

Too Big to Supervise: The Rise of Financial Conglomerates and the Decline of Discretionary Oversight in Banking

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TOO BIG TO SUPERVISE: THE RISE OF FINANCIAL CONGLOMERATES AND THE DECLINE OF DISCRETIONARY OVERSIGHT IN BANKING

Lev Menand†

The authority of government officials to define and eliminate “unsafe and unsound” banking practices is one of the oldest and broadest powers in U.S. banking law. But this authority has been neglected in the recent literature, in part because of a movement in the 1990s to convert many supervisory judgments about “safety and soundness” into bright-line rules. This movement did not entirely do away with discretionary oversight, but it refocused supervisors on compliance, risk management, and governance—in other words, on internal bank processes.

Drawing on the rules versus standards debate, this Article develops a taxonomy for parsing the various approaches to banking law and documents a shift in supervisory policy over the last thirty years. It shows how today’s focus on internal bank processes, a policy called risk-focused supervision (RFS), was the result of a deregulatory agenda that reconceptualized the role of banks in the economy and led to the emergence of large, complex banking organizations (LCBOs). Unlike traditional banks, LCBOs engage in a wide range of nonmonetary financial activities, including market making in derivatives and corporate securities and investing in private equity funds. The policymakers who designed this new system believed that government oversight of LCBOs was costly and unnecessary—if even possible. Therefore, they constructed a new legal framework based on facilitating market discipline through RFS and risk-based capital requirements.

Although most officials today repudiate “market discipline” and the philosophy underlying the pre-crisis legal framework, the pillars of that framework remain intact. Moreover, the future of the Fed’s innovative stress tests – which represent a resurgence in traditional safety and soundness

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oversight is in doubt. Ultimately, today's conglomerates, which engage in both monetary and nonmonetary activities, may be, as policymakers in the 1990s first postulated, too big to supervise in the traditional sense. This is a problem because a framework that relies on market oversight or rules alone is unlikely to prevent excessive risk taking and the procyclical expansion of bank balance sheets. It is time, therefore, to reconsider the proper role of banks in the economy and our legal strategies for ensuring a stable and efficient monetary system.

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INTRODUCTION

Wells Fargo is one of the largest banks in the United States, and also one of the country's most closely supervised businesses.¹ Yet, over the course of a decade, Wells Fargo issued millions of unwanted debit and credit cards and fraudulently opened millions of checking and savings accounts for hundreds of thousands of unsuspecting customers.² In 2016, in response to this scandal, the head of the nation's primary banking supervisor, the Comptroller of the Currency, commissioned a report to determine why his agency, the Office of the Comptroller of the Currency (OCC), had not caught the problem sooner. His report, released in April 2017, concluded that, while the OCC's Large Bank Office had been aware of 700 whistleblower complaints about Wells Fargo's sales practices in 2010,³ its oversight had been "untimely and ineffective" because its supervisors had been "focused too heavily on bank processes versus what those processes were actually reporting."⁴ In other words, the OCC had checked to make sure that Wells Fargo had a whistleblower program, but not that the bank had addressed the complaints it had received through that program.⁵

What the OCC's report did not say, and what I argue here, is that this myopia was the result of an intentional policy choice made in the late 1990s to change how the government supervises and regulates banks. In other words, the OCC's heavy focus on Wells Fargo's processes was not a mistake; it was by design. As Chair of the Board of Governors of the Federal Reserve System (the Fed) Alan Greenspan described the shift back in 1996: "[S]upervisors' evaluation of [banks] will be focused [more] on process, and less on historical records."⁶ According to Greenspan, if supervisors focused on "processes"

¹ See BD. OF GOVERNORS OF THE FED. RESERVE SYS., CONSOLIDATED FINANCIAL STATEMENTS FOR HOLDING COMPANIES—FR Y-9C: WELLS FARGO & CO. 13–14 (Aug. 9, 2017).

² See Stacy Cowley & Jennifer A. Kingson, *Wells Fargo to Claw Back \$75 Million From 2 Former Executives*, N. Y. TIMES: DEALBOOK (Apr. 10, 2017), <https://www.nytimes.com/2017/04/10/business/wells-fargo-pay-executives-accounts-scandal.html> [<http://perma.cc/5BJD-6UXB>].

³ See OFFICE OF THE COMPTROLLER OF THE CURRENCY, LESSONS LEARNED REVIEW OF SUPERVISION OF SALES PRACTICES AT WELLS FARGO 5 (2017).

⁴ *Id.* at 4–5.

⁵ When OCC examiners asked Wells Fargo's executives about the numerous complaints, the bank's executives told the examiners that the high volume was a sign that its whistleblower process was working. *Id.* at 5.

⁶ Alan Greenspan, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks to the Federation of Bankers Associations of Japan: Banking in the Global Marketplace 8 (Nov. 18, 1996) (transcript available at <https://>

and not “after-the-fact results,” then the *market*, rather than the government, could do the work of disciplining banks, reducing “moral hazard and inefficient bank management.”⁷ The Fed called this approach “risk-focused supervision” (RFS).⁸ RFS—still the official policy of the OCC’s Large Bank Office today—is not so much about evaluating risk appetite and risk-taking as it is about evaluating risk management, internal controls, and the quality of a bank’s public disclosures.

The rise of RFS was part of a sea change in the relationship between banks and the government. For most of U.S. history, banks were permitted to engage only in monetary activities: to issue deposits, originate high-quality credit assets, and settle payment flows. To aid banks in doing these things, beginning in the 1930s, the government insured their deposits and offered them access to cheap liquidity, allowing them to trade on the government’s full faith and credit.⁹ In return, Congress subjected banks to extensive monitoring by special government officials called supervisors, who scrutinized banks’ capital adequacy, asset quality, earnings, and liquidity, as well as the honesty and integrity of banks’ management. Congress empowered these supervisors to require banks and their directors, officers, employees, and agents to correct “unsafe or unsound” practices,¹⁰ meaning “any action, or lack of action, which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk or loss or damage to an institution, its shareholders, or the agencies administrating the insurance funds.”¹¹ As one official summed up the prevailing view at the time: the “widespread consequences of misconduct or bad judgment” at a bank “are such as to require governmental rather than market sanction.”¹²

www.federalreserve.gov/boarddocs/speeches/1996/19961118.htm [<https://perma.cc/4776-Z2UG>].

⁷ Alan Greenspan, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks Before the International Conference of Banking Supervisors: Bank Supervision in a World Economy 15–16 (June 13, 1996) (transcript available at <https://www.federalreserve.gov/boarddocs/speeches/1996/19960613.htm>) [<https://perma.cc/7N92-TEG3>].

⁸ BD. OF GOVERNORS OF THE FED. RESERVE SYS., FED. RESERVE, SR 99-15, SUPERVISORY LETTER ON RISK-FOCUSED SUPERVISION OF LARGE COMPLEX BANKING ORGANIZATIONS (1999) [hereinafter SUPERVISORY LETTER, SR 99-15].

⁹ See discussion *infra* subpart II.A.

¹⁰ See 12 U.S.C. § 1818 (2016).

¹¹ See 112 CONG. REC. 26,445, 26,474 (1966).

¹² Gerald T. Dunne, *The Legal Basis of Bank Supervision*, 10 ST. LOUIS B.J. 31, 35–37 (1964).

To ensure that supervisors had wide latitude in carrying out their duties, Congress did not explicitly define “unsafe and unsound” or “prudent operation.” Because banks were businesses “affected with a public interest,”¹³ Congress wanted supervisors to be able to address deficiencies “when[ever] an institution ha[d] been harmed or the interests of the depositors ha[d] been prejudiced without requiring the agencies to quantify the harm or [the] prejudice.”¹⁴

Beginning in the late 1980s, however, a group of policymakers reimagined the role of banks in the economy and the role of government in banking. These officials—economists like Greenspan and financiers like Robert Rubin—sought to facilitate the growth of financial conglomerates by tearing down the statutory restrictions that limited banks to performing monetary functions.¹⁵ The firms that emerged became known as large complex banking organizations (LCBOs).

As LCBOs grew far larger than traditional banks and began engaging in all sorts of activities not historically supervised by the government, Greenspan and others decided that the government could not and should not oversee their operations in the same way that they had overseen the operations of traditional banks in the past. Not only did Fed officials think that LCBOs were too big and complex to supervise using traditional means, they also concluded that discretionary “safety and soundness” oversight was inefficient and costly. Instead, they developed rules called risk-based capital requirements that required bank shareholders to contribute a minimum amount of money, called equity or capital, to fund a bank’s investments. The Fed and the OCC thought that capital requirements could, in effect, replace traditional oversight by ensuring that shareholders’ stakes in banks would be large enough to allow the government to outsource safety and soundness work to credit rating agencies and professional investors.¹⁶

¹³ See, e.g., *Munn v. Illinois*, 94 U.S. 113, 126–30 (1877) (differentiating businesses affected with a public interest).

¹⁴ H.R. REP. NO. 101-222, at 439 (1989) (Conf. Rep.). Courts also accord wide deference to agency judgments in banking. See *Indep. Bankers Ass’n of Am. v. Heimann*, 613 F.2d 1164, 1168–69 (D.C. Cir. 1979) (noting that the “discretionary authority” of the banking agencies “to define and eliminate ‘unsafe and unsound conduct’ is to be liberally construed”).

¹⁵ See Lisa M. DeFerrari & David E. Palmer, *Supervision of Large Complex Banking Organizations*, FED. RES. BULL. 47, 50 (2001) (discussing LCBOs and their supervision).

¹⁶ See Laurence H. Meyer, *Supervising Large Complex Banking Organizations: Adapting to Change*, in *PRUDENTIAL SUPERVISION: WHAT WORKS AND WHAT DOESN’T* 97 (Frederic S. Mishkin ed., 2001). Interestingly, for smaller firms—those not staffed

In this new regime, policymakers envisioned just two tasks for traditional supervisors: (1) enforcing the capital rules to ensure that shareholders were sufficiently incentivized to oversee risk-taking adequately and (2) policing “processes”—governance frameworks, internal controls, and risk management techniques—to ensure that shareholders were sufficiently informed to oversee risk-taking effectively.¹⁷ The latter task, policymakers thought, was necessary to prevent LCBO executives from hiding material information about their activities from market participants. RFS, in other words, was designed to combat the principal-agent problem between managers and shareholders—not to prevent excessive risk-taking or directly ensure safety and soundness.

Following the financial crisis, the lynchpin of this new philosophy—the idea that market oversight could replace government lawmaking—was largely repudiated. And yet, as reflected in the Wells Fargo episode, supervisors continue to focus on processes and not results.¹⁸ Indeed, the OCC’s *Large Bank Supervision Handbook* still states that its examiners “do not attempt to restrict risk-taking but rather [to] determine whether banks identify and effectively manage the risks they assume.”¹⁹ All the while, the pathologies of RFS—blindingly apparent in the Wells Fargo report—have gone largely undiagnosed.²⁰ The academic literature continues to focus on the “regulatory” and “structural” aspects of banking law: the rules promulgated by the banking agencies and the legal provisions, typically enacted directly by statute, which determine what forms of financial support banks receive from the government, what types of activities banks can engage in, and who bears the loss if banks fail. Supervision, when it is mentioned, is often

by sophisticated financiers and subject to the salutary forces of the capital markets—policymakers decided that supervisors should continue to assess “results” (through a program the OCC calls risk-based supervision). See OFFICE OF THE COMPTROLLER OF THE CURRENCY, *LARGE BANK SUPERVISION: COMPTROLLER’S HANDBOOK 1–2* (2010); see also DeFerrari & Palmer, *supra* note 15, at 51–53.

¹⁷ See Meyer, *supra* note 16, at 100.

¹⁸ This Article argues the opposite of JOHN ARMOUR ET AL., *PRINCIPLES OF FINANCIAL REGULATION* 579–80 (2016) (suggesting that supervision has become more discretionary and less rules-based over the last twenty-five years).

¹⁹ OFFICE OF THE COMPTROLLER OF THE CURRENCY, *supra* note 16, at 3.

²⁰ *But see* FIN. CRISIS INQUIRY COMM’N, *THE FINANCIAL CRISIS INQUIRY REPORT* 170–71, 307–08 (2011) (noting that the “risk-focused” approach to supervision contributed to supervisors’ failure to address growing risk levels); Joseph J. Norton, *A Perceived Trend in Modern International Financial Regulation: Increasing Reliance on a Public-Private Partnership*, 37 *INT’L LAW.* 43, 44–47 (2003) (assessing the rise of RFS).

conflated with regulation, as if the former were merely the enforcement side of the latter.²¹

This Article seeks to give supervisory policy its due—to explain why, two decades ago, the government shifted its approach to overseeing banks, particularly large ones like Wells Fargo, and to show how this change was part of a larger re-orientation of banking’s legal architecture.

It proceeds in three parts. Part I develops a taxonomy, drawing from the legal literature on rules and standards. Rules, roughly speaking, are bright-line requirements developed in advance of actual application (e.g., “the speed limit is 60 miles per hour”). Standards are general requirements that must be tailored *ex post* to address specific cases (e.g., “drive safely”).²² As the existing rules versus standards debate fails to account for the wide range of approaches to bank lawmaking, subpart I.A differentiates between two ways of writing rules and two ways of enforcing standards. One way of enforcing a standard, by interrogating outcomes or results, I call *substantive oversight*. Another way of enforcing a standard, by evaluating the processes that lead to those outcomes or results, I call *procedural oversight*. In banking, for example, instead of defining “unsafe and unsound” in terms of “what” risks a bank is taking, supervisors, practicing RFS, define it in terms of “how” a bank is taking risks.

To address the “what” part of the equation, the Fed and the OCC now rely on market oversight and *formulas*. A *formula* is a type of rule that delineates between permissible and impermissible variants of an activity in advance, restricting as little salutary activity as possible. The risk-based capital requirements, for example, are a formula. Another type of rule, which I call a *ban*, is prophylactic, intentionally overbroad, and simple. When choosing how to regulate an activity, policymakers have three choices: they can prohibit the activity (with a ban); permit

²¹ See Thomas Eisenbach et al., *Supervising Large, Complex Financial Institutions: What Do Supervisors Do?*, ECON. POLY REV., Feb. 2017, at 57–58 (noting the widespread conflation of supervision and regulation). When supervision is treated independently, it is often given short shrift. In one of the leading textbooks on financial institutions law, for example, thirteen pages out of 1,246 are devoted to bank supervision and enforcement; RFS is not mentioned at all. See MICHAEL S. BARR ET AL., FINANCIAL REGULATION: LAW AND POLICY 831–36, 841–49 (2016). As Professor Roberta Romano aptly puts it, supervisors today are an adjutant “directed at assessing the adequacy of a bank’s capital” under the Basel rules. Roberta Romano, *For Diversity in the International Regulation of Financial Institutions: Critiquing and Recalibrating the Basel Architecture*, 31 YALE J. ON REG. 1, 10 (2014).

²² See discussion *infra* subpart I.A.

the activity and differentiate between permissible and impermissible variants *ex post* (through substantive oversight); or permit the activity and differentiate between permissible and impermissible variants *ex ante* (with a formula).

Part II documents a shift in the choices made by policy-makers in banking, charting the decline of a legal regime based on structural bans and substantive oversight and the rise of a legal regime based on formulas (e.g., risk-based capital requirements) and procedural oversight (e.g., RFS). I examine thirty years of public remarks by Fed and OCC officials, and tease out the reasons why they created RFS and risk-based capital requirements. The modern regime, I conclude, is founded upon a belief that banks are no different from other businesses and that targeted government policies designed to counteract the effects of deposit insurance can ensure that the market, not the government, disciplines their executives and advances the public interest.

Part III seeks to explain why this framework endures. It focuses on the difficulty of substantively overseeing nonmonetary financial activities and the enormous pressure large conglomerates exert on the banking agencies. Not only do banks prefer rules, but procedural oversight insulates government officials from legal, professional, and political risks. Part III also considers the Fed's innovative stress testing program, the Comprehensive Capital Assessment and Review (CCAR), which represents a rebirth of traditional oversight.²³ CCAR allows supervisors to make independent judgments about banks' risk-taking. Yet increasingly, banks are insisting on changes to CCAR, which would convert it to a rules-based exercise. If the industry succeeds in its efforts, as seems likely, it will suggest that today's financial conglomerates are simply too "big" (in terms of activities, if not assets) to supervise in the traditional sense. Unfortunately, it is not clear that rules on their own are sufficient.²⁴ Thus it is time to reconsider the changes made in the 1990s, which allowed banks to engage in non-monetary activities (and non-banks to engage in monetary activities).²⁵ The appropriate regime for one set of activities may be incompatible with the appropriate regime for the other. Indeed, if we do not act soon we may find ourselves with a post-

²³ See discussion *infra* section III.A.3

²⁴ See discussion *infra* subpart III.D.

²⁵ See generally MORGAN RICKS, *THE MONEY PROBLEM: RETHINKING FINANCIAL REGULATION* (2016) (examining the modern monetary and banking system, and recommending changes).

crisis legal structure in banking that, in certain key respects, is not much different from the one we had in 2008.

I

BEYOND RULES V. STANDARDS

As in other areas of law, the distinction between rules and standards provides a useful starting point for thinking about the tools available to policymakers in banking.²⁶ But this dichotomy alone suggests that, methodologically, banking law has not changed much in the last 150 years. After all, both rules and standards have been in place since the mid-nineteenth century, and government supervision has been part of banking for just as long. To better illuminate why and how supervisory policy has changed over the past three decades, this Part defines a set of terms for parsing the evolution of banking law, distinguishing between two ways of writing rules and two ways of enforcing standards. As I will ultimately argue, RFS—a new way of interpreting an old standard—was designed to accompany risk-based capital requirements—a new way of writing rules.

A. Rules and Standards

I define a *standard* as an obligation or prohibition governing conduct, for which compliance is assessed through an inter-subjective inquiry. I define a *rule* as an obligation or prohibition governing conduct, for which compliance is assessed through an objective inquiry.²⁷ As I am using the words, something is inter-subjective, if, to interpret it, we must rely on shared understandings, values, and norms.²⁸ Something is objective, by contrast, if we expect any two people to reach

²⁶ See, e.g., Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257, 258–59 (1974); Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685, 1687–89 (1976); Carol M. Rose, *Crystals and Mud in Property Law*, 40 STAN. L. REV. 577, 577–80 (1988); Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 559–63 (1992); Cass Sunstein, *Problems with Rules*, 83 CALIF. L. REV. 953, 957–59 (1995); Kathleen Sullivan, *Foreword: The Justices of Rules and Standards*, 106 HARV. L. REV. 22, 23–24 (1992).

²⁷ The literature typically defines standards as general requirements that must be tailored *ex post* to specific cases and rules as bright-line requirements developed in advance of actual application. See Louis Kaplow, *A Model of the Optimal Complexity of Legal Rules*, 11 J. L. ECON. & ORG. 150, 161 (1995). But all laws must be interpreted *ex post*: the true difference between rules and standards lies in the type of inquiry that is meant to be conducted when the law is applied.

²⁸ See, e.g., JÜRGEN HABERMAS, *BETWEEN FACTS AND NORMS: CONTRIBUTIONS TO A DISCOURSE THEORY OF LAW AND DEMOCRACY* 13–14 (1996) (elaborating on the concept of inter-subjectivity).

similar conclusions about it regardless of their perspectives or experiences. A rule, then, distinguishes between permissible and impermissible conduct in a way that allows us to be relatively certain of our obligations in advance, because it at least purports to offer an objective test for compliance. “Be home by eight” is a rule. “Don’t stay out too late” is a standard.

Objectivity, of course, comes in degrees; we can never transcend background context and shared understandings entirely. (Where is “home”? When is “eight”?) An inquiry can be more objective or less objective. If objectivity is valued, as it is with rules, we prefer an inquiry that is more objective. Since a rule specifies conduct in a way that permits as objective an inquiry into compliance as practicable, a rule is really a type of standard.²⁹

Importantly, a standard does not allow for *subjective* interpretation—which would entail each person determining the standard’s meaning for his or her self. Instead, a standard references a set of shared understandings between a group of people. Thus, when a person interprets a standard, he or she must inquire into these shared understandings, reflect on them, and apply them to a specific situation.³⁰

Ontologically, standards precede rules because rules are attempts to further the shared goals reflected in our inter-subjective understandings.³¹ Consider the obligation to act in good faith. We can write down rules articulating what that duty means in specific cases. Or we can enforce it, articulating what it means after the fact, in effect turning a specific set of circumstances into a rule through adjudication.

The paradigmatic example of rules versus standards is automobile regulation, which relies on both rules *and* standards to promote public safety on the road.³² The speed limit is a rule; the prohibition on “reckless driving” is a standard. Speeding is reckless but so is certain behavior that complies with the speed limit such as driving fast in a downpour, on an icy road,

²⁹ *But see* Ronald M. Dworkin, *The Model of Rules*, 35 U. CHI. L. REV. 14, 25 (1967) (arguing that rules are logically distinct because they are “applicable in an all-or-nothing fashion”).

³⁰ A standard that can be interpreted independently from shared understandings is sometimes known as a “black hole” or a “gray hole.” *See* Adrian Vermeule, *Our Schmittian Administrative Law*, 122 HARV. L. REV. 1095, 1096 (2009).

³¹ *See* Habermas, *supra* note 28, at 13–14.

³² *See e.g.*, Kaplow *supra* note 26, at 560; Sunstein, *supra* note 26, at 959; Ehrlich & Posner, *supra* note 26, at 257. One wonders why scholars use as their canonical example of rules a case in which rule breaking is so widespread and expected.

or in heavy traffic. The concept of reckless driving cannot be fully translated into rules. There are too many ways in which driving can be reckless, too many possible scenarios to consider. Thus, policymakers often employ both rules and standards because it is too difficult, perhaps impossible, to anticipate and adequately address the wide diversity and variability of potential real-world situations in advance.³³

Notwithstanding these limitations, rules are appealing because they increase individual freedom by putting people on notice about precisely what conduct is permitted and what conduct is prohibited. Rules are easier to comply with than standards and easier to enforce. Moreover, a standard-based regime requires adjudicatory discretion, which creates uncertainty about what will be permitted and what will be prohibited. Thus, as a matter of legal design, we should adopt standards in situations where discretion is necessary or even beneficial, and we should write rules in situations where discretion is unnecessary or even harmful.

B. Bans and Formulas

A problem with previous incarnations of the rules versus standards debate is that it fails to compare the different ways policymakers can write rules with the different ways they can enforce standards. Policymakers can write rules that are simple and broad, for which it is easy to assess compliance, and policymakers can write rules that are complex and tailored, for which it is technically difficult to assess compliance.³⁴ The first type of rule I call a *ban* and the second type of rule I call a *formula*.³⁵ As defined earlier, a *ban* is a type of rule that inten-

³³ Aristotle may have been the first to identify this problem, observing that it is impossible to write rules to cover all cases. ARISTOTLE, *NICOMACHEAN ETHICS* bk. V, at 98 (Roger Crisp ed. & trans., Cambridge Univ. Press rev. ed. 2014) (c. 330 B.C.E.) (“[A]ll law is universal, and there are some things about which one cannot speak correctly in universal terms.”).

³⁴ There are a few authors who have discussed the complexity of rules, most significantly Louis Kaplow. See Kaplow, *supra* note 26 at 151–52, 161. See also Prasad Krishnamurthy, *Rules, Standards, and Complexity in Capital Regulation*, 43 J. LEG. STUD. 273 (2014) (examining choice of rules and standards in the context of bank capital regulation). Unlike these authors, I see bans and formulas as more than just “more complex” and “less complex” rules. Rather than situate bans and formulas on one side and standards on another, I see standards occupying a middle ground between the two in certain key respects.

³⁵ Cass Sunstein hints at this distinction, although he does not elaborate on it, in observing that “rules may be simple or complex” and that you might even write “a formula for deciding who may drive.” See Sunstein, *supra* note 26, at 962 (emphasis omitted). Sunstein suggests that such a formula “might look, for example, to age, performance on a written examination, and performance on a

tionally and prophylactically restricts an easily distinguishable category of activity, providing a high level of clarity about what is permitted and what is not permitted, both for regulators and regulated entities. A *formula* is a type of rule that delineates an intricate series of permissible and impermissible aspects of an activity in advance.³⁶

As with the distinction between rules and standards, this distinction between formulas and bans is one of family resemblances and not categorical separateness.³⁷ Some rules are more ban-like (e.g., a sign that says, “road closed,”) and some more formula-like (e.g., a sign that says, “permit required for winter driving: weekdays only, between dawn and dusk, if there is no accumulated snow.”). Rules governing banking include broad activity restrictions akin to bans as well as narrowly tailored formulas that attempt to influence the conduct of an activity as opposed to eliminate it. For example, banks are not allowed to own equity in other businesses (the separation of banking and commerce, a ban).³⁸ But banks can extend a variety of credits to other businesses, provided that they limit their own overall leverage (risk-based capital requirements, a formula).³⁹

Formulas are designed to allow much more activity than bans. If we believe that driving on a road is a social ill at any

driving test. Each of these three variables might be given a specified numerical weight.” *Id.* My definition of a formula is roughly synonymous with Sunstein’s, but not identical, since the factors he lists are not all “rules” in my framework. I would characterize a driving test and potentially a written exam as forms of substantive oversight.

³⁶ There is some similarity between the distinction that I make between formulas and bans and the distinctions that economists make between price and quantity regulation. See generally, Martin L. Weitzman, *Prices vs. Quantities*, 41 REV. ECON. STUD. 477 (1974) (differentiating between regulating a harmful activity by calculating the right price for the harm and imposing a tax and restricting the quantity of the harmful activity and allowing the market to find its own price). See also Andrew G. Haldane, Exec. Dir., Bank of Eng., Remarks at the Federal Reserve Bank of Kansas City’s Economic Policy Symposium: The Dog and the Frisbee 18 (Aug. 31, 2012) (transcript available at <https://www.bis.org/review/r120905a.pdf>) [<https://perma.cc/L4JV-4GCW>] (noting that in the context of banking regulation, regulators have pursued price over quantity-based regulation).

³⁷ See generally, LUDWIG WITTEGENSTEIN, PHILOSOPHICAL INVESTIGATIONS, 32 (1953) (examining the idea of “family resemblances” or “family likenesses”).

³⁸ See Glass-Steagall Act, 12 U.S.C. § 24, 78, 377–78 (2018); Bank Holding Company Act, 12 U.S.C. § 1841 (2018).

³⁹ There are hard cases. For example, the Dodd-Frank Act includes a prohibition on proprietary trading, the Volcker Rule, codified at 12 U.S.C. § 1851, a ban. But the hundreds of pages of rules that the banking agencies have written distinguishing between proprietary trading and permissible trading are formulas. Accordingly, since proprietary trading is not an easily distinguished category of activity, Dodd-Frank’s ban on it appears to have morphed into a formula.

time of the day, then a ban is intuitively appealing. But if we think that there are times when driving on the road might bring about a social benefit, or if we believe that people should be allowed to make that choice for themselves under certain circumstances, then we might find a ban excessively restrictive and write a rule that more closely reflects our intuitions. Closing a potentially dangerous road, for example, may inconvenience a lot of people. A more permissive formula, however, may be hard to develop, follow, and enforce. Troublingly, a formula may fail to capture harmful activity that we want to prohibit. With a ban, what behavior is permitted and what behavior is proscribed is immediately clear, simplifying the task of those who must comply with the rule. When choosing between bans and formulas, we must weigh the increased use of the road, for example, against the likelihood that more people will drive in dangerous conditions.

Another design issue is the feasibility of writing out a workable, objective decision function that distinguishes between permissible and impermissible conduct *ex ante*. Since formula-writers must delineate, in advance, permissible behavior in different states of the world, they presuppose an ability to predict those potential states.⁴⁰ Complexity may make formula writing difficult. Uncertainty may make it impossible.⁴¹ If our predictions are unlikely to be correct, or if our predictions are likely to alter real-world activity in unforeseeable ways,⁴² then we may be better served by a blunter instrument like a ban or an *ex post* mechanism like a standard.

C. Substantive and Procedural Oversight

It is also helpful to distinguish between two ways of enforcing standards like the prohibition on unsafe and unsound banking practices. As defined earlier, *substantive oversight* is

⁴⁰ Often the best response to a complex, highly interconnected system is a simple rule. Studies have shown that simple rules outperform more complex approaches in a variety of endeavors from diagnosing heart attacks to predicting avalanches. See Haldane *supra* note 36, at 4–5 (citing studies, including Gerd Gigerenzer & Stephanie Kurzenhauser, *Fast and Frugal Heuristics in Medical Decision Making*, in SCIENCE AND MEDICINE IN DIALOGUE: THINKING THROUGH PARTICULARS AND UNIVERSALS (Roger Billbace et al. eds., 2005) and Gerd Gigerenzer & Henry Brighton, *Homo Heuristics: Why Biased Minds Make Better Inferences*, 1 TOPICS IN COGNITIVE SCI. 107 (2009)).

⁴¹ See generally FRANK KNIGHT, RISK, UNCERTAINTY, AND PROFIT ch. VII (1921) (explaining the difference between “risk” and “uncertainty”).

⁴² See Jeffrey N. Gordon, *The Empty Call for Benefit-Cost Analysis in Financial Regulation*, J. LEG. STUD. at 2–4 (2014) (suggesting that new rules in the financial sector, a “constructed system,” lead to unpredictable results).

the assessment of actual outcomes (“what you did”). *Procedural oversight* is the assessment of “how you did it.” For example, a parent might tell a child to “do a good job on their homework.” The parent could enforce that standard (“do a good job”) procedurally, by assessing whether the child spent enough time working on their homework and answered every question. Or the parent could enforce that standard substantively, by reading the answers and deciding whether the work was good. In the banking context, I define something as procedural if it reflects the bank’s wholly internal activities (governance, auditing, risk management) and substantive if it involves the bank’s outward actions (extending a loan, buying a security, creating a fake account).⁴³

Generally, substantive oversight is much more tightly connected to underlying policy goals because it involves a direct inquiry into whether the ends we are trying to achieve are being achieved. Procedural oversight includes an additional inference, which is that when certain processes are followed, certain ends are achieved.⁴⁴ There may be many cases where permissible processes are consistent with impermissible intended outcomes. This is a significant issue in banking, where different risk appetites can be consistent with the same internal procedures for identifying and assuming risks.

Nonetheless, to oversee substantively, a supervisor must be able to assess the substance. And it helps if the supervisor can assess the substance at least as well as the subject can. Returning to the previous example, it might be difficult for parents to assess their children’s homework in a foreign language class. But a parent may still be able to check that their child answered every question and spent time working on the assignment. For one, this form of oversight may require less effort; it is easier to check *for* answers than it is to check the answers themselves. For another, it may be less contentious to monitor acceptable procedures than to repeatedly contest acceptable outcomes through *ex post* lawmaking. Returning to

⁴³ This dichotomy is not always meaningful. But for lawmaking targeted at groups, it is a useful distinction as outcomes are typically the result of many people working together.

⁴⁴ An example of this in corporate law is the tendency of courts to police “fair process” when determining “fair price.” See Jason Halper, *Fair Price and Process in Delaware Appraisals*, HARV. L. SCH. F. ON CORP. GOV. AND FIN. REG. (Nov. 6, 2015), <https://corpgov.law.harvard.edu/2015/11/06/fair-price-and-process-in-delaware-appraisals> [<https://perma.cc/H35L-TJ9L>] (noting that Delaware courts use “merger price [following an arm’s length, thorough and informed sales process]” to determine fair value).

banking, a supervisor taking a procedural approach, rather than assessing the level of risk in a loan or trade, might look at whether internal control functions were involved in the decision to make that loan or trade and if the loan or trade was consistent with the bank's own stated investment policies.

There are other practical reasons why government actors might choose not to enforce a standard substantively. As a matter of legal design, the choice between prohibiting an activity (bans), permitting an activity but differentiating between permissible and impermissible variants *ex post* (substantive oversight), and permitting an activity and differentiating between permissible and impermissible variants *ex ante* (formulas), is complicated by the fact that banks will challenge the legal regime, especially to achieve higher levels of risk and therefore higher returns. Accordingly, external industry pressure will affect which tools the government adopts and whether those tools work. It is in this context that procedural oversight, which does not appear to be a first-best solution, emerges as a dominant strategy. The next Part considers how some of these dynamics affected the evolution of supervisory policy in banking.

II

THE DECLINE OF DISCRETIONARY OVERSIGHT

Using the taxonomy developed in Part I, this Part tries to make sense of how banking law has changed over the last three decades. It traces a shift in the 1980s and 1990s from a system in which banks were restricted to core monetary activities by bans, and overseen substantively by state actors, to a system in which banks were allowed to grow into large financial conglomerates, and the responsibility for their oversight was transferred from state actors to the market. This latter regime, still in place today, is governed by complex formulas designed to ensure that the market appropriately disciplines bank executives. Supervisors are primarily deployed to police banks' internal processes as a means to further facilitate such market discipline.

A. Supervisory Policy in the Quiet Period

For a period of nearly fifty years, rules, in the form of strict structural bans, limited the scale and scope of banks, and other ban-like provisions limited the rates banks could charge borrowers and pay depositors. Rules did not, however, regulate day-to-day banking activity. Instead, supervisors, exercis-

ing discretion, assessed the safety and soundness of banks' balance sheets and business practices. Below, I (1) sketch out this traditional approach to bank supervision and (2) explicate the role of bans in facilitating it.

1. *Safety and Soundness Oversight*

The fount of supervisory authority in the U.S. is a statutory standard prohibiting banks from engaging in “unsafe and unsound” practices. This prohibition was first codified in 1847 in New York and was subsequently adopted by over a dozen states.⁴⁵ For these early legislatures, the standard was a tool through which the government could fulfill its obligation to establish a stable and efficient monetary system: one in which each banking institution was sound (i.e., solvent) so that the public's money supply would be safe. When supervisors identified practices that they considered “unsafe and unsound,” they could take a variety of remedial actions, including removing a bank's officers and directors or revoking its license to issue deposits.

Early legislatures also endowed supervisors with another significant power—visitation—which has an even more ancient pedigree. Visitation derives from the right of the sovereign to enter unannounced, uninvited, and unexpected to examine the affairs of legal entities that it constitutes.⁴⁶ Visitation allows the state to protect its interests whenever such an entity is “abusing the power given it” or “acting adversely to the public, or creating a nuisance.”⁴⁷ As the Supreme Court put it, visitation provides a “right to oversee corporate affairs, quite separate from the [general] power to enforce the law.”⁴⁸ When Congress established the OCC in 1864, it granted the agency the exclusive right of visitation over banks it chartered.⁴⁹ (Previously, U.S. banks were chartered only by state governments,

⁴⁵ My research suggests that the phrase first entered the statute books in close to its current form in New York in 1847. Act of Dec. 4, 1847, ch. 419, Laws 1847, 519, *reprinted in* THE BANKING SYSTEM OF THE STATE OF NEW YORK (1864) (empowering the state comptroller to “examine” the “books, papers and affairs” and produce and publish a report on any bank that “in the opinion of the comptroller,” is “in an unsound or unsafe condition to do banking business”).

⁴⁶ See *Cuomo v. Clearing House Ass'n.*, 557 U.S. 519, 526 (2009).

⁴⁷ Horace L. Wilgus, *Private Corporations*, in *AMERICAN LAW AND PROCEDURE* 81, 224–25 (James Parker Hall & James DeWitt Andrews, eds., 1910).

⁴⁸ See *Cuomo*, 557 U.S. at 526.

⁴⁹ Act of June 3, 1864, ch. 106, 1864 Stat. 100 (establishing the OCC).

often directly by state legislatures, and those governments conferred similar powers to their examiners.)⁵⁰

For most of U.S. history, safety and soundness and visitation powers were relatively unremarkable as banks were understood to be monetary institutions engaged in the critical work of creating money and facilitating payments, functions which they performed on behalf of the state, whose ultimate obligation it was to provide a viable currency.⁵¹ Supervisors, as agents of the state, policed the activities of these franchisees, ensuring that their efforts served the public interest.⁵²

The California Supreme Court eloquently described this system in *State Savings & Commercial Bank v. Anderson*,⁵³ affirmed by the U.S. Supreme Court. According to the court, there was “nothing novel in the legislation,” which allowed the superintendent to put banks into receivership “[w]henever [he] shall have reason to conclude that any bank is in an unsound or unsafe condition to transact the business for which it is organized.”⁵⁴ Banks, the court argued, performed functions “essentially of a public nature.”⁵⁵ “The capital which [the bank shareholder] has invested and the returns which he receives upon it are insignificant in importance relative to the advantages which society at large derives from the conduct of the banking business.”⁵⁶ Indeed, “the evil consequences of unsound banking are distributed between the banker and the general public in like proportion.”⁵⁷ Thus, the court explained,

⁵⁰ See Christine E. Blair & Rose M. Kushmeider, *Challenges to the Dual Banking System: The Funding of Bank Supervision*, 18 FED. DEPOSIT INS. CORP. BANKING REV. 1, 2 (2006). The First and Second Banks of the United States are the two exceptions to this: the federal government chartered them. See generally JOHN JAY KNOX, A HISTORY OF BANKING IN THE UNITED STATES (1900) (surveying the early history of American banking).

⁵¹ U.S. CONST. art. I § 8 (“to coin money [and] regulate the value thereof”). See also MILTON FRIEDMAN & ANNA JACOBSON SCHWARTZ, A MONETARY HISTORY OF THE UNITED STATES, 1867–1960 (1963) (conceptualizing banks as monetary institutions); MILTON FRIEDMAN, A PROGRAM FOR MONETARY STABILITY 8 (1960) (“Something like a moderately stable monetary framework seems an essential prerequisite for the effective operation of a private market economy. It is dubious that the market can by itself provide such a framework. Hence, the function of providing one is an essential government function on par with the provision of a stable legal framework.”).

⁵² See Robert C. Hockett & Saule T. Omarova, *The Finance Franchise*, 102 CORNELL L. REV. 1143, 1147–49 (2017).

⁵³ *State Sav. & Commercial Bank v. Anderson*, 165 Cal. 437 (Cal. 1913) *aff’d per curiam*, 238 U.S. 611 (1915).

⁵⁴ *Id.* at 439.

⁵⁵ *Id.* at 442.

⁵⁶ *Id.*

⁵⁷ *Id.* “Such legislation adopted so generally has come as the result of years of observation of the intimate relation of banking with the business world, the disas-

it was "well-settled doctrine that the business of banking is a proper subject of legislative control by the state in the exercise of what is known as the police power."⁵⁸

Bank supervision, then, was originally conceived of as a legal tool for ensuring a stable and efficient monetary system. Banks were vital nodes in that system and carried out essential functions in exchange for certain special privileges. When banks failed, the consequences were severe. Accordingly, in the aftermath of the worst monetary system collapse in American history, the Great Depression, Congress expanded the powers of national supervisory authorities by importing state safety and soundness law into the federal code, granting new authority to the Fed,⁵⁹ the FDIC,⁶⁰ and the OCC.

Today, safety and soundness appears in over a dozen places in the federal code. The primary provision is in the Federal Institutions Supervisory and Insurance Act of 1966, codified at 12 U.S.C. § 1818, which reads:

If, in the opinion of the appropriate Federal banking agency [any covered bank] . . . is engaging or has engaged, or the agency has reasonable cause to believe . . . is about to engage, in an unsafe or unsound practice . . . the appropriate Federal banking agency . . . may issue and serve upon [the bank] a notice of charges.⁶¹

Thereafter, the agency may pursue a range of actions including terminating the bank's deposit insurance, ordering the bank to cease and desist from any unsafe or unsound practice, or removing one or more of the bank's officers and directors.⁶²

According to Congress:

The concept of 'unsafe or unsound practices' is one of general application which touches upon the entire field of the operations of a financial institution. For this reason, it would be virtually impossible to attempt to catalog within a single all-inclusive or rigid definition the broad spectrum of activities which are embraced by the term. The formulation of such a definition would probably operate to exclude those practices not set out in the definition, even though they might be

trous consequences of unsound banking and the necessity for prompt measures for the protection of the public therefrom." *Id.* at 446.

⁵⁸ *Id.* at 441.

⁵⁹ Emergency Banking Act, ch. 1, 48 Stat. 1 (March 9, 1933).

⁶⁰ Edwin J. Perkins, *The Divorce of Commercial and Investment Banking: A History*, 88 BANKING L.J. 483, 524 (1971).

⁶¹ See 12 U.S.C. § 1818(b)(1).

⁶² See *id.* at (a)-(e); 12 U.S.C. § 1821(c)(5)(H); see also Thomas L. Holzman, *Unsafe or Unsound Practices: Is the Current Judicial Interpretation of the Term Unsafe or Unsound?*, 19 ANN. REV. BANKING L. 425, 428 (2000).

highly injurious to an institution under a given set of facts or circumstances or a scheme developed by unscrupulous operators to avoid the reach of the law. . . . [A] particular activity not necessarily unsafe or unsound in every instance may be so when considered in the light of all relevant facts. Thus, what may be an acceptable practice for an institution with a strong reserve position, such as concentration in higher risk lending, may well be unsafe or unsound for a marginal operation.⁶³

The point of the standard, in other words, is to allow the government to make case-by-case judgments about bank investments and activities. To that end, supervisors traditionally interpreted it both substantively and procedurally. The OCC acted to address, for example, the “accumulation of certain unsafe assets in an amount constituting 37% of the Bank’s gross capital funds” or a “failure to implement adequate internal controls and auditing procedures.”⁶⁴ Supervisors forced banks to claw back compensation, when they saw “payment of excessive bonuses to Bank officers” or “payment of excessive salaries to Bank officers.”⁶⁵ Supervisors also used their “removal and prohibition”⁶⁶ power to ban dishonest individuals, one of the earliest goals of safety and soundness law.⁶⁷ This remedy reflects the government’s longstanding concern with the reputability and trustworthiness of the banking business, considerations that transcend the confines of an individual institution’s solvency.⁶⁸

⁶³ *Financial Institutions Supervisory and Insurance Act of 1966: Hearings on S. 3158 Before the H. Comm. on Banking and Currency*, 89th Cong. 49 (1966).

⁶⁴ *First Nat. Bank of Eden v. Dep’t of Treasury*, 568 F.2d 610, 611 n.1 (8th Cir. 1978).

⁶⁵ *Id.*

⁶⁶ 12 U.S.C. § 1818(e) (“Removal and prohibition authority”).

⁶⁷ *See, e.g.*, Act of February 24, 1845, ch. 299, 1845 Ohio Laws 776 (1846).

⁶⁸ *See generally, Governance and Culture Reform*, FEDERAL RESERVE BANK OF NEW YORK, <https://www.newyorkfed.org/governance-and-culture-reform> [<https://perma.cc/2YNX-FB95>] (collection of articles and speeches on governance and banking reforms); Mark Carney, Governor of the Bank of Can., Remarks at the 7th Annual Thomas d’Aquino Lecture of Leadership: Rebuilding Trust in Global Banking (Feb. 25, 2013) (transcript available at <https://www.bis.org/review/r130226c.pdf>) [<https://perma.cc/T5FK-Y23K>] (discussing the importance of trust in the financial system and the reforms needed to restore it); William Dudley, President and Chief Exec. Officer of the Fed. Reserve Bank of N.Y., Remarks at the Global Economic Policy Forum: Ending Too Big to Fail (Nov. 7, 2013) (transcript available at <https://www.bis.org/review/e131108g.pdf>) [<https://perma.cc/UP4E-BGH>] (noting “the apparent lack of respect for law, regulation and the public trust” and “evidence of deep-seated cultural and ethical failures at many large financial institutions” and calling it “another critical problem that needs to be addressed”); Mark Carney, Financial Stability Board Chair’s Letter to G20 Leaders: Building a Resilient and Open Global Financial System to Support Sus-

Modern safety and soundness law also allows supervisors to require banks to correct specific deficiencies—oversight that demands judgment and discretion. “To be effective,” one Fed official explained, a supervisor “must scrupulously avoid imposing conditions ‘too quickly and too great,’ but he must be even more alert to avoid committing the unpardonable sin of bank supervision of doing ‘too little, too late.’”⁶⁹ Take asset quality, for example. In a bank where it appears to be deteriorating, supervisors must “try to determine whether there had been a weakening in the loan servicing procedures or in the bank’s basic lending policies.”⁷⁰ If supervisors found “a noticeable increase” in problem loans, they might issue “a transmittal letter urging the directors to review the bank’s lending policies and to take such action as is necessary to obtain additional security for weak loans, reductions or definite repayment programs.”⁷¹

During the Quiet Period, these judgments were made in a systematized manner, through a regime of periodic on-site examinations, by OCC staff in the case of nationally chartered banks, and Fed staff in the case of holding companies and state member banks.⁷² Starting in the 1970s, the OCC developed a ratings system called CAMELS, which quantified key supervisory judgments regarding capital adequacy, asset quality, management, earnings, liquidity, and interest rate sensitivity.⁷³ Banks with persistent problems or major weaknesses along these dimensions were subject to enforcement actions.

For example, in 1980, the OCC brought an action against a large bank “experiencing unsatisfactory earnings performance,” which the agency noted was leading the bank’s equity to become “strained.”⁷⁴ Supervisors ordered the bank to improve its asset quality, reconstitute its management committee, and submit a plan to improve its capital position.⁷⁵

tainable Cross-Border Investment (Aug. 30, 2016) (stating that “financial sector misconduct has risen to a level that has the potential to create systemic risks by undermining trust in both financial institutions and markets”).

⁶⁹ Orville O. Wyrick, *The General Nature of Bank Supervision*, in FED. RESERVE BANK OF ST. LOUIS, BANK SUPERVISION 5 (1963).

⁷⁰ See Wilbur H. Isbell, *Review and Appraisal*, in FED. RESERVE BANK OF ST. LOUIS, BANK SUPERVISION 29 (1963) (chief examiner of the Federal Reserve Bank of St. Louis).

⁷¹ *Id.* at 31.

⁷² *Id.* at 27.

⁷³ The “management” dimension encompasses many quintessentially procedural concerns such as governance and internal controls.

⁷⁴ OFFICE OF THE COMPTROLLER OF THE CURRENCY, ANNUAL REPORT 132 (1980) (including three cases of substantive oversight for the largest banks).

⁷⁵ *Id.*

Senior officials also used their discretionary authority to address risks to the larger system. They were attuned, for example, to regulatory arbitrage, and the spread of banking activity outside of banks. For example, in 1980, Fed chairman Paul Volcker was concerned about banks manipulating “certain Euro-dollar transactions to reduce reserve requirements artificially.”⁷⁶ Though no law or regulation “prohibited the practice,” it distorted “the international payments system and competitive relationships.”⁷⁷ The Fed resolved the problem, Volcker tells us, by asking “the few banks engaging in the practice to cease.”⁷⁸

Quiet Period oversight was predicated on a shared understanding that the state was a partner in the business of banking and that, to achieve its goals, the state had to have the flexibility and discretion to intervene in a bank’s operations on a case-by-case basis. Banks were not like other businesses, for which competition and bankruptcy were part of a salutary process of creative destructive and economic growth; they were institutions that provided vital services to other businesses in conjunction with the state and its “central” bank. When these services were disrupted or improperly rendered, the result was extreme public harm.

2. *The Role of Bans*

Rules played a critical role in this regime. Assessing the underlying riskiness of a loan portfolio or determining whether a trade hedges risk or amplifies it is hard, especially when it is in the financial interest of bank management to thwart such efforts. In the 1930s, Congress substantially alleviated the difficulty of supervision by enacting a series of bans that (a) better aligned the interests of bank managers with the interests of other stakeholders (weakening incentives for excessive risk-taking) and (b) reduced the complexity of banking so that it was easier to monitor and risk-taking was easier to measure.

a. *Activity Bans*

Activity bans, the lynchpin of the Quiet Period regime, restricted banks to banking: issuing monetary instruments, fa-

⁷⁶ Paul A. Volcker, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks at the Annual Convention of the American Bankers Association: The Burden of Banking Regulation 12 (Oct. 14, 1980) (transcript available at <https://fraser.stlouisfed.org/title/451/item/8226>).

⁷⁷ *Id.*

⁷⁸ *Id.*

cilitating payments, and extending high-quality credit assets. Given the innate funding advantages of banks (they can, within limits, create money),⁷⁹ governments have typically found activity restrictions necessary to prevent the undue concentration of economic power.⁸⁰ These restrictions, however, also serve to prophylactically prevent banks from pursuing high-risk ventures that do not further the monetary aims for which banks receive their special legal privileges and government financial backing.

To that end, U.S. banks have always been prohibited from engaging in non-banking business, a policy known as the separation of banking and commerce.⁸¹ In the Banking Act of 1933,⁸² Congress expanded the prohibition to cover certain other financial activities as well, specifically dealing in non-government securities,⁸³ underwriting or distributing non-government securities,⁸⁴ investing in non-investment grade securities for their own account,⁸⁵ and affiliating with companies that engage in such activities.⁸⁶ Congress also prohibited non-banks from engaging in banking activities. The purpose of these new restrictions (known as “Glass-Steagall”), according to Congress, was “[t]o provide for the safer and more effective use of the assets of banks, to regulate interbank control, [and] to prevent the undue diversion of funds into speculative operations[.]”⁸⁷

⁷⁹ John Maynard Keynes explained this phenomenon as such: “It is certainly not the case that the banks are limited to that kind of deposit, for the creation of which it is necessary that depositors should come on their own initiative bringing cash or cheques. But it is equally clear that the rate at which an individual bank creates deposits on its own initiative [through extending loans and crediting accounts] is subject to certain rules and limitations;—it must keep step with the other banks and cannot raise its own deposits relatively to the total deposits out of proportion to its quota of the banking business of the country.” JOHN MAYNARD KEYNES, *TREATISE ON MONEY* 23–30 (1930).

⁸⁰ See Charles F. Dunbar, *The Bank of Venice*, 6 Q. J. ECON. 308, 314 (1892) (detailing fourteenth century Venetian restrictions on dealing in commodities).

⁸¹ See Bernard Shull, *The Separation of Banking and Commerce in the United States: An Examination of Principal Issues* 4 (OFFICE OF THE COMPTROLLER OF THE CURRENCY, Economics Working Paper No. 1999–1). These sorts of restrictions were not codified by statute but placed in banking charters granted by the states and later by the federal government.

⁸² Glass-Steagall Act, ch. 89, 48 Stat. 162 (1933).

⁸³ *Id.* at § 20.

⁸⁴ *Id.* at § 21.

⁸⁵ *Id.* at § 16.

⁸⁶ *Id.* at § 32. Before the 1929 crash, the OCC had the “duty of determining what types of securities were eligible for bank affiliates to underwrite.” Perkins, *supra* note 60, at 494 n.27.

⁸⁷ See Glass-Steagall Act, ch. 89, 48 Stat. 162 (1933) (discussing the purpose of the Act).

Glass-Steagall was simple and broad, easy to enforce and hard to dodge, politically salient and durable.⁸⁸ One way to conceptualize the Act is as a loan covenant: in exchange for backstopping banks, the government required them to refrain from risky, hard-to-monitor activities, much as a lender to an oil company might include a moratorium on new drilling. Although such a covenant might prevent low-risk exploratory drilling projects, given monitoring and transaction costs, it may still be efficient *ex ante*. Because underwriting and trading securities do not advance monetary goals, policymakers decided that these services should be provided instead by private businesses free to compete and fail without harm to the monetary system.

b. *Scale and Scope Bans*

Scale and scope restrictions were also longstanding features of banking law. They ensured that banks were distributed across the country so that every city and town had access to the payments network and to monetary instruments (bank notes and deposits). A byproduct of these provisions was that individual firms were much easier to oversee. For example, nationally chartered banks were restricted by statute from opening branches across state lines.⁸⁹ Even within states, branching was highly restricted by state legislatures, reducing the systemic footprint and political influence of banks.⁹⁰ Banks, therefore, were closely tied to local regions; their employees were generally part of one institution for their entire careers; and their executives often composed a significant percentage of the liability side of their balance sheets. Further, states had a significant stake in the fate of the banks head-

⁸⁸ See generally, HELEN A. GARTEN, WHY BANK REGULATION FAILED: DESIGNING A BANK REGULATORY STRATEGY FOR THE 1990S, 36–37 (1991) (discussing the Glass-Steagall regime).

⁸⁹ See McFadden Act, Pub. L. No. 639, 69th Congress, H.R. 2 (1927).

⁹⁰ The Act had a variety of unintended risk-reducing effects. Generally, it allowed national banks to branch to the extent permitted by their home states, which meant little branching into other states. Though the law was meant to protect community banks, it also improved profitability and reduced the systemic importance of individual banks.

quartered in their jurisdictions.⁹¹ These structural provisions aligned the interests of banks with the interests of the public.⁹²

c. *Competition Bans*

Because banks were monetary institutions, it did not make sense for them to compete on the pricing of money itself—the provision of money was a public good. Regulation Q, promulgated under the Banking Act of 1933, reduced bank risk-taking by establishing interest rate caps for savings accounts and prohibiting interest payments on checking accounts.⁹³ These restrictions prevented banks from luring deposits away from other banks by offering their customers a higher price. Thus, banks were not pressured to competitively reduce their lending standards to earn higher interest income (to afford higher interest expense). Such pressures might prompt a vicious cycle, in which individual banks weaken themselves and other banks simultaneously (banks were free, however, to compete on lending quality). Congress also restricted entry into banking, limiting the number of entities with access to deposit issuance, the payments network, and emergency lending facilities.⁹⁴

Taken together, bans on activities, scale and scope, and competition, reduced the ability of, and the incentive for, bankers to take excessive risk. The law made it hard for banks to pursue high-risk balance sheet strategies by prohibiting banks from trading securities, affiliating with non-banks, and devel-

⁹¹ Until 1978, national banks could not “export” regulations in their home state to their business in other states, averting a regulatory race-to-the-bottom. See *Marquette Nat’l Bank v. First of Omaha Serv. Corp.*, 439 U.S. 299, 301 (1978) (holding that state usury laws cannot be enforced against national banks chartered in other states). See generally, Steven Mercatane, *The Deregulation of Usury Ceilings, Rise of Easy Credit, and Increasing Consumer Debt*, 53 S.D.L. REV. 37 (2008) (exploring the negative symbiotic relationship between deregulated usury ceilings and consumer debt).

⁹² There were downsides to this fragmented system. Banks had little geographical diversity in their loan portfolios and deposit bases, which increased the likelihood of insolvency during regional downturns. In addition, small banks could not fully leverage their fixed costs for basic administrative functions. Nonetheless, the arrangement was politically durable: every congressional district had a bank, an influential constituent, and these banks knew that the McFadden Act restrictions favored them. Small banks feared that they would be driven out of business by big banks if the restrictions were lifted, binding their political coalition together for generations.

⁹³ See 12 C.F.R. § 217 (1933).

⁹⁴ See generally, *The National Bank Act*, ch. 58 § 10, 12 Stat. 665 (1863) (empowering the comptroller of the currency to charter banks); *Federal Reserve Act of 1913*, Pub. L. 63-43, ch. 6, 38 Stat. 251, et seq. §§ 221-522 (establishing the Federal Reserve System, the discount window, and the member banking network); *Banking Act of 1933*, 48 Stat. 162 (establishing the FDIC and the system of deposit insurance).

oping large conglomerates that might enjoy too-big-to-fail subsidies. And the law made it easy for banks to collect a steady stream of rents without pursuing high-risk strategies by limiting competition, restricting entry, capping interest expense, and reducing interstate branching.⁹⁵ The law also restricted banks to a core set of critical activities, which supervisors could easily understand and evaluate.

While it is difficult to calculate the costs of this ban and supervision-intensive era, the benefits are easy to estimate: there were no major bank failures or panics in the U.S. between 1935 and 1980—the longest period of financial stability in American history.⁹⁶ Based on the historical incidence of bank panics in the U.S., we might have expected two 2008-magnitude calamities during this time.⁹⁷

B. Supervisory Policy in the Deregulatory Era

Despite the stability generated by the “old regime”—and, perhaps, in part, because of it—it began to unravel in the 1980s. A new generation of policymakers came to Washington, dominated by Ph.D. economists like Alan Greenspan and Laurence Meyer, and former Wall Street executives like Robert Rubin. These officials had a different view of banks and the role of government in banking.⁹⁸ They believed that the Depression-era laws were excessively blunt instruments that repressed efficient economic activity.⁹⁹ They favored the

⁹⁵ See Helen A. Garten, *Regulatory Growing Pains: A Perspective on Bank Regulation in a Deregulatory Age*, 57 *FORDHAM L. REV.* 501, 508–09 (1989). In any system of bans, the more profitable the activity prohibited, the greater the incentive for avoidance. One of the easiest ways to skirt bans is to innovate corporate form, i.e., to figure out how to do the same business (issue deposits, make loans) without being subject to regulation.

⁹⁶ The first bank failure to draw significantly from the FDIC insurance fund was the collapse of Penn Square Bank in 1982 (the cause was largely risky oil and gas loans). See Jeff Gerth, *Penn Square's Insider Dealing*, *N.Y. TIMES* (1982), <https://www.nytimes.com/1982/08/14/business/penn-square-s-insider-dealing.html> [<https://perma.cc/K4MM-TAGL>]. Franklin National Bank failed in 1974 due mainly to fraud and self-dealing. See John H. Allan, *Franklin Found Insolvent by U.S. and Taken Over*, *N.Y. TIMES* (Oct. 9, 1974), <https://www.nytimes.com/1974/10/09/archives/franklin-found-insolvent-by-us-and-taken-over-european-group-in.html> [<https://perma.cc/7Z6E-L6UP>].

⁹⁷ See Carmen M. Reinhart & Kenneth S. Rogoff, *Recovery from Financial Crises: Evidence from 100 Episodes*, 104 *AM. ECON. REV. PAPERS AND PROCEEDINGS* 50 (2014).

⁹⁸ See Saule T. Omarova, *The Quiet Metamorphosis: How Derivatives Changed the “Business of Banking”*, 63 *U. MIAMI L. REV.* 1041, 1044–46 (2009).

⁹⁹ Greenspan, for example, called the regulatory regime an “outdated competitive straightjacket” and reiterated frequently that banks were subject to an “over-regulated and over-restrained structure.” Alan Greenspan, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks to 28th Annual Conference on Bank

conglomeration, diversification, and expansion of banks into other intermediation activities, to enhance banks' stability, increase their profitability, and reduce their earnings volatility. They thought that stronger, bigger banks would spur faster and broader economic growth. They were also internationalists, who sought to build powerful American firms to compete with heavily concentrated financial sectors in Europe and Asia.¹⁰⁰ Instead of focusing on protecting bank creditors, like their predecessors had, these men sought to empower bank shareholders. Shareholders, they believed, were the best judges of how to run banks, and, unhampered, could accelerate economic growth and enhance social welfare.¹⁰¹

First, they worked to change the structural law to allow banks to grow into multi-purpose financial conglomerates.¹⁰² Then they changed the way the banking agencies supervised and regulated these firms. Some of these policymakers, like Greenspan, Meyer, and Rubin, believed that market discipline could moderate risk-taking and largely replace government oversight.¹⁰³ Others, like Gene Ludwig, conceded the need for government oversight, but believed that technocrats could lib-

Structure and Competition: Putting FDICIA in Perspective 7, 10 (May 7, 1992) (transcript available at https://fraser.stlouisfed.org/content/?item_id=8473&file_path=/files/docs/historical/greenspan/Greenspan_19920507.pdf) [<https://perma.cc/Y7GS-VMZQ>].

¹⁰⁰ Eugene A. Ludwig, Comptroller of the Currency, Remarks Before the Exchequer Club (Jan. 24, 1996) (transcript available at <https://www.occ.treas.gov/news-issuances/news-releases/1996/nr-occ-1996-8.html>) [<https://perma.cc/PP8F-XS8T>] (noting these reforms were critical to “helping the American economy compete internationally”).

¹⁰¹ See Garten, *supra* note 95, at 505–06.

¹⁰² See Saule T. Omarova, *Central Banks, Systemic Risk and Financial Sector Structural Reform*, in RESEARCH HANDBOOK ON CENTRAL BANKING 3 (Rosa Lastra & Peter Conti-Brown eds., 2018); John C. Coates IV, *The Volcker Rule as Structural Law: Implications for Cost-Benefit Analysis and Administrative Law*, 10 CAP. MKTS. L.J. 447, 448 (2015) (defining structural law as an attempt to “organize, constrain and channel activity”).

¹⁰³ Alan Greenspan, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks to the American Bankers Association: The Evolution of Bank Supervision 2 (Oct. 11, 1999) (transcript available at <https://www.federalreserve.gov/boarddocs/speeches/1999/19991011.htm>) [<https://perma.cc/F69Y-4Y3E>] [hereinafter Evolution of Bank Supervision] (noting that “supervisors have little choice but to try to rely more—not less—on market discipline—augmented by more effective public disclosures—to carry an increasing share of the oversight load”); Alan Greenspan, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks to the International Conference of Banking Supervisors: Bank Supervision in a World Economy 12 (Jun. 13, 1996) (transcript available at <https://www.federalreserve.gov/boarddocs/speeches/1996/19960613.htm>) [<https://perma.cc/9MWJ-DUBF>] (noting that “the technology that has enabled institutions to design complex new products also provides the techniques with which the resulting risks can be identified, measured, and controlled”).

eralize banking law by fine-tuning regulation and limiting supervisory discretion. Nearly all policymakers believed that innovative technological breakthroughs like value-at-risk modeling and credit derivatives made banking more stable and rendered parts of the old regime obsolete.¹⁰⁴ The new legal ordering these policymakers established was unlike any that had come before it—with a different design and a different set of guiding principles.

1. *Dismantling Bans*

As with many ideological reorientations, the deregulatory movement had a very tangible and material catalyst: economic stagnation. Over the course of the 1970s, inflation soared; unemployment climbed to nearly 10%, and GDP growth plummeted. As a new decade dawned, the economy fell into recession. Given relatively “high” levels of financial stability and “low” levels of economic performance, the government traded a bit of the former to boost the latter. First, Congress repealed Regulation Q, allowing depository institutions to raid each other’s deposits.¹⁰⁵ This policy spurred competition between banks. It also led to competition between banks and thrifts—non-banks permitted to sell savings accounts and residential mortgages. Then, to help constituents buy homes,¹⁰⁶ Congress exempted thrifts from restrictions on interest expense, interstate branching, and non-banking activities, and allowed them to make commercial loans and issue checkable deposits. Thrifts boomed.¹⁰⁷

¹⁰⁴ Alan Greenspan, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks to the Annual Convention of the American Bankers Association (Oct. 5, 1996) (transcript available at <https://www.federalreserve.gov/boarddocs/speeches/1996/19961005.htm>) [<https://perma.cc/75UQ-7B9C>] (arguing that better and more quantifiable estimates of risk are tantamount to risk reduction).

¹⁰⁵ Regulation Q was phased out over six years beginning in 1980 by the Depository Institutions Deregulation and Monetary Control Act. See Pub. L. 96-221, 94 Stat. 132 (1980) (codified at 12 U.S.C. § 226).

¹⁰⁶ As Volcker noted in 1984: “[T]he public policy rationale for the favorable regulatory, tax, and credit treatment of thrift institutions is fundamentally rooted in their activity as home lenders.” *Statement Before the S. Comm. on Banking, Hous., & Urban Affairs*, 98th Cong. 5 (1984) (statement of Paul A. Volcker, Chairman, Bd. of Governors of the Fed. Reserve Sys.) (transcript available at <https://fraser.stlouisfed.org/title/451/item/8288>) [<https://perma.cc/J4DQ-K6AJ>].

¹⁰⁷ Assets at thrifts grew from \$604 billion in 1980 to \$1.35 trillion in 1988. See DIV. OF RESEARCH & STATISTICS, FDIC, AN EXAMINATION OF THE BANKING CRISES OF THE 1980S AND EARLY 1990S, 168–69 (1997) <https://www.fdic.gov/bank/historical/history/vol1.html> [<https://perma.cc/ETV9-LY7W>].

The competition put financial pressure on banks.¹⁰⁸ Banks were not pleased. As the banks saw it, thrifts lacked the strict prudential oversight to which banks were subject, yet were permitted to conduct similar activities. Seeking alternative sources of revenue, banks stepped up their lobbying in Washington. Although some adjustments were made,¹⁰⁹ prominent policymakers, like Paul Volcker at the Fed, defended the existing legal regime.

Volcker thought that banks (and thrifts, if they were allowed to conduct banking activities) had a special “fiduciary responsibility” to the public, which necessitated their close supervision. As trustees of the public’s money, these organizations must, as he put it, invest “prudently while making loans available competitively, productively, and impartially to all sectors of the economy.”¹¹⁰ Accordingly, Volcker resisted industry efforts to undermine regulations. At the annual conference of the American Bankers Association (ABA) in 1983, he derided the “banking lobbyists scurrying around Washington,” telling bank executives that “the role of a supervisor,” is not “that of chief industry cheerleader.”¹¹¹

To Volcker, the problem was not that banks were too regulated, but that “the non-bank bank has become a device for tearing down the separation of commerce and banking by permitting a commercial firm to enter the traditional banking business without abiding by the provisions of the Bank Holding Company Act.”¹¹² “Both thrift and bank regulators,” he told Congress, “need additional tools to deal with pressing problems,” as “[p]articular institutions . . . are responding to the shifting competitive pressures . . . by exploiting loopholes and inconsistencies . . . in ways that will ultimately threaten

¹⁰⁸ See Garten, *supra* note 95, at 524.

¹⁰⁹ For example, the Fed lowered reserve requirements so that banks could lend out more of their funds. See Joshua N. Feinman, *Reserve Requirements: History, Current Practice, and Potential Reform*, 79 FED. RES. BULL. 569, 581 (1993).

¹¹⁰ *Statement Before the S. Comm. on Banking, Hous., & Urban Affairs*, 100th Cong. 7 (1987) (statement of Paul A. Volcker, Chairman, Bd. of Governors of the Fed. Reserve Sys.) (transcript available at <https://fraser.stlouisfed.org/title/451/item/8351> [<https://perma.cc/9EFF-7CVC>]).

¹¹¹ Paul Volcker, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks at the Annual Convention of the American Bankers Association 15 (Oct. 10, 1983) (transcript available at <https://fraser.stlouisfed.org/title/451/item/8282> [<https://perma.cc/2UTY-BTKX>]).

¹¹² *Statement Before the S. Comm. on Banking, Hous., & Urban Affairs*, 100th Cong. 5 (1987) (statement of Paul A. Volcker, Chairman, Bd. of Governors of the Fed. Reserve Sys.) (transcript available at <https://fraser.stlouisfed.org/title/451/item/8351> [<https://perma.cc/9EFF-7CVC>]).

the integrity of the whole.”¹¹³ Volcker proposed enhanced oversight of thrifts to restore the level playing field. Regulatory arbitrage, Volcker told Congress, must be “halted before irretrievable damage is done.”¹¹⁴ Needless to say, Volcker’s advice went unheeded.

In 1987, Greenspan succeeded Volcker as chairman of the Fed. Greenspan had an entirely different view of banking. To Greenspan, banks were just like other businesses, except for the fact that their failure often started panics, which harmed other banks and businesses. The government safety net, including deposit insurance and liquidity insurance, reduced these externalities but distorted the market by incentivizing bankers to make higher-risk loans and increase leverage. Government oversight was necessary not because banks were partners of the state in the creation and circulation of money, but because banks might try to socialize their losses. If the government’s intervention in the banking business was not highly tailored—and this point was critical to Greenspan and his followers—it would further distort markets and lead to even worse outcomes.¹¹⁵ “The self-interest of market participants generates private market regulation,” Greenspan explained. Thus, “the real question is not whether a market should be regulated. Rather the real question is whether government intervention strengthens or weakens private regulation.”¹¹⁶

According to Greenspan, the New Deal regime was of the weakening variety—a “regulatory straitjacket that stifles innovation and prudent risk management.”¹¹⁷ Since it did much more harm than good, Greenspan implored Congress to tear it down. In his view, the growth of the non-bank sector “significantly eroded the ability of the present structure to sustain competition and safe-and-sound financial institutions in a fair

¹¹³ *Id.* at 1–2.

¹¹⁴ *Id.* at 4.

¹¹⁵ The fundamental error in Greenspan’s model is his tendency to view banks as “financial intermediaries” rather than money issuers and credit creators. See Hockett and Omarova, *supra* note 52, at 1158.

¹¹⁶ Alan Greenspan, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks at the Financial Markets Conference of the Federal Reserve Bank of Atlanta: Government Regulation and Derivatives Contracts (Feb. 21, 1997) (transcript available at <https://www.federalreserve.gov/boarddocs/speeches/1997/19970221.htm>) [<https://perma.cc/9LLW-829N>].

¹¹⁷ Alan Greenspan, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks at the 29th Annual Conference on Bank Structure and Competition: FDICIA and the Future of Banking Law and Regulation 13 (May 6, 1993) (transcript available at https://fraser.stlouisfed.org/content/?item_id=8486&file_path=/files/docs/historical/greenspan/Greenspan_19930506.pdf) [<https://perma.cc/6P3T-A9V7>].

and equitable way.”¹¹⁸ It “is essential,” he told Congress, that the government “put in place a new, more flexible framework.”¹¹⁹ Specifically, he sought the repeal of Glass-Steagall, which he said depressed the franchise value of banks, reduced their capital, and raised the costs of financial services.¹²⁰

But Congress did not listen to Greenspan. The country was in the midst of its first banking crisis since the Great Depression. Excessive risk-taking by thrifts—and banks under competitive pressures from thrifts—prompted 262 FDIC-insured institutions to fail or require assistance, the most in the history of the insurance fund. In September of 1987, the stock market plummeted nearly 23% in one day. The next year, another 470 insured depository institutions failed, including 168 thrifts. In 1989, another 534 depository institutions failed, including 275 thrifts. Greenspan, however, stuck with his message: “[I]n the Board’s view, the single most important step [toward restoring stability] . . . is to repeal . . . Glass-Steagall[.]”¹²¹ To that end, Greenspan used the Fed’s administrative authority to weaken Glass-Steagall by allowing banks to derive a portion of their revenues from investment banking activities.¹²²

Following the savings and loan crisis, many questioned the initial deregulatory moves made in the 1980s, and Congress passed a major new law strengthening government oversight. But Greenspan and others argued that *more* liberalization was the solution. The problems in the banking system were not symptoms of too little regulation but too much. Congress had simply not gone far enough; the “key laws and regulations that impose significant costs on many banks have been re-

¹¹⁸ *Testimony Before the H. Subcomm. on Fin. Insts. Supervision, Regulation & Ins. of the H. Comm. on Banking, Fin. & Urban Affairs*, 100th Cong. 1 (1987) (testimony of Alan Greenspan, Chairman, Bd. of Governors of the Fed. Reserve Sys.) (transcript available at <https://fraser.stlouisfed.org/title/452/item/8367> [<https://perma.cc/4Z54-SBWR>]).

¹¹⁹ *Id.*

¹²⁰ *Id.* at 3.

¹²¹ Alan Greenspan, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks at the 24th Annual Conference on Bank Structure and Competition: An Overview of Financial Restructuring 8 (May 12, 1988) (transcript available at https://fraser.stlouisfed.org/content/?item_id=8380&filepath=/files/docs/historical/greenspan/Greenspan_19880512.pdf) [<https://perma.cc/CT7K-ALDE>].

¹²² See Bd. of Governors of the Fed. Reserve Sys., *Legal Developments*, 73 FED. RES. BULL. 453, 473 (1987) (“Order Approving Applications to Engage in Limited Underwriting and Dealing in Certain Securities”); Bd. of Governors of the Fed. Reserve Sys., *Legal Developments*, 73 FED. RES. BULL. 717, 731 (1987) (“Order Approving Applications to Engage in Limited Underwriting and Dealing in Consumer-Receiveable-Related Securities”).

tained[,] . . . [including] the McFadden Act's restrictions on interstate branching, the Glass-Steagall Act's constraints on combinations of commercial and investment banking, [and] restrictions on the integration of banking and insurance[.]”¹²³ Activity migration continued, but rather than seek to reverse it as Volcker had, Greenspan argued that it revealed the need for further deregulation.¹²⁴ The Treasury Department even published a report in 1991, recommending that Congress eliminate the separation of banking and commerce and allow non-bank businesses to buy and own banks, arguing that this would reduce the need for bailouts by providing a new source of capital to absorb loan losses.¹²⁵

The Fed continued to weaken Glass-Steagall by raising the limit on investment banking revenues in commercial banks to 25%; an aggressive interpretation of the 1933 statute.¹²⁶ The Fed also looked the other way as large conglomerates exploited a loophole in the Bank Holding Company Act to acquire non-banks that either refrained from commercial lending or from issuing deposits.¹²⁷

In 1993, the Clinton administration installed deregulatory leaders at the Treasury Department and its bureau, the OCC. The new Comptroller, Gene Ludwig, supported both “activities diversification” (the repeal of Glass-Steagall) and “geographic diversification” (the repeal of McFadden). Like Greenspan, Ludwig thought that these changes would allow banks to better “meet the needs of their local customers and communities as

¹²³ Alan Greenspan, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks at the 27th Annual Conference on Bank Structure and Competition: Banking in the 21st Century 2 (May 2, 1991) (transcript available at https://fraser.stlouisfed.org/content/?item_id=8455&filepath=/files/docs/historical/greenspan/Greenspan_19910502.pdf) [<https://perma.cc/4WP8-95MT>].

¹²⁴ See Greenspan, *supra* note 118, at 7, 10 (noting that “[a]ttempts to hold the present structure in place will be defeated through the inevitable loopholes that innovation forced by competitive necessity will develop, although there will be heavy costs in terms of competitive fairness and respect for law” and that “banking organizations are nearing the limits of their ability to act within existing law; and spending real resources to interpret outmoded law creatively is hardly wise”).

¹²⁵ See U.S. TREASURY DEP'T, MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS 57 (1991) (arguing that “allowing combinations of banking and commerce is particularly compelling in the context of permitting commercial firms to acquire failed banks”).

¹²⁶ Bd. of Governors of the Fed. Reserve Sys., Notice, Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, Board of Governors of the Federal Reserve System, Docket No. R-0841 (Dec. 20, 1996).

¹²⁷ See Shull, *supra* note 81, at 22.

well as remain competitive in international financial markets.”¹²⁸

Embracing the vision of bankers like Hugh McColl, who thought the best way for the banking industry to recover from the thrift crisis was to “let the strong take over the weak,” the Clinton administration prioritized the liberalization of interstate branching.¹²⁹ In 1994, President Clinton pushed the Riegle-Neal Act through Congress, repealing the McFadden restrictions, and kicking off a decade-long mergers bonanza.¹³⁰ Within five years, the three largest banks in the country held 20% of all banking assets, twice their 1990 share. Several of these growing banks sought to acquire insurance companies and investment banks. Congress, with the support of the Treasury Department, the Fed, and the White House, finally repealed Glass-Steagall in 1999.¹³¹ Eight years later, the three largest banks in the country held over 40% of all banking assets.¹³²

This structural transformation set the stage for a dramatic shift in day-to-day supervision and regulation. Banks were no longer specialized monetary institutions, they were sprawling financial businesses. With banks’ unique public purposes obscured by their new activities, it no longer seemed clear why the government should be involved in closely monitoring their business through substantive supervision.

2. *Writing Formulas*

Thus, a key plank of the reform agenda was minimizing discretionary oversight. The new generation of policymakers thought that substantive oversight, like bans, had deleterious effects on salutary risk-taking, and they built a rules-based

¹²⁸ *Testimony Before the H. Comm. on Banking & Fin. Servs.*, 104th Cong. 1 (1995) (testimony of Eugene A. Ludwig, Comptroller of the Currency) (transcript available at <https://www.occ.treas.gov/news-issuances/congressional-testimony/1995/pub-test-1995-133-written.pdf> [<https://perma.cc/CM3G-CFU8>]).

¹²⁹ Bill Medley, *Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994*, FED. RESERVE HISTORY (Sept. 1994), https://www.federalreservehistory.org/essays/riegle_neal_act_of_1994 [<https://perma.cc/RHF9-BQND>].

¹³⁰ Keith Bradsher, *Interstate-Banking Bill Gets Final Approval in Congress*, N.Y. TIMES (Sept. 14, 1994), <https://www.nytimes.com/1994/09/14/business/interstate-banking-bill-gets-final-approval-in-congress.html> [<https://perma.cc/HB93-EKJ2>].

¹³¹ Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999).

¹³² See Andrew Haldane, Exec. Dir., Fin. Stability, Bank of Eng., Remarks at the Institute of Regulation and Risk Conference: The \$100 Billion Question 18 (Mar. 30, 2010) (transcript available at <https://www.bis.org/review/r100406d.pdf>) [<https://perma.cc/9B6P-YT4P>] (depicting graphically the “[c]oncentration of the US banking system in Chart 2”).

regime in its place, converting the concept of safety-and-soundness into formulas. They believed that dramatically reducing discretionary oversight would increase bank profits, enhance system-wide resiliency and long-term stability, and ensure U.S. supremacy in the global financial marketplace.

As with structural deregulation, the shift toward rules began in the early 1980s. But, unlike structural deregulation, the promulgation of the first major rules was initially part of a crackdown on bank risk-taking. In the beginning, the banking agencies did not think much of rules as a method; they adopted them more as a clear statement of supervisory policy.¹³³

As mentioned earlier, the government traditionally assessed equity levels alongside loan portfolio quality, managerial capability, funding mix, and economic conditions, as part of a holistic safety and soundness review. Supervisors shunned the sort of one-size-fits-all approach inherent in a rule. As one senior OCC official noted in 1972, “such arbitrary formulas do not always take into account important factors.”¹³⁴ Or as the FDIC Manual of Examination Policies stated, capital ratios are “but a first approximation of a bank’s ability to withstand adversity. A low capital ratio by itself is no more conclusive of a bank’s weakness than a high ratio is of its invulnerability.”¹³⁵ Volcker noted on more than one occasion that capital ratios were “crude.”¹³⁶

But because equity capital stands between a bank and disorderly default, inadequate levels of it are a critical concern. In 1982, severe economic stagnation left banks with their lowest levels of equity funding ever (less than 4% of total assets at the largest firms), and bank failures spiked to their highest point since the 1930s. (Failures continued to rise every year of Volcker’s term and did not drop below pre-1982 levels until

¹³³ Between 1970 and 1981, the capital ratios for the then-largest banks in the country (those with over \$5 billion in assets) dropped 20%. Paul Volcker, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks at the Annual Convention of the American Bankers Association: Banking; A Framework for the Future 13 (Oct. 7, 1981) (transcript available at https://fraser.stlouisfed.org/content/?item_id=8245&filepath=/files/docs/historical/volcker/Volcker_19811007.pdf) [<https://perma.cc/RF6F-TVG5>].

¹³⁴ Susan Burhouse et al., *Basel and the Evolution of Capital Regulation: Moving Forward, Looking Back*, FDIC (Jan. 14, 2003), <https://www.fdic.gov/bank/analytical/fyi/2003/011403fyi.html> [<https://perma.cc/YQM5-F8NZ>].

¹³⁵ *Id.*

¹³⁶ Paul A. Volcker, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks at the Annual Convention of the American Banking Association 8 (Oct. 21, 1985) (transcript available at https://fraser.stlouisfed.org/content/?item_id=8332&filepath=/files/docs/historical/volcker/Volcker_19851021.pdf) [<https://perma.cc/FU7F-RPKZ>].

1994.)¹³⁷ Increasing bank leverage posed a challenge for supervisors. In 1981, to put all firms on notice, the Fed, drawing on its § 1818 safety and soundness authority, issued guidance regarding capital minimums in the form of a leverage ratio, with equity capital in the numerator and total assets in the denominator.

Even this seemingly simple ratio was a complex formula. The numerator and denominator can both be manipulated (capital may include preferred shares or equity-like debt instruments, and assets may include goodwill and other intangibles, or off-balance sheet exposures that can be hard to value). The ratio was also blunt. But it was not meant to be a primary regulatory tool—Volcker referred to it as an “arbitrary ‘rule of thumb.’”¹³⁸ In conjunction with the guidance, the Fed announced that supervisors would “monitor closely the capital position of large banking organizations.”¹³⁹

And they did. Over the next few years, both the Fed and the OCC issued cease and desist orders under §1818 to address inadequate capital levels.¹⁴⁰ Given the competition with thrifts, some banks were not keen to comply. As Volcker himself acknowledged, there were “strong competitive pressures . . . pushing toward more leverage,”¹⁴¹ and as Greenspan later put it, “[b]ank owners have incentives to minimize their capital investments in order to maximize their returns[.]”¹⁴² For example, in 1983, Continental Illinois, one of the biggest banks in the country, ran into trouble. Volcker pressured the bank’s management to reduce risk, but the bank responded with half measures.¹⁴³ In 1984, the bank collapsed, and the

¹³⁷ See Failures and Assistance Transactions—Historical Statistics on Banking, FDIC, <https://www5.fdic.gov/hsob/SelectRpt.asp?EntryTyp=30&Header=1> [<https://perma.cc/C9AG-D6WM>].

¹³⁸ Volcker, *supra* note 136, at 9.

¹³⁹ FED. RESERVE BOARD, ORDER APPROVING FORMATION OF BANK HOLDING COMPANY, ACQUISITION OF NONBANK AND EDGE ACT SUBSIDIARIES AND RETENTION OF NONBANK COMPANIES; ORDER DENYING RETENTION OF TRAVEL AGENCY ACTIVITIES OF THOMAS COOK, INC. 6 (1981).

¹⁴⁰ Stephen K. Huber, *Enforcement Powers of Federal Banking Agencies*, 7 ANN. REV. BANKING L. 123, 147 (1988).

¹⁴¹ Volcker, *supra* note 136, at 8.

¹⁴² Alan Greenspan, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks to the Annual Convention of the American Bankers Association 3 (Oct. 16, 1989) (transcript available at https://fraser.stlouisfed.org/content/?item_id=8417&filepath=/files/docs/historical/greenspan/Greenspan_19891016.pdf) [<https://perma.cc/Y9J2-PKXY>].

¹⁴³ Conversation with Paul Volcker, New Haven, Ct. (2012).

government stepped in to rescue it. With assets of \$40 billion, it was, by far, the largest bank failure in American history.¹⁴⁴

That same year, the First National Bank of Bellaire sued the OCC claiming that the government did not have the authority to force it to reduce its leverage. The Fifth Circuit Court of Appeals handed down a shocking decision, finding that the evidence presented by the OCC was insufficient to sustain its capital order.¹⁴⁵ In response, the banking agencies turned to Congress. The International Lending Supervision Act of 1983 (ILSA), passed largely to address risky investments by U.S. banks in Latin America, included provisions restricting precluding judicial review of capital orders and buttressing the discretionary latitude of the banking agencies under § 1818. The law also authorized the agencies to promulgate binding capital minimums through notice and comment rulemaking.¹⁴⁶

Ironically, in trying to save substantive oversight, Congress may have hastened its demise.¹⁴⁷ Concerned by the increasing number of bank failures, in 1985, the banking agencies drew on their authority under ILSA to establish a leverage ratio.¹⁴⁸ This new rule was meant to play only a supporting role (at least initially). Volcker explained that it was “simply [a] capital/asset ratio[.] that cannot really reflect the diversity of risk among banks[.]” further noting that it “seem[s] to provide some perverse incentives to reduce liquidity or relatively safe but low-margin assets to curtail asset growth, while encouraging extraordinary growth in off-balance sheet risks, particularly at very large banking organizations.”¹⁴⁹ Volcker expected super-

¹⁴⁴ See Failures and Assistance Transactions—Historical Statistics on Banking, *supra* note 137.

¹⁴⁵ First Nat'l Bank of Bellaire v. Comptroller of Currency, 697 F.2d 674, 685–87 (5th Cir. 1983).

¹⁴⁶ International Lending Supervision Act of 1983, Pub. L. No. 98–181, §§ 902–913, 97 Stat. 1153, 1278 (1983) (codified at 12 U.S.C. §§ 3901–3912 (Supp. IV 1986)). Congress specifically overturned *Bellaire* in part of the statute. See 12 U.S.C. § 3907(b)(1) (Supp. III 1985) (stating that “[f]ailure . . . to maintain capital at or above its minimum level . . . may be deemed by the appropriate Federal banking agency, in its discretion, to constitute an unsafe and unsound practice within the meaning of section 1818”). See also Michael P. Malloy, *U.S. International Banking and the New Capital Adequacy Requirements: New, Old and Unexpected*, 7 ANN. REV. BANKING L. 75, 76 (1988).

¹⁴⁷ See Huber, *supra* note 140, at 147; Jack S. Older & Howard N. Cayne, *Capital Standards: Regulators Wield Big New Stick*, LEGAL TIMES, Apr. 30, 1984, at 11.

¹⁴⁸ Minimum Capital Ratios, 50 Fed. Reg. 10,207 (Mar. 14, 1985) (codified at 12 C.F.R. pts. 3 & 7) (adopting a final regulation on capital requirements for national banks).

¹⁴⁹ Volcker, *supra* note 136, at 8.

visors to still take the lead, and the Fed announced “a number of [] steps to enhance the effectiveness of our supervisory activities . . . [including] intensifying the frequency and scope of our examinations and inspections of larger banking organizations[.]”¹⁵⁰

When Greenspan succeeded Volcker in 1987, however, the central bank changed course. Greenspan sought to use the capital rules to limit supervisory discretion. To do this, the rules would have to be refined. Greenspan and economists like Anthony Santomero, the President of the Federal Reserve Bank of Philadelphia, agreed with Volcker that leverage ratios could be thwarted if banks shifted investments into higher risk assets.¹⁵¹ Since there were two ways for a bank to increase risk—changing asset allocation by making riskier investments or borrowing more money by reducing the amount of equity behind each investment—blocking off one avenue while leaving the other open achieves very little. In fact, Santomero thought it would make matters worse.¹⁵² If regulators treated all assets alike, bankers would sell their safe assets and buy higher yielding, riskier ones. Instead of investing in treasuries, for example, bankers might make unsecured consumer loans. From the perspective of a profit-maximizing shareholder, increasing leverage and increasing portfolio risk are economically equivalent.

In 1988, the Fed reached an international agreement with nine other advanced economies through the Basel Committee on Bank Supervision (Basel I).¹⁵³ The countries agreed to common capital standards and risk-weights.¹⁵⁴ The new regime aimed to reduce overall enterprise risk by requiring more (or less) capital depending on asset type.¹⁵⁵ It grouped assets into different categories (e.g., residential mortgages, business loans, cash, and sovereign debt) and assigned them different risk weights (e.g., 0%, 20%, 50%, and 100%).¹⁵⁶ Regulators reduced the required percentage of equity funding (8% of total

¹⁵⁰ *Id.* at 9.

¹⁵¹ *See generally* Michael Koehn & Anthony M. Santomero, *Regulation of Bank Capital and Portfolio Risk*, 35 J. FIN. 1235 (1980); Daesik Kim & Anthony M. Santomero, *Risk in Banking and Capital Regulation*, 43 J. FIN. 1219 (1988).

¹⁵² Koehn & Santomero, *supra* note 151, at 1235 (“[T]he results of a higher required capital-asset ratio in terms of the average probability of failure are ambiguous, while the intra-industry dispersion of the probability of failure unambiguously increases”).

¹⁵³ BASEL COMM. ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS (1988).

¹⁵⁴ *See id.* at 3–13.

¹⁵⁵ *See id.* at 1.

¹⁵⁶ *See id.* at 21–22.

assets) by weight, creating an incentive for banks to hold lower risk assets (thus, banks were required to fund 4% of their residential mortgages, subject to the 50% weighting, with money from shareholders).¹⁵⁷

For those like Greenspan who saw the growth of U.S. firms into international megabanks as a key strategic priority for U.S. economic policy, harmonization of regulatory standards was of paramount importance. Yet Greenspan did not immediately expect supervision to fall away: “We will surely always require supervision, monitoring, and regulation of some aspects of banking organizations,” he said in 1988, “[b]ut having in place an effective risk-based capital system—and one that is also widely used by the major industrial nations—would be a major step in the right direction.”¹⁵⁸ Or, as he put it in another context, Basel I was “an important first step toward having in place market oriented regulatory policies that encourage banking organizations to maintain adequate capital and prudently manage their risk.”¹⁵⁹

In the 1990s, the rules movement found new sources of support in Congress who suspected that regulatory capture and lax oversight had contributed to the savings and loan crisis. To these policymakers, rules offered a way to strengthen regulatory safeguards. Throughout the 1990s, the Fed took additional steps to expand these formulas in aid of both the deregulatory agenda and an international push to expand into foreign markets.¹⁶⁰ Regulators tried to resolve the crudeness problems by connecting the capital rules to complex internal models produced by the banks themselves. For example, in 1996, the Market Risk Amendment allowed large financial conglomerates to use their own models to determine the required amount of capital on their trading book. Many policymakers, especially economists, saw these models as the future of the capital rules—perfectly aligning capital charges with actual risk, asset by asset.¹⁶¹

¹⁵⁷ See *id.* at 14, 15.

¹⁵⁸ Greenspan, *supra* note 121, at 10.

¹⁵⁹ *Id.* at 9–10.

¹⁶⁰ The rules were not calibrated by conducting a cost-benefit analysis and determining the socially appropriate level of capital financing; they were set by “norming,” essentially drawing a line two standard deviations below the mean existing capital levels. See Eric A. Posner, *How Do Bank Regulators Determine Capital-Adequacy Requirements?*, 82 U. CHI. L. REV. 1853, 1855 (2015).

¹⁶¹ Meyer, *supra* note 16, at 97 (“[U]sing models to determine capital for market risk on traded securities and derivative positions is another genuine step forward.”).

By the mid-1990s, capital regulation anchored a new shareholder-centric legal regime. The Fed thought that the capital rules were a much less disruptive “intervention” than traditional oversight, more narrowly tailored to “correcting” the “market failures” precipitated by the safety net. “The key to engendering market incentives,” Greenspan explained, “is to require that those owners who would profit from an institution’s success have the appropriate amount of their own capital at risk.”¹⁶² As he put it, “[the owners of depository institutions] who stand to gain substantially if the institution is successful must also stand to lose substantially if outcomes are not so favorable.”¹⁶³ Capital requirements were the cleanest and most straightforward solution: “There is no better way to ensure that owners exert discipline on the behavior of their firm than to require that they have a large stake in that enterprise.”¹⁶⁴ In other words, if we “fortify the natural ‘shock absorbers’ of the financial system—capital and liquidity,” we can “make better use of market and market-like incentives to discourage excessive risk-taking at individual [depository] institutions.”¹⁶⁵ Ultimately, capital regulation would “offset the moral hazard incentives” of the safety net.¹⁶⁶

With this corrective in place, policymakers decided that most other restrictions could be lifted.¹⁶⁷ And, once the bans were shorn away, the capital rules stood as the central pillars around which a new supervisory regime was constructed.

3. *Proceduralizing Oversight*

In the late 1990s, the Fed designed a new supervisory program for LCBOs to facilitate market discipline and minimize government intervention in banking. Unlike traditional substantive oversight, which the Fed believed would be harmful and inadequate for these conglomerates, risk-focused supervision used capital requirements and procedural oversight to harness the salutary forces of the market.

¹⁶² Alan Greenspan, Chairman of the Bd. of Governors of the Fed. Reserve Sys., Remarks to the American Bankers Association: Innovation and Regulation of Banks in the 1990s 5 (Oct. 11, 1988) (transcript available at https://fraser.stlouisfed.org/content/?item_id=8394&filepath=/files/docs/historical/greenspan/Greenspan_19881011.pdf) [<https://perma.cc/MY5F-4DTQ>].

¹⁶³ *Id.*

¹⁶⁴ *Id.*

¹⁶⁵ *Id.*

¹⁶⁶ Greenspan, *supra* note 99, at 2.

¹⁶⁷ Greenspan, *supra* note 123, at 11.

The decline of discretionary oversight proceeded in three phases. First, the risk-based capital formulas were finalized. Second, the OCC created a program called “risk-based supervision,” leaving more oversight of outcomes to the market. Third, Glass-Steagall was repealed and the Fed developed RFS, an even more process-focused system of supervision for overseeing the largest conglomerates. Bank examinations did not end, but what it took to fail one changed dramatically.

a. *Formulas Finalized*

Greenspan first publicly expressed doubts about traditional supervision in 1992, soon after the risk-based capital requirements went into effect. “[I]n our view,” he explained, “sound banks,” meaning those well-capitalized under the Basel rules, “need not be subject to intrusive supervision.”¹⁶⁸ By “intrusive supervision,” he meant the sort of substantive oversight that had existed up until that point—extensive transaction testing and a full review of a bank’s investments and activities. Even before the industry had evolved into its modern form, Greenspan decided that the Basel rules reduced the need for supervisors to reach their own conclusions about leverage and asset risk.¹⁶⁹

b. *Risk-Based Supervision*

Following the repeal of the McFadden Act restrictions, the OCC announced a new program for overseeing large banks called risk-based supervision (RBS). Risk-based supervision was embraced, in part, because the savings and loan crisis had discredited the traditional approach to bank oversight. Eugene Ludwig, the new head of the OCC, sold the program to Congress as a step forward, an effort to stay ahead of the curve. In his words, RBS “identifies those activities and products that pose the greatest risk to an institution and evaluates the effec-

¹⁶⁸ Greenspan, *supra* note 99, at 2.

¹⁶⁹ It was several more years before Greenspan split fully from the traditional framework. See Alan Greenspan, Chairman of the Bd. of Governors of the Fed. Reserve Sys., Remarks before the 30th Annual Conference of Bank Structure and Competition: Optimal Bank Supervision in a Changing World 10–11, (May 12, 1994) (transcript available at <https://fraser.stlouisfed.org/title/452/item/8507>) [<https://perma.cc/HVX6-QAP2>] (noting that “the core of bank supervision must continue to be the on-site evaluation of the individual bank” and that the “basic ‘unit of supervision’” had to be the “evaluation and stress-testing of the bank’s overall risk position”).

tiveness of the institution's policies and processes to control the risks associated with those products and activities."¹⁷⁰

Supervisors, of course, had long considered these aspects of bank activities, especially governance, as part of safety and soundness (the "M" in CAMELS is for management). For example, examiners traditionally considered underwriting policies because intervening to address an inappropriate underwriting policy is better than waiting to act until a bank's assets are underperforming. These processes are related to and precede outcomes. The OCC—and others¹⁷¹—emphasized how increasing procedural oversight would be more preventative, "strategic []," and "forward-looking."¹⁷² For example, in 1995, Ludwig argued that the root causes of two recent bank failures, Daiwa and Barings, emanated from a "failure to separate the risk management and control functions from the risk-taking function and an inadequate level of oversight by senior management."¹⁷³ He suggested that, for large banks, this is why the OCC would be placing "great emphasis on the need for . . . strong internal controls."¹⁷⁴

But at the same time, Ludwig pulled back on-site, hands-on bank examinations from large firms and "directed a concerted effort to streamline [] supervision and lower its cost."¹⁷⁵ "I strongly believe," he told Congress, "the key for bank supervisors . . . is to identify the risks incurred by banks, to assess their systems for managing those risks, and to ensure that the

¹⁷⁰ *Testimony Before the Subcomm. on Fin. Insts. & Consumer Credit of the H. Comm. on Banking & Fin. Servs.*, 104th Cong. 3 (1995) (testimony of Eugene A. Ludwig, Comptroller of the Currency) (transcript available at <https://www.occ.treas.gov/news-issuances/congressional-testimony/1995/pub-test-1995-133-written.pdf>) [<https://perma.cc/CM3G-CFU8>].

¹⁷¹ GAO assessed the new approach and found that "risk-focused examinations are intended to be more forward looking, focusing on banks' management practices and controls to manage current and future risks. Prior to the adoption of a risk-focused approach, examinations were more retrospective. Examiners assessed a bank's overall safety and soundness by testing transactions that were based on past decisions and past management practices." U.S. GOV'T ACCOUNTABILITY OFFICE, GAO/GGD-00-48, RISK-FOCUSED BANK EXAMINATIONS: REGULATORS OF LARGE BANKING ORGANIZATIONS FACE CHALLENGES 5 (2000).

¹⁷² *Testimony Before the Subcomm. on Fin. Insts. & Consumer Credit of the H. Comm. on Banking & Fin. Servs.*, 105th Cong. (1997) (testimony of Eugene A. Ludwig, Comptroller of the Currency) (transcript available at <https://www.occ.treas.gov/news-issuances/congressional-testimony/1997/pub-test-1997-90-written.pdf>) [<https://perma.cc/K9SP-DCCF>].

¹⁷³ Ludwig, *supra* note 170, at 6.

¹⁷⁴ *Id.* at 7.

¹⁷⁵ *Testimony Before the H. Comm. on Banking & Fin. Servs.*, 104th Cong. 2 (1996) (testimony of Eugene A. Ludwig, Comptroller of the Currency) (transcript available at <https://www.occ.treas.gov/news-issuances/congressional-testimony/1996/pub-test-1996-32-written.pdf>) [<https://perma.cc/G86U-DTH8>].

banks' risk management systems are, in fact, identifying, measuring, monitoring and controlling risks."¹⁷⁶ As the OCC's analysis increasingly began and ended with the process and never turned to the results (e.g., whether underwriting standards were too low or whether capital was strained), supervision became a very different exercise. Ludwig welcomed this: "[a]s the banking industry adapts to a dynamic economy," he explained, "so too must bank supervision evolve."¹⁷⁷

c. *Risk-Focused Supervision*

Following the roll-out of Ludwig's more process-centric approach to bank supervision, the Fed developed RFS—an even more process-centric approach designed especially with LCBOs in mind.

Greenspan first articulated this framework at a conference in Sweden. "Within the United States," he explained, "the Federal Reserve and other bank supervisors are placing growing importance on a bank's risk management process and . . . are also working to develop supervisory tools and techniques that utilize available technology and that help supervisors perform their duties with less disruption to banks."¹⁷⁸ For example,

rather than evaluate a high percentage of a bank's loans and investment products by reviewing individual transactions, we will increasingly seek to ensure that the management process itself is sound, and that adequate policies and controls exist. While still important, the amount of transaction testing, especially at large banks, will decline.¹⁷⁹

Whereas supervisors' primary priority had traditionally been forming an independent view of safety and soundness, Greenspan saw "[e]ncouraging and promoting sound qualitative risk management and internal controls" as "a high priority of bank supervisors."¹⁸⁰ In fact, for the largest firms, he now viewed substantive oversight as potentially damaging:

We supervisors will be appreciably more involved in evaluating individual bank risk management processes, than after-the-fact results. In doing so, however, we must be assured that with rare and circumscribed exceptions we do not substitute supervisory judgments for management decisions. That is the road to moral hazard and inefficient bank man-

¹⁷⁶ Ludwig, *supra* note 172, at 5.

¹⁷⁷ *Id.*

¹⁷⁸ Greenspan, *supra* note 7, at 13.

¹⁷⁹ *Id.* at 14.

¹⁸⁰ *Id.*

agement. Fortunately, the same technology and innovation that is driving supervisors to focus on management processes will, through the development of sophisticated market structures and responses, do much of our job of ensuring safety and soundness. We should be careful not to impede the process.¹⁸¹

Greenspan, in a series of public remarks, gave a range of reasons for minimizing substantive oversight, including (1) banks' expansion into new activities, which had "begun to render obsolete much of the bank examination regime established in earlier decades";¹⁸² (2) technological change, which allowed supervisors to piggy-back on bank's quantitatively rigorous assessments of risk;¹⁸³ (3) the tendency of bank shareholders to look out for their own interests; (4) the need to promote market discipline and ensure that shareholders manage risks appropriately;¹⁸⁴ and (5) "scarce examination resources," "most effectively employed by focusing on risk management processes."¹⁸⁵ The Fed also argued that supervisors would no longer be able to keep up with the bankers they regulated. Substantive oversight, Greenspan explained:

¹⁸¹ *Id.* at 15–16.

¹⁸² Alan Greenspan, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks Before the Annual Meeting and Conference of the Conference of State Bank Supervisors: Our Banking History (May 2, 1998) (transcript available at https://fraser.stlouisfed.org/content/?item_id=8636&filepath=/files/docs/historical/greenspan/Greenspan_19980502.pdf) [<https://perma.cc/JW92-ZTSY>] [hereinafter Greenspan, Our Banking History]. As Greenspan explained elsewhere: "In recent years, the focus of supervisory efforts in the United States has been on the internal risk measurement and management processes of banks. This emphasis on internal processes has been driven partly by the need to make supervisory policies more risk-focused in light of the increasing complexity of banking activities." Alan Greenspan, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks Before the Conference on Capital Regulation in the 21st Century: The Role of Capital in Optimal Banking Supervision and Regulation (Feb. 26, 1998) (transcript available at https://fraser.stlouisfed.org/content/?item_id=8629&filepath=/files/docs/historical/greenspan/Greenspan_19980226.pdf) [<https://perma.cc/8TNA-M2PE>].

¹⁸³ See Greenspan, *supra* note 169, at 1 ("[T]he technological characteristics of banking products and services are changing profoundly. As a result, the ways in which we conduct bank supervision must also change.").

¹⁸⁴ Greenspan explained: "To cite the most obvious and painful example, without federal deposit insurance, private markets presumably would never have permitted thrift institutions to purchase the portfolios that brought down the industry insurance fund and left taxpayers responsible for huge losses." Our Banking History, *supra* note 182, at 7.

¹⁸⁵ Alan Greenspan, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks at the Annual Meeting and Conference of the Conference of State Bank Supervisors: Financial Reform and the Importance of the State Charter (May 3, 1997) (transcript available at https://fraser.stlouisfed.org/content/?item_id=8598&filepath=/files/docs/historical/greenspan/Greenspan_19970503.pdf) [<https://perma.cc/7BHR-A3W6>] (emphasis in original).

requires that regulators be able to attract and retain a highly trained and capable staff . . . [but] I am concerned about our ability to continue to do this, given what appears to be a widening gap between the returns that the brightest financial minds can make in the private marketplace compared to what they can make in government.¹⁸⁶

To convert these ideas into a minimally invasive, market-friendly regime for overseeing large banks, the Fed launched a task force, called the F-6, composed of three Reserve Bank presidents, three Board Governors, and chaired by Governor Meyer.¹⁸⁷ The F-6 developed RFS for independently testing and comparing internal control systems and risk management practices at LCBOs.¹⁸⁸ As Greenspan explained the purpose of the new approach:

[I]n contemplating the growing complexity of our largest banking organizations, it seems to us that the supervisors have little choice but to try to rely more—not less—on market discipline—augmented by more effective public disclosures—to carry an increasing share of the oversight load. This is, of course, only feasible for those, primarily large, banking organizations that rely on uninsured liabilities in a significant way.¹⁸⁹

In addition to avoiding the damaging effects of government intervention, the Fed thought this new policy was needed because LCBOs were too complex to supervise traditionally; as Meyer put it, “market discipline” “must play a greater role.”¹⁹⁰

Herein lies the need for procedural discretionary oversight. “[M]arkets,” Meyer explained, “cannot operate well without transparency.”¹⁹¹ A “prerequisite for market discipline is [the] more rapid dissemination of information by the regulators and,

¹⁸⁶ Greenspan, *supra* note 169, at 12.

¹⁸⁷ Meyer, *supra* note 16, at 98 (discussing the work of Mark Flannery and Charlie Calomiris on market discipline).

¹⁸⁸ See SUPERVISORY LETTER, SR 99-15, *supra* note 8. The policy built on a 1995 letter setting out a similar program for supervising trading activities, and the policy was further developed in subsequent letters. See *e.g.*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., FED. RESERVE, SR 00-13, FRAMEWORK FOR FINANCIAL HOLDING COMPANY SUPERVISION (2000) (providing guidance concerning the purpose and scope of the Federal Reserve’s supervision of financial holding companies); BD. OF GOVERNORS OF THE FED. RESERVE SYS., FED. RESERVE, SR 95-51, RATING THE ADEQUACY OF RISK MANAGEMENT PROCESSES AND INTERNAL CONTROLS AT STATE MEMBER BANKS AND BANK HOLDING COMPANIES (Nov. 14, 1995) (providing supervisory guidance to state member banks and holding companies with \$50 billion or more in total assets).

¹⁸⁹ Evolution of Bank Supervision, *supra* note 103.

¹⁹⁰ Meyer, *supra* note 16, at 99.

¹⁹¹ *Id.* at 100.

more importantly, the direct provision to market participants of critical and timely information about risk exposures by the LCBOs themselves.”¹⁹² This is of particular concern in banking, a notoriously opaque business, in which insiders can shift investments quickly and easily without public notice.¹⁹³ Thus, supervisors’ new task would be to ensure that managers disseminated relevant information to shareholders quickly by “reviewing an LCBO’s disclosures to confirm that the organization’s policy is consistent with best practices and to confirm that the bank’s actual disclosures are consistent with its own policy.”¹⁹⁴

The risk-focused approach emphasized procedural elements even further removed from actual risk-taking. For example, rather than examine the underwriting policy itself, supervisors focused on the process of drafting and approving the underwriting policy. Supervisors would no longer decide for themselves whether the policy reflected an excessive risk appetite. Instead, they would consider whether the board was involved in reviewing the policy and whether control functions were involved in applying it. They might look at whether the firm produced projections of potential losses using state-of-the-art modeling technology or whether those forecasts were shared with the board in a timely manner. This sort of oversight was designed to ensure that the market could police risk-taking. RFS was necessary because “[p]ublic disclosure is not going to be easy for bankers because it may well bring new pressures that they may not like in the short run.”¹⁹⁵

RFS, then, was a logical extension of the emphasis on capital regulation, which sought to put shareholders in the driver’s seat by addressing the “need[] for larger shock absorbers and for increased private incentives to monitor and control risk.”¹⁹⁶ This need to replace traditional supervisory oversight with mar-

¹⁹² *Id.*

¹⁹³ See SUPERVISORY LETTER, SR 99-15, *supra* note 8 (“Given the speed with which risk profiles can change the Federal Reserve’s approach to LCBOs . . . plac[es] increased emphasis on an organization’s internal systems and controls for managing risk.”); see also Robert Charles Clark, *The Soundness of Financial Intermediaries*, 86 YALE L.J. 1, 14–15 (1976) (arguing that “a financial intermediary’s assets consist of intangible claims” and that “[a]bsent special regulation, it would be easy for the management . . . to sell off its intangible assets and replace them with new claims that in the aggregate constitute a portfolio with a radically different level of risk” meaning that “financial intermediaries can shift their aggregate risk levels more readily than other corporations”).

¹⁹⁴ Meyer, *supra* note 16, at 102.

¹⁹⁵ *Id.*

¹⁹⁶ Greenspan, *supra* note 162, at 5.

ket oversight was “the fundamental reason[] why increasing the amount of capital in the depository institution system has been a major goal of . . . regulatory policy.”¹⁹⁷ As the Financial Crisis Inquiry Commission explained it, the OCC and the Fed “acted something like consultants, working with banks to assess the adequacy of their systems.”¹⁹⁸

d. *Propagation*

Other agencies adopted the Fed’s approach to overseeing LCBOs, including the OCC. In its *Large Bank Supervision: Comptroller’s Handbook*, the OCC explained that their examiners would no longer “attempt to restrict risk-taking but rather [to] determine whether banks identify and effectively manage the risks they assume.”¹⁹⁹ Treasury Secretary Rubin praised these “actions . . . to focus supervisors much more strongly on banks’ assessment of market risk and their systems for evaluating that risk.”²⁰⁰

The acclaim was not universal. In 2000, the General Accounting Office (GAO) produced an assessment of risk-focused examinations and noted several shortcomings:

Regulators face a number of challenges in supervising and examining large, complex banks. Since a risk-focused approach requires that examiners make judgments that may result in some bank operations receiving minimal scrutiny, the possibility exists that some risks may not be appropriately identified. . . . [R]egulators [also] face challenges in ensuring that their assessments of risk are sufficiently independent of the bank’s risk-management systems and are mindful of industrywide risk trends.²⁰¹

Nonetheless, the formula-driven, risk-focused approach appeared to be working. The banking industry grew much larger and more profitable, and, as a result, became better capitalized. The U.S. exported its model overseas through the Basel Committee. The Basel II accord, which the US never technically adopted, provided a three-pillared framework for banking oversight: “market discipline,” meaning private moni-

197 *Id.*

198 See FIN. CRISIS INQUIRY COMM’N, *supra* note 20, at 307.

199 OFFICE OF THE COMPTROLLER OF THE CURRENCY, *supra* note 16, at 3.

200 Robert E. Rubin, Treasury Sec’y, U.S. Dep’t of the Treasury, Remarks on Reform of the International Financial Architecture to the School of Advanced International Studies (Apr. 21, 1999) (transcript available at <https://www.treasury.gov/press-center/press-releases/Pages/rr3093.aspx> [<https://perma.cc/9GPM-DV9V>]).

201 U.S. GOV’T ACCOUNTABILITY OFFICE, *supra* note 171, at 7.

toring by shareholders and creditors, “supervision,” meaning compliance verification and procedural oversight to facilitate market discipline, and “capital regulation,” meaning risk-based capital requirements to ensure that shareholders have enough skin in the game to adequately oversee bank executives.²⁰²

RFS, in other words, was the irreducible rump of safety and soundness—the aspects of discretionary judgment that the banking agencies decided to preserve as the proper purview of government officials after converting traditional supervisory wisdom about bank risk and leverage into rules (and outsourcing the rest). Capital requirements, in the new regime, are not merely, or even primarily, efforts to increase firms’ loss absorbing capacity.²⁰³ Rather, they are central columns in a legal architecture designed to facilitate private sector oversight.²⁰⁴

On his way out in 2006, Greenspan summarized the transformation: “[s]upervision has become increasingly less invasive and increasingly more systems- and policy-oriented. These changes have been induced by evolving technology, increased complexity, and lessons learned from significant banking crises, not to mention constructive criticism from the banking community.”²⁰⁵

Ben Bernanke, who succeed Greenspan as Chairman in 2006, adopted his predecessor’s approach. He advocated for further regulatory relief, because, as he noted, “[m]inimizing the regulatory burden on banks is very important.”²⁰⁶ “The

²⁰² See generally, BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT’L SETTLEMENTS, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (2004) (setting forth the “Basel II” framework and explaining the three pillars).

²⁰³ See, e.g., Posner, *supra* note 160, at 1854 (“Bank regulators care about capital adequacy because their mandate is to prevent bank panics and contagions. A bank with a high ratio of capital to assets will, all else equal, be better able to withstand a sudden loss . . .”).

²⁰⁴ This legal ordering was intentionally deregulatory: “Increased government regulation,” as Greenspan put it, “is inconsistent with a banking system that can respond to the kinds of changes that have characterized recent years, changes that are expected to accelerate in the years ahead.” *Evolution of Bank Supervision*, *supra* note 103.

²⁰⁵ Alan Greenspan, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks Before the Independent Community Bankers of America National Convention: Bank Regulation (Mar. 11, 2005) (transcript available at <https://www.federalreserve.gov/boarddocs/speeches/2005/20050311/default.htm>) [<https://perma.cc/TZ6K-B7H2>].

²⁰⁶ Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks Before the Annual Convention of the American Bankers Association and the Annual Convention of America’s Community Bankers: Bank Regulation and Supervision; Balancing Benefits and Costs (Oct. 16, 2006) (transcript available at https://fraser.stlouisfed.org/content/?item_id=8944&filepath=/files/docs/historical/bernanke/bernanke_20061016.pdf) [<https://perma.cc/B4V2-QK84>].

objective” of the banking agencies, he said, was “to address weaknesses in management and internal controls *before* financial performance suffers rather than being satisfied with identifying what went wrong after the fact.”²⁰⁷ “At the heart of the modern bank examination,” he explained, “is an assessment of the quality of a bank’s procedures for evaluating, monitoring, and managing risk, and of the bank’s internal models for determining economic capital.”²⁰⁸ Even “supervisory policies regarding prompt corrective action,” he pointed out, “are linked to a bank’s leverage and risk-based capital ratios.”²⁰⁹ Indeed, the banking agencies had explicitly tied safety and soundness to the capital formulas, converting a discretionary exercise to a rules-based one. As Bernanke put it: “Capital regulation is the cornerstone of . . . [our] efforts to maintain a safe and sound banking system.”²¹⁰ Had he made the equivalent statement about monetary policy—the Taylor Rule is the cornerstone of our efforts to maintain price stability and maximum sustainable employment—people surely would have taken greater notice.²¹¹

Instead, these policy changes have been largely overlooked.²¹² And supervision has become far less important.²¹³ What was once a banking system predicated on the close substantive oversight of institutions performing critical monetary functions became a system composed of massive conglomerates offering a wide range of financial products and services.

²⁰⁷ Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks at the Stonier Graduate School of Banking: Modern Risk Management and Banking Supervision (June 12, 2006) (transcript available at https://fraser.stlouisfed.org/content/?item_id=8935&filepath=/files/docs/historical/bernanke/bernanke_20060612.pdf) [<https://perma.cc/6DEK-JCX8>] (emphasis in original).

²⁰⁸ *Id.*

²⁰⁹ Bernanke, *supra* note 206.

²¹⁰ *Id.*

²¹¹ See generally John B. Taylor, *Discretion Versus Policy Rules in Practice*, 39 CARNEGIE-ROCHESTER CONF. SERIES ON PUB. POLY 195 (1993) (advocating monetary policy by rule).

²¹² *But see generally* FINANCIAL SUPERVISION IN THE 21ST CENTURY (A. Joanne Kellermann, Jakob de Haan & Femke de Vries eds., 2013) (assessing European supervisors’ practices and methods); Donato Masciandaro & Marc Quintyn, *The Evolution of Financial Supervision: The Continuing Search for the Holy Grail*, in 50 YEARS OF MONEY AND FINANCE: LESSONS AND CHALLENGES 263 (Morten Balling & Ernest Gnan eds., 2013) (comparing supervisory approaches in advanced economies); Eric J. Pan, *Understanding Financial Regulation*, 2012 UTAH L. REV. 1897 (discussing supervision as one of the available banking law tools).

²¹³ During the five years preceding the crisis, for example, the ten biggest recipients of bailout dollars were not subject to a single safety and soundness enforcement action. Nor were firms with over \$50 billion in assets subject to enforcement actions between September 2005 and September 2008.

These new banks, too sprawling to be supervised through traditional methods, were governed instead by formulas designed to facilitate market discipline. Policymakers thought that LCBOs would function most effectively if they were protected from state interference. Unfortunately, they were wrong.

III

DISCRETIONARY OVERSIGHT POST-CRISIS

Following the 2008 crisis, many policy makers repudiated the market-based philosophy that characterized the pre-crisis regulatory regime. Congress and the agencies made significant changes to the broader financial system by reforming the derivatives markets and enhancing consumer protections. But in banking law, post-crisis supervisory policy continues to reflect pre-crisis ideas. Specifically, the dramatic methodological and conceptual changes made during the Deregulatory Era (i.e., the shift from bans to formulas and substantive to procedural oversight) have been left largely undisturbed.

This Part examines post-crisis supervisory policy and considers some of the forces preventing supervisors from preventing returning to Quiet Period methods of substantive oversight. It also examines the development of annual Fed stress testing (which I consider a form of substantive oversight) and some of the potential consequences of watering down these stress tests and reverting to an entirely rules-based regime.

A. Supervisory Policy Post Crisis

Although “market discipline” was largely rejected following the 2008 financial crisis, pre-crisis methods—namely, formulas and procedural oversight—remain, with one exception, the legal tools banking agencies use to oversee financial conglomerates.

1. *The Repudiