capital targets in the early 1990s: The regulators versus the markets, 19 Journal of Banking & Finance 563 (1995).

[92] See Calomiris, supra note 88, at 1510-16 (suggesting that the government could purchase preferred stock to recapitalize banks and maintain a reasonable flow of bank credit during severe economic crises); Evanoff & Wall, supra note 88, at 47-48, 51 n.29 (suggesting that regulators could provide "temporary relief" from subordinated debt rules if corporate bond markets were frozen by a generalized "liquidity crunch").

b. Resistance to Market Discipline among Bank Regulators

Bank regulators fully recognize the potentially harsh effects of market discipline during financial crises.[93] For that reason, regulators have shown little enthusiasm for any "strong" form of market oversight, despite their recent expressions of support for improved monitoring of LCBOs by investors and other market participants.

For example, during the banking crisis of 1989-91 regulators lamented many of the adverse effects of market discipline (e.g., bank failures, the difficulty of raising new capital, and the "credit crunch" resulting from the inability of capital-constrained banks to make new loans).[94] Regulators also did their best to weaken the restrictions on supervisory forbearance established by the PCA regime.[95] During the mid-1990's, regulators joined the banking industry in trying to block changes in accounting rules that required banks to adopt market-value accounting principles for assets held in trading accounts. The new accounting rules were designed to improve market discipline by making the financial operations of banks more transparent to investors. Nevertheless, regulators argued that the new rules would have a destabilizing effect by creating more "volatility" in the reported earnings of banks.[96]

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[93] E.g., 1999 Greenspan IMF Speech, supra note 28, at 1-3; 2000 Meyer NBER Speech, supra note 27, at 1-4.

[94] See Helen A. Garten, Whatever Happened to Market Discipline of Banks?, 1991 Annual Survey of American Law 749, 750-54, 776-83.

[95] Benston & Kaufman, supra note 33, at 146-49; GAO PCA Study, supra note 33 at 20-21, 36-40, 49-52.

[96] See Benston & Kaufman, supra note 33, at 149 (discussing regulatory opposition to market-value accounting for bank assets). The FRB joined the banking industry in opposing FASB's decision to adopt Statement of Financial Accounting Standards ("FAS") 115 in 1993. FAS 115 requires banks to "mark to market" all investment securities except for those properly designated as "held to maturity." Bank executives and federal regulators argued that FAS 115 would increase the "volatility" of bank

The most recent evidence of regulatory opposition to strict market discipline can be seen in the decision by the FRB and the Treasury Department to *reject* a mandatory subordinated debt program for LCBOs. The agencies acknowledged that a mandatory policy would increase market discipline. However, they warned, a mandatory rule could disrupt credit flows and increase "systemic risk" during economic downturns if it (i) required issuance of subordinated debt at regular intervals with limits on yield spreads, and (ii) forced LCBOs to shrink their assets if they could not issue qualifying debt. The agencies concluded that the "net benefits" of mandatory subordinated debt were "currently too uncertain to justify adopting a mandatory policy."[97] A prominent analyst declared that the FRB and the Treasury Department had effectively "dump[ed] buckets and buckets of cold water on the idea of using subordinated debt as a tool for market discipline."[98]

The opposition of federal regulators to any strong form of market discipline is consistent with their faithful adherence to the TBTF doctrine whenever they have determined that the failure of a large financial institution could destabilize the financial system. TBTF bank rescues

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earnings and expose banks to sudden shortfalls in their capital. See David Siegel, Capital: FASB Votes to Adopt Mark-to-Market Rule, Am. Banker, April 14, 1993, at 1; Barbara A. Rehm, Rising Rates Put Banks in Double Bind, Am. Banker, May 13, 1994, at 1 (quoting FRB chairman Alan Greenspan).

The FRB also supported the banking industry's strong objections to FASB's adoption of FAS 133 in 1998. FAS 133 requires banks to apply market-value accounting principles to all derivatives except for those qualifying as bona fide hedges. Once again, bank executives and federal regulators contended that the FASB's new rule would create undesirable "volatility" in the reported earnings of banks. See Elizabeth McDonald, Greenspan Urges FASB to Drop Plan On Adjusting Earnings for Derivatives, Wall St. J., Aug. 7, 1997, at B2; Aaron Elstein, Banks Decry Plan to Make Them Report Derivatives' Market Value, Am. Banker, Nov. 19, 1996, at A1.

[97] Federal Subordinated Debt Study, supra note 88, at vii, 53-56.

[98] Rob Garver, Skepticism Rising on Market as Regulator, American Banker, Jan. 22, 2001, at 1 [hereinafter cited as Garver, Market as Regulator] (quoting Bert Ely).

appear to be part of a broader, unstated federal policy of maintaining stable financial markets. This implicit policy has grown out of the recognition that (i) major banks increasingly depend on the stability and liquidity of the securities and derivatives markets, due to their leading role in those markets, and (ii) investments tied to the capital markets (including OTC derivatives, mutual funds, annuities and variable life insurance) account for a rapidly growing percentage of the financial assets and risk management tools of businesses and consumers. Strong evidence of the regulators' commitment to market stabilization can be seen in their rescues of TBTF banks (from Franklin National Bank in 1974 to Continental Illinois in 1984, First RepublicBank in 1988, and Bank of New England in 1991) and in the FRB's repeated interventions to prevent serious disruptions in the financial markets (from the Penn Central crisis of 1970 to the Hunt silver crisis of 1980, the stock market crash of 1987 and the near-collapse of LTCM in 1998).[99]

The FRB's responses to the recent stock market slump and the terrorist attack on the World Trade Center provide further evidence of its determination to maintain stable and liquid capital markets. From January 2001 to January 2002, the FRB implemented eleven cuts in short-term interest rates and reduced those rates to their lowest level in four decades.[100] In July 2001, FRB Chairman Alan Greenspan informed Congress that the FRB was cutting interest rates to

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[99] Henry T.C. Hu, Faith and Magic: Investor Beliefs and Government Neutrality, 78 Texas Law Review 777, 780, 865-72 (2000); Kaufman, On Money and Markets, supra note 19, at 208-21, 257-59, 310-12; Mahoney, supra note 26, at 56-58; Steinherr, supra note 70, at 53-61, 274-76, 282-83; Wilmarth, Transformation, supra note 2, at 224-25, 235-37, 300-06, 312-15, 369-73, 470-71.

[100] See Richard W. Stevenson, Fed Chairman Hints at End of Rate Cuts, N.Y. Times, Jan. 25, 2002, at C1. See also James C. Cooper & Kathleen Madigan, Business Outlook: The Data Will Be Grim – But Give the Fed a Chance, Business Week, Oct. 15, 2001, at 37 (stating that the FRB's interest rate cuts during 2001 were "the most aggressive easing [of monetary policy] in the postwar era"); Wilmarth, Big Bank Mergers, supra note 14, at 45-46 (discussing the FRB's similar interest rate cuts in response to the banking crisis and recession of 1990-92).

offset the adverse impact of a sharp downturn in the high-technology sector, which had weakened the general economy and caused a slump in equity market prices. In his remarks, Chairman Greenspan revealed the FRB's underlying policy goal of stabilizing the financial markets:

> [O]ur only realistic response to a speculative bubble is to lean against the economic pressures that may accompany a rise in asset prices, bubble or not, and *address forcefully the consequences of a sharp deflation in asset prices should they occur.*[101]

In response to the terrorist attack on the World Trade Center in September 2001, the FRB flooded the financial markets with liquidity by purchasing more than $150 billion in government securities and extending more than $45 billion in discount window loans to banks. The FRB also reportedly suspended Section 23A's limitations on affiliate transactions and urged LCBOs to transfer funds to their securities subsidiaries in order to maintain the liquidity of those affiliates. The FRB's actions prevented a prolonged liquidity crunch in the capital markets, just as its similar response had done during the 1987 stock market crash. Gerald Corrigan, who was President of the Federal Reserve Bank of New York during the 1987 crash, defended the FRB's conduct in September 2001 in the following terms: "This whole thing is a confidence game, and you better damn well think carefully of anything that can shake . . . public confidence in the financial markets, and in particular, the stock market."[102]

Few would question the FRB's wisdom in cutting interest rates to counteract a serious

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[101] Testimony of FRB Chairman Alan Greenspan before the House Committee on Financial Services, July 18, 2001, reprinted in 87 Federal Reserve Bulletin 588 (2001) (quote at 592) (emphasis added).

[102] See Christopher J. Neely, September 11, 2001, Monetary Trends (Fed. Res. Bank of St. Louis, MO), Nov. 2001 (available at <www.stls.frb.org/research>) (discussing FRB's discount window loans); Raghavan et al., supra note 41 (describing FRB's purchase of government securities and waiver of Section 23A, and quoting Mr. Corrigan); supra notes 39-40 and accompanying text (discussing restrictions on affiliate transactions under Section 23A).

economic downturn, or in providing emergency liquidity through open-market operations during a stock market crash. However, the FRB's actions in organizing the rescue of LTCM in 1998, and in waiving affiliate transaction rules for LCBOs in 2001, strongly indicate that the FRB views the survival of major financial conglomerates as an indispensable element of its broader mission to preserve market stability. Investors therefore have every reason to be confident that the TBTF policy remains a centerpiece of U.S. financial regulation.

In sum, the TBTF policy is the great unresolved problem of bank supervision, because it undermines the effectiveness of both regulatory oversight and market discipline over LCBOs.[103] A recent article in the *American Banker* summed up the current situation in the following words:

> [A] lingering impression that the government will bail out any large institution that gets into trouble has encouraged the markets to give financial institutions less scrutiny than other businesses. 'Until the market has a credible expectation that discipline is required,' market discipline is 'a long way off.'[104]

III. A New Regulatory Regime Is Needed to Control the Risk-Taking Incentives of Financial Conglomerates

Given the shortcomings of current approaches, a new regulatory program must be designed to constrain the risk-taking incentives of LCBOs. As described below, my proposed program has three major elements: (i) protecting the deposit insurance system from the expense of TBTF bailouts, (ii) requiring financial conglomerates to bear primary responsibility for the financial costs of such bailouts, and (iii) adopting further reforms to improve supervisory

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[103] See Robert T. Parry, Financial Services in the New Century, FRBSF Economic Letter No. 98-15 (Fed. Res. Bank of S.F., CA), May 8, 1998, at 2; Hoenig, supra note 27, at 10-13; Kaufman, On Money and Markets, supra note 19, at 207-10, 237-40; Stern, supra note 27, at 4-5, 24-26.

[104] Garver, Market as Regulator, supra note 98 (quoting analyst Karen Shaw Petrou).

oversight, reduce conflicts of interest and enhance market discipline.

A. Insulating the Deposit Insurance System from TBTF Bailouts

The most effective way to protect the deposit insurance system from the cost of TBTF rescues is to create a two-tiered structure of bank regulation and deposit insurance.[105] The first tier would consist of "traditional" banking organizations that limit their activities (including the activities of all holding company affiliates) to lines of business that meet the "closely related to banking" test in Section 4(c)(8) of the BHC Act. For example, this first tier of traditional banks could take deposits, make loans and offer fiduciary services. They could act as *agents* in selling securities, mutual funds and insurance products underwritten by *non-affiliated* firms. They could underwrite, purchase and deal in "bank-eligible" securities that national banks are permitted to underwrite or deal in directly. They could use derivatives for bona fide hedging transactions that qualify for hedging treatment under FAS 133.[106] Most first-tier banks would probably be smaller, community-based banks, because those banks do not have any comparative advantage – and therefore have not shown any substantial interest – in engaging *as principal* in insurance underwriting, securities underwriting, derivatives dealing or other capital markets activities. These community banks are well positioned to continue their traditional business of attracting core deposits, providing relationship loans to consumers and firms, and offering wealth

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[105] For a previous description of this proposal for a two-tiered structure of bank regulation and deposit insurance, see Wilmarth, Big Bank Mergers, supra note 14, at 77-87. As indicated in that article, I am indebted to Robert Litan for many of the concepts incorporated in my two-tiered proposal. See Robert E Litan, What Should Banks Do? 164-89 (Brookings, 1987).

[106] See Wilmarth, Transformation, supra note 2, at 225-26 (describing securities that are "eligible" for underwriting and dealing by national banks under 12 U.S.C. § 24(Seventh)); supra note 96 (discussing FASB's adoption of FAS 133).

management services through their fiduciary operations.

In order to provide reasonable flexibility for this first tier of traditional banks, Congress should amend Section 4(c)(8) of the BHC Act by allowing the FRB to expand the list of approved "closely related" activities for holding company affiliates of traditional banks.[107] Traditional banks and their holding companies would continue to operate under their current supervisory arrangements, and all of the banks' deposits (up to the statutory limit) would be covered by deposit insurance.

In contrast, depository institutions and their affiliates would be placed in the second tier of "nontraditional" banking organizations if they engage in (i) underwriting or trading in "bank-ineligible" securities, (ii) underwriting insurance (except for credit-related insurance), (iii) dealing or trading in derivatives (except for bona fide hedging transactions under FAS 133), or (iv) merchant banking. These second-tier, nontraditional banking organizations would include: (A) financial holding companies registered under Section 4(k) of the BHC Act (which was added by the GLB Act), (B) holding companies owning grandfathered "nonbank banks," and (C) grandfathered "unitary thrift" holding companies.[108] Second-tier holding companies would

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[107] Unfortunately, the GLB Act prohibits the FRB from approving any new "closely related" activities for bank holding companies under Section 4(c)(8) of the BHC Act. See Malloy, supra note 9, at 801 (stating that the GLB Act "freezes in place," as of November 12, 1999, the list of permissible activities under Section 4(c)(8)). Congress should revise Section 4(c)(8) by authorizing the FRB to approve a limited range of new activities that are "closely related" to the traditional banking functions of accepting deposits, extending credit, discounting negotiable instruments and providing fiduciary services. See Wilmarth, Big Bank Mergers, supra note 14, at 80 n.365, 84 & n.378.

[108] See O'Neal, supra note 9, at 100-08 (discussing activities authorized for financial holding companies under the GLB Act); Wilmarth, Transformation, supra note 2, at 423-24 (explaining that (i) during the 1980's and 1990's, many securities firms, life insurers and industrial firms used the "nonbank bank" loophole or the "unitary thrift" loophole to acquire FDIC-insured institutions, and (ii) those loopholes were closed to new acquisitions by a 1987 statute and the GLB Act, respectively).

therefore encompass all of the largest banking organizations, which are heavily engaged in capital markets activities, together with other financial conglomerates that control FDIC-insured depository institutions.

Under my proposal, FDIC-insured depository institutions that are subsidiaries of second-tier holding companies must adopt a "narrow bank" structure. Narrow banks would hold all of their assets in the form of cash and marketable, short-term debt obligations, such as qualifying government securities, highly-rated commercial paper and other debt instruments that are eligible for investment by money market mutual funds ("MMMFs") under the SEC's rules. Narrow banks could not accept any *uninsured* deposits. Narrow banks would present a very small risk to the FDIC's deposit insurance funds, because (i) each narrow bank's assets would be "marked to market" on a daily basis, and the FDIC could therefore readily determine whether a narrow bank was threatened with insolvency, and (ii) the FDIC could promptly convert a narrow bank's assets into cash if the FDIC decided to liquidate the bank and pay off the claims of its insured depositors.[109]

The foregoing asset restrictions would effectively protect the FDIC from loss if a narrow bank failed. In addition, three rules would prevent nontraditional holding companies and their *nonbanking* subsidiaries from receiving any subsidy from the narrow bank's deposit insurance. First, the narrow bank could not make (or receive) any transfer of funds or credit to (or from) its affiliates, *except* for (i) the bank's payment of dividends out of profits to its parent holding company, and (ii) the bank's receipt of capital infusions from its parent holding company. Second, if a narrow bank failed, the FDIC would be strictly prohibited from making payments to

[109] See Wilmarth, Big Bank Mergers, supra note 14, at 79-82.

anyone who was not an *insured* depositor of the bank. Third, the "systemic risk" provision currently included in the Federal Deposit Insurance Act ("FDI Act") would be repealed. As a consequence, the FDIC would be required to follow the least costly resolution procedure for *all* failed banks, and the FDIC could no longer rely on the TBTF policy as a justification for protecting *uninsured* creditors of a failed bank or its nonbank affiliates.[110] As discussed below, the FRB, as LOLR, would undertake primary responsibility for addressing TBTF problems.

Insulating the FDIC's deposit insurance funds from the possibility of TBTF bailouts would have important benefits. It would make clear to the financial markets that the FDIC's deposit insurance funds could *only* be used to protect *insured* depositors of failed banks. *Uninsured* creditors of a financial holding company – regardless of its size – would no longer have any reasonable expectation of being protected by the FDIC if the holding company or any of its banking or nonbanking subsidiaries failed. Shareholders and creditors of the holding company would therefore have stronger incentives to monitor its financial condition. In addition, the narrow bank format would prevent financial conglomerates from exploiting the deposit insurance subsidy, because conglomerates could no longer call upon their insured depository subsidiaries to make transfers of funds or credit to (or for the benefit of) nonbank affiliates.

A further advantage of my proposal is that traditional banks (which are likely to be smaller banks) would no longer bear any part of the cost of rescuing *uninsured* creditors of TBTF banks. Under current law, all FDIC-insured banks must pay a special assessment (allocated in

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[110] See Wilmarth, Transformation, supra note 2, at 300 (describing (i) the FDI Act's general rule requiring the FDIC to choose the least costly method for resolving failed banks, and (ii) the "systemic risk" exception in 12 U.S.C. § 1823(c)(4)(G), which allows the FDIC, with the concurrence of the FRB and the Treasury Dept., to protect uninsured creditors while resolving a TBTF bank).

proportion to their total assets) to reimburse the FDIC for the cost of protecting uninsured claimants of a TBTF bank under the "systemic risk" provision. The FDIC has noted the unfairness of expecting smaller banks – which could *never* be the subject of a TBTF rescue – to help pay for "systemic risk" bailouts. The FDIC has suggested that the way to correct this inequity is "to remove the systemic risk exception from the [FDI Act],"[111] as I am proposing here.

Critics have raised two major objections to the narrow bank concept. First, critics point out that the asset restrictions imposed on narrow banks would prevent them from acting as intermediaries of funds between depositors and borrowers. Most narrow bank proposals would require such banks to invest their deposits in safe, highly marketable assets such as those permitted for MMMFs. Narrow banks would therefore be largely or entirely barred from making commercial loans. As a result, a banking system composed *exclusively* of narrow banks could not provide credit to small and midsized firms that lack access to the securities markets.[112]

However, my two-tiered proposal should greatly reduce any disruption of the traditional role of banks in acting as intermediaries between depositors and bank-dependent firms. My proposal would permit first-tier banks (primarily community banks) to continue making commercial loans that are funded by deposits. As I have shown elsewhere, community banks make most of their commercial loans in the form of longer-term "relationship" loans to small and

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[111] Federal Deposit Ins. Corp., Options Paper, Aug. 2000 [hereinafter cited as 2000 FDIC Options Paper], at 33 (explaining that the FDI Act requires the FDIC to recover the cost of a "systemic risk" bailout by imposing a special assessment on all FDIC-insured banks in proportion to their total assets).

[112] See, e.g., Neil Wallace, Narrow Banking Meets the Diamond-Dybvig Model, 20 Quarterly Review No. 1 (Fed. Res. Bank of Minneapolis, MN), Winter 1996, at 3. See also Wilmarth, Big Bank Mergers, supra note 14, at 79-81 (explaining that narrow banks would be prohibited from making commercial loans, except perhaps for a limited basket of loans based on a fraction of their equity capital).

midsized firms. Community banks have significant advantages in making such loans, because (i) their main offices are located in the communities where they make most of their commercial loans, and their employees are therefore well informed about the character, reputation and skills of local business owners, (ii) they maintain greater continuity in their branch managers and loan officers, thereby creating stronger relationships with local business owners, and (iii) they typically provide greater flexibility to their loan officers and business customers. Under my proposal, community banks could carry on their deposit-taking and lending activities without any change from current law, and their primary commercial lending customers would continue to be smaller, bank-dependent firms.

In contrast to community banks, most big banks do not make a substantial number of relationship loans to small firms. Instead, big banks provide credit to smaller firms primarily through automated "transaction-based" programs that (A) disburse loans in relatively small amounts (usually under $100,000), (B) use centralized, impersonal approval methods based on credit scoring, and (C) enable loans to be securitized into asset-backed securities sold to investors in the capital markets. Under my proposal, as indicated above, most large banks would become second-tier organizations. Second-tier holding companies would conduct their business lending programs through nonbank finance subsidiaries that are funded by commercial paper and other debt instruments sold to investors in the capital markets. This operational structure should not create a substantial disincentive for the small business lending programs currently offered by big banks, because a major portion of those programs is already financed by the capital markets through securitization. Accordingly, my two-tier proposal should not cause a significant reduction in bank loans to bank-dependent firms, because big banks have already moved away

from traditional relationship-based lending funded by deposits.[113]

The second major criticism of narrow bank proposals is that they lack credibility, because federal regulators would retain the inherent authority (whether explicit or implicit) to organize bailouts of major financial firms during periods of severe economic distress. Accordingly, critics maintain, the narrow bank concept simply shifts the TBTF problem from the insured bank to its nonbank affiliates.[114] I answer this criticism in the following section, in which I propose to transfer to the FRB – with important new restrictions – the responsibility for administering TBTF rescues.

B. Assigning the FRB with Responsibility over TBTF Institutions

Given its role as "umbrella regulator" for financial holding companies, as well as its responsibility for monetary policy and the payments system, the FRB is best suited to deal with large financial conglomerates whose failure might create a systemic crisis.[115] In addition, as LOLR, the FRB has authority to provide emergency discount window advances to a major financial institution or its affiliates.[116] Under my proposal, the FRB could use its LOLR powers

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[113] For discussions of the important differences between the small business lending patterns of community banks and larger banks, see, e.g., Allen N. Berger & Gregory F. Udell, Small Business Credit Availability and Relationship Lending: The Importance of Bank Organisational Structure, Economic Journal (2002) (forthcoming); Wilmarth, Transformation, supra note 2, at 254-70.

[114] E.g., Mishkin, supra note 27, at 689-90; Stern, supra note 27, at 25-26.

[115] See O'Neal, supra note 9, at 104-06 (observing that the GLB Act designates the FRB as the "umbrella regulator" for financial holding companies); Heidi Mandanis Schooner, Regulating Risk Not Function, 66 University of Cincinnati Law Review 441, 478-86 (1998) (contending that the FRB is best situated to act as "systemic risk regulator" for financial conglomerates).

[116] The FRB provides discount window loans to banks under 12 U.S.C. §§ 347, 347a & 347b. In addition, under 12 U.S.C. § 343, the FRB may extend discount window loans to nonbank entities in "unusual and exigent circumstances." Thus, the FRB may provide emergency liquidity support to securities firms and other nonbank firms after a major economic shock similar to the 1987 stock market

to support financial conglomerates in situations involving systemic risk.

However, I would impose three restrictions to prevent the FRB from encouraging moral hazard among large financial conglomerates. First, the FRB must obtain the Treasury Department's concurrence before making any discount window advances for the purpose of protecting uninsured creditors of a failing financial institution or its affiliates. Second, if an institution fails after receiving LOLR assistance, the FRB must recover all unpaid emergency advances by imposing a special assessment on other second-tier holding companies of the same class as the entity that received the advances.[117] This reform would require the FRB to charge *all* depository institution holding companies of the relevant class, in proportion to their total assets, for the unpaid balance of any discount window loan extended to a second-tier holding company of the same class. As indicated above, the three classes of second-tier holding companies would be (i) financial holding companies registered under Section 4(k) of the BHC Act, (ii) holding companies owning grandfathered "nonbank banks," and (iii) grandfathered "unitary thrift" holding companies.[118]

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crash. See James A. Clouse, Recent Developments in Discount Window Policy, 80 Federal Reserve Bulletin 965, 965-67, 972-76 (1994); Walker F. Todd, FDICIA's Emergency Liquidity Provisions, 29 Economic Review No. 3 (Fed. Res. Bank of Cleve., OH), 3d Qtr. 1993, at 16, 19-22.

[117] These two conditions would be similar to provisions currently embodied in the FDIC's "systemic risk" authority under the FDI Act. See 2000 FDIC Options Paper, supra note 111 (explaining that the FDIC must (i) obtain the concurrence of the FRB and the Treasury Dept. before protecting any uninsured creditors of a TBTF bank, and (ii) make a special ex post assessment on the banking industry to recover the cost of any such bailout).

[118] See supra note 108 and accompanying text (describing the three classes of "nontraditional" second-tier holding companies). If the FRB made emergency discount window loans to protect the creditors of a failing securities firm or a failing insurance company that was *not* affiliated with an insured depository institution, my proposal would require the FRB to recover the unpaid balance of those advances by imposing a special assessment on all *non-affiliated* securities firms or insurance companies, as the case may be.

Potential liability for FRB special assessments would give nontraditional holding companies a strong incentive to monitor other second-tier organizations and to alert the FRB if they became aware of circumstances indicating that a competitor was taking excessive risks or was otherwise exposed to losses that might threaten its solvency. A system of joint liability and mutual discipline could be formalized by organizing second-tier holding companies into one or more self-regulating clearinghouses. Such clearinghouses could attract members based on a common geographic location or a similarity of product offerings. A clearinghouse structure would allow its members to establish rules for (i) monitoring the financial condition of each member, (ii) settling obligations between members, and (iii) providing assistance to weakened members during market disruptions. Each clearinghouse could also organize a self-insurance system by requiring its members to make contributions to a reserve fund, which could be used to help members during financial emergencies or to satisfy FRB special assessments for unpaid discount window loans to members.[119]

Under my third proposed restriction on its LOLR powers, the FRB could not make emergency advances to protect uninsured creditors of a financial conglomerate unless a mandatory "haircut" was assessed against all uninsured claims. Requiring about a 10% "haircut" would appear reasonable, as it would encourage uninsured creditors to exercise greater discipline over financial holding companies but would probably not be so great as to trigger contagious "runs" by large depositors, holders of commercial paper and other uninsured short-term

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[119] For descriptions of the monitoring, liquidity and self-insurance services provided by private bank clearinghouses to their members prior to the creation of the FRB and the FDIC, see, e.g., Calomiris, supra note 2, at 8-10, 60, 71; David G. Oedel, Private Interbank Discipline, 16 Harvard Journal of Law & Public Policy 327, 344-60 (1993).

creditors.[120] The FRB could be given discretion to waive this mandatory "haircut" during an exceptionally severe economic crisis. However, as an appropriate disincentive, the FRB should be obligated to use its own reserves to pay for the cost of any waiver.

C. Further Reforms to Improve Supervisory Oversight and Market Discipline

The proposals outlined above would significantly reduce the TBTF subsidy currently enjoyed by large financial conglomerates. However, six additional regulatory initiatives are urgently needed to address existing flaws in supervisory oversight and market discipline. First, regulators should compel LCBOs to provide more extensive and timely disclosures about their risk exposures and the effectiveness of their risk management systems.[121] In particular, LCBOs should reveal more information about the linkages between their lending activities and their underwriting and dealing operations in the capital markets. For example, each LCBO should specify whether it has provided loans or credit enhancements (e.g., standby letters of credit or credit derivatives) to firms that have retained the LCBO for securities underwriting or merger advisory services. Since the 1980's, financial conglomerates have aggressively marketed their lending and capital markets services as "package deals." The potential risks of these combined services are shown by (i) the near-failures of several large securities firms after the leveraged buyout ("LBO") market collapsed in 1989-90, due to high-risk "bridge loans" the firms provided

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[120] See Feldman & Rolnick, supra note 20, at 11-16 (suggesting that uninsured creditors of a TBTF bank should be required to absorb a "coinsurance" deductible of up to 20% of their claims before receiving protection from the FDIC).

[121] The Basel Committee has recommended new rules – contained in "Pillar 3" of its 2001 proposal – that would require banks to provide more extensive disclosures to investors. LCBOs have vehemently opposed these recommendations, thereby indicating the strong desire of financial conglomerates to insulate themselves from market discipline to the maximum extent possible. See Wilmarth, Transformation, supra note 2, at 300-08, 455, 474-75 & n.1128.

as part of their LBO financings, and (ii) J.P. Morgan Chase's exposure to large potential losses in 2002, arising out of $2.6 billion of loans and OTC derivatives the bank provided to Enron.[122]

Timely disclosures of linkages between each LCBO's credit exposures and its capital markets services are urgently needed to strengthen the ability of regulators and investors to monitor LCBOs. Such disclosures would also facilitate my second proposed initiative – namely, that regulators should undertake a comprehensive investigation of conflicts of interest resulting from the combination of lending, insurance and investment banking activities within financial conglomerates. Recent evidence indicates that aggressive cross-selling has exposed LCBOs to serious financial, legal and reputational risks, because the resulting conflicts of interest have (i) compromised the independence and objectivity of lending decisions and investment advice, and (ii) undermined the effectiveness of risk management programs.

For example, in 2002, serious charges of misconduct were made against Citigroup and J.P. Morgan Chase in connection with the following transactions, which grew out of their new universal banking powers under the GLB Act:

(1) Congressional investigators and private litigants alleged that Citigroup and Chase assisted Enron in its fraudulent financial reporting schemes by structuring prepaid commodity forward contracts involving the banks, Enron and offshore entities that

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[122] For a discussion of the phenomenon of "package deals" offered by major banks and Wall Street firms, as well as the disclosure and risk problems created by those deals, see, e.g., Martin Mayer, Banking's Future Lies in its Past, N.Y. Times, Aug. 25, 2002, § 4 (Review & Outlook), at 9; Wilmarth, Transformation, supra note 2, at 312-17, 326-30, 411-12. For descriptions of J.P. Morgan Chase's dealings with Enron, see, e.g., Miller et al., supra note 83; Jathon Sapsford & Anita Raghavan, Trading Charges: Lawsuit Spotlights J.P. Morgan's Ties to the Enron Debacle, Wall St. J., Jan. 25, 2002, at A1; Jathon Sapsford, Insurers' Filing Says J.P. Morgan Burnished Enron Financial Status, Wall St. J., June 22, 2002, at C14; Tully, supra note 13.

were established and allegedly controlled by the banks. These complex OTC derivatives contracts effectively provided $8 billion of debt financing to Enron but were recorded on Enron's financial statements as commodity trades, thereby significantly understating Enron's debt and overstating its trading revenues.[123]

(2) During 1997-2000, Citigroup became the dominant investment bank in the telecommunications ("telecom") sector. Citigroup reportedly earned almost $1 billion in fees and raised $190 billion of debt and equity financing for its telecom clients. Jack Grubman, Citigroup's star analyst, became the key player in arranging financing and merger deals for rapidly growing firms in the telecom industry. Citigroup rewarded senior executives of its telecom clients by giving them preferential allocations of shares in IPOs underwritten by Citigroup's investment banking unit. Grubman also acted as the leading cheerleader for the telecom industry in his bullish reports to investors. Ten large companies that Grubman advised and strongly recommended to investors – including Global Crossing, Winstar and WorldCom – filed for bankruptcy by mid-2002. Yet Grubman, despite his exceptionally close ties to the firms' executives, failed to give timely warnings to investors about the firms' grave problems. By August 2002, when Grubman resigned, Citigroup confronted numerous governmental

[123] See, e.g., Paul Beckett et al., Deals & Deal Makers: Enron Probe Shines Harsh Light on Financiers, Wall St. J., Aug. 13, 2002, at C1; Paul Beckett & Jathon Sapsford, Energy Deals Made $200 Million in Fees for Citigroup, J.P. Morgan, Wall St. J., July 24, 2002, at A1; Rachel McTague, Levin Warns JP Morgan Execs of SEC, Justice Investigation of Enron Deals, 34 Securities Regulation & Law Report (BNA) 1240 (July 29, 2002); Jathon Sapsford & Paul Beckett, Citigroup Deals Helped Enron Disguise Its Debts as Trades, Wall St. J., July 22, 2002, at A1.

investigations and a barrage of lawsuits based on the bank's alleged conflicts of interest and violations of securities laws.[124]

(3) In May 2001, Citigroup and Chase acted as lead underwriters for an $11.8 billion bond offering for WorldCom. By arranging financing through the bond market, the banks earned handsome fees and enabled WorldCom to pay off outstanding bank loans. In addition, the bond financing allowed WorldCom to forgo calling on the banks for further advances under existing lines of credit. After WorldCom revealed in 2002 that it had grossly overstated its revenues and profits, bond purchasers sued Citigroup and Chase, alleging that (a) the banks' self-interest as lenders conflicted with their duties as underwriters, and (b) the banks failed to act with due diligence to ensure that WorldCom's financial condition was accurately portrayed in the offering documents.[125]

In view of the foregoing events, regulators and policy analysts should carefully consider whether structural "firewalls" (including restrictions on self-dealing) are needed to reduce conflicts of

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[124] See, e.g., Peter Elstrom, Rainmaker in a Firestorm, Business Week, May 13, 2002, at 44; Charles Gasparino et al., Salomon Made IPO Allocations Available to Ebbers, Others, Wall St. J., Aug. 28, 2002, at A1; Gretchen Morgenson, Bullish Analyst of Tech Stocks Quits Salomon, N.Y. Times, Aug. 16, 2002, at A1; Steven Rosenbush et al., Inside the Telecom Game, Business Week, Aug. 5, 2002, at 34; Emily Thornton et al., Crisis at Citi, Business Week, Sept. 9, 2002, at 34; Gregory Zuckerman & Mitchell Pacelle, Credit Markets: Now, Telecom Bond Deals Face Scrutiny, Wall St. J., June 28, 2002, at C1.

[125] See, e.g, Beckett & Sapsford, Citigroup's Headaches, supra note 17; Gretchen Morgenson, Banks Are Havens (and Other Myths), N.Y. Times, July 28, 2002, § 3 (Money & Business), at 1; Thornton et al., supra note 124, at 38; Heather Timmons et al., Citi's Sleepless Nights, Business Week, Aug. 5, 2002, at 42, 43; Zuckerman & Pacelle, supra note 124.

interest within LCBOs.[126]

As a third reform to reduce moral hazard in the banking industry, Congress must repeal the 1996 law that effectively compels the FDIC to provide free deposit insurance to more than 90% of all insured banks and thrifts. This 1996 legislation prevents the FDIC from collecting deposit insurance premiums from "well capitalized" and "well managed" institutions as long as the reserve ratio for each deposit insurance fund remains above its statutory minimum of 1.25%. As a result, more than 900 recently-chartered depository institutions have never paid premiums on their insured deposits. In addition, as previously noted, Citigroup and Merrill Lynch have enabled their brokerage customers to transfer $75 billion into insured deposit accounts at affiliated banks, again without paying any premiums to the FDIC. By mid-2002, the rapid growth of insured deposits at these "free rider" institutions had reduced the reserve ratio of the Bank Insurance Fund ("BIF") slightly below the statutory floor of 1.25%.[127]

Congress must bring an end to this unfair "free riding" on the deposit insurance funds. Congress can do so by amending the Federal Deposit Insurance Act ("FDI Act") in two respects. The first amendment would authorize the FDIC to impose a *retroactive* risk-based assessment based on deposit growth at all FDIC-insured institutions since December 31, 1996 (the effective

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[126] See, e.g, Michele Heller, Bankers and GLB Take Lumps on Capitol Hill, Am. Banker, July 24, 2002, at 1; Mayer, supra note 122; Thornton et al., supra note 124, at 36-37. I intend to examine conflicts of interest within LCBOs as part of a future project.

[127] See Wilmarth, Transformation, supra note 2, at 245-47 (discussing 1996 legislation); Fed. Deposit Ins. Corp., Keeping the Promise: Recommendations for Deposit Insurance Reform, April 2001 (available at <www.fdic.gov>) [hereinafter cited as 2001 FDIC Reform Plan], at 2-5 (describing the "free rider" problem created by restrictions on the FDIC's authority to assess deposit insurance premiums); supra note 44 and accompanying text (describing the brokerage-to-bank "sweep" programs established by Citigroup and Merrill Lynch); Richard Cowden, BIF Ratio Falls below Statutory Minimum as Deposits Rise by $75 Billion in Quarter, 78 BNA's Banking Report 1049 (June 17, 2002).

beginning date for free deposit insurance).[128] The second amendment would require all insured institutions to pay *prospective* risk-based premiums, regardless of their capitalization and supervisory ratings.[129]

My fourth proposed reform would require financial conglomerates to assume full responsibility for the potential risk to the deposit insurance funds created by their brokerage-to-bank "sweep" programs. As previously noted, these "sweep" programs circumvent the present $100,000 ceiling on deposit insurance by enabling brokerage customers to make structured transfers into insured deposit accounts at two or more affiliated banks.[130] Under my two-tiered proposal for deposit insurance coverage, much of the moral hazard threat created by these "sweep" programs would be removed. As explained above, financial holding companies with broker-dealer affiliates would be allowed to accept insured deposits *only* within narrow banks. In addition, strict limitations would be imposed on transactions between narrow banks and their affiliates, thereby preventing narrow banks from transferring their deposit insurance subsidy to

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[128] The FDIC recently determined that an average annual assessment rate of 11.2 basis points would have been sufficient to equate premium revenues with expenses and losses incurred by the BIF during 1980-99. See 2000 FDIC Options Paper, supra note 111, at 24 & tbl. 3. Accordingly, the FDIC should be authorized to impose an average annual assessment rate of about 11 basis points (with appropriate variations based on the risk of each insured bank) on the deposit growth at each insured bank since 1996. Insured institutions that have actually paid premiums since 1996 should be allowed to deduct those premiums from the FDIC's retroactive risk-based assessment.

[129] In early 2001, the FDIC issued a detailed proposal calling for similar legislation. See 2001 FDIC Reform Plan, supra note 127. In May 2002, the House of Representatives passed a bill that incorporated many of the FDIC's recommendations. However, prospects for Senate passage of the bill remained uncertain as of mid-August 2002. See Keith Perrine, Coverage Boost for FDIC Slows Bill, 60 CQ Weekly 1400 (May 25, 2002); Karen L. Weiner, Bills on Real Estate, Deposit Insurance Are Most-Watched Measures by Bankers, 79 BNA's Banking Report 263, 264 (Aug. 12, 2002).

[130] See supra note 44 and accompanying text (discussing "sweep" programs established by Citigroup and Merrill Lynch).

nonbank affiliates.

To eliminate any remaining risk to the FDIC from "sweep" programs, I would expand the cross-guarantee provision of the FDI Act. When an insured bank fails, the cross-guarantee statute empowers the FDIC to assess all affiliated banks for the net cost of resolving the failed bank.[131] The scope of the cross-guarantee provision should be extended to include affiliated broker-dealers whenever the FDIC can show that (i) an affiliated broker-dealer assisted customers in making structured transfers of funds into insured deposit accounts at two or more affiliated banks, and (ii) the evasion of deposit insurance limits produced by those structured transfers increased the FDIC's net cost of handling the failure of any affiliated bank.

Fifth, regulators should require all LCBOs to issue publicly-traded senior or subordinated debt securities on a frequent basis. Regular issuance of publicly-traded debt would increase the disclosure obligations of LCBOs and would also improve the monitoring of LCBOs by securities analysts and credit rating agencies. I would allow regulators to experiment with publicly-traded debt requirements over a period of five to seven years. I would then require regulators to report to Congress concerning the prospects for adopting a more formalized system of market-based discipline (e.g., a program requiring LCBOs to issue qualifying subordinated debt on a continuous basis, with mandatory PCA sanctions for institutions that are unable to do so, subject to the possibility of emergency waivers during economic crises).

Finally, regulators should enhance their own monitoring systems by incorporating signals from the capital markets. Recent studies have shown that supervisory oversight would be more

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[131] See 12 U.S.C. § 1815(e); Howell E. Jackson, The Expanding Obligations of Financial Holding Companies, 107 Harvard Law Review 509, 536-37 (1994) (discussing the FDIC's authority under the cross-guarantee provision).

effective if regulators frequently reviewed market signals such as (i) equity securities prices, (ii) yield spreads and ratings on senior and subordinated debt securities, and (iii) interest rates paid on uninsured deposits and interbank loans. While market discipline is unlikely to replace supervisory oversight within the foreseeable future, market-based signals would provide regulators with helpful tools for analyzing the financial condition and potential risks of large, publicly-traded financial institutions.[132]

Conclusion

The U.S. financial services industry has been fundamentally restructured over the past two decades, culminating in the emergence of huge universal banks and other large financial conglomerates. The GLB Act has effectively ratified this ongoing consolidation of the financial services industry. However, regulatory policies have not kept pace with the challenges of supervising financial conglomerates. Under current rules, these giant institutions present formidable risks to the federal safety net and are largely insulated from both market discipline and supervisory oversight.

International and domestic regulators have tinkered with supervisory policies in the vain hope that revised capital rules, better oversight procedures and increased disclosure to investors will induce financial conglomerates to adopt prudent risk management policies. However, the unmistakable lesson of the past three decades is that regulators will protect major financial firms against failure whenever such action is deemed necessary to preserve the stability of the capital

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[132] See, e.g., Berger, Davies & Flannery, supra note 64; DeYoung et al., supra note 64; Ron Feldman & Mark Levonian, Market Data and Bank Supervision: The Transition to Practical Use, 15 Region No. 3 (Fed. Res. Bank of Minneapolis, MN), Sept. 2001, at 11; Jeffery W. Gunther, Mark E. Levonian & Robert R. Moore, Can the Stock Market Tell Bank Supervisors Anything They Don't Already Know?, Economic & Financial Review (Fed. Res. Bank of Dallas, TX), 2d Qtr. 2001, at 2.

markets. As a consequence, financial institutions understand that they can increase their leverage and pursue more risky activities as they grow in size and complexity. Without a comprehensive reform of the current regulatory structure, LCBOs will continue to exploit the subsidies provided under the TBTF policy and other components of the federal safety net.

This paper proposes a new regulatory regime for financial conglomerates. Under my plan, diversified banking organizations would be allowed to accept insured deposits only through narrow banks. Strict limitations on affiliate transactions would prevent narrow banks from transferring their deposit insurance subsidy to nonbank affiliates. The FDIC's deposit insurance funds would be used *solely* to pay insured depositor claims and would be completely insulated from the potential cost of TBTF bailouts. The FRB would be given primary responsibility for dealing with financial failures involving systemic risk, and the cost of TBTF rescues would be borne *entirely* by large financial conglomerates, since they are the TBTF policy's potential beneficiaries. Six additional initiatives would seek to improve supervisory oversight and market discipline and restrain conflicts of interest within universal banks. In combination, these reforms should significantly reduce the incentives for excessive risk-taking that currently threaten the soundness of major financial institutions.

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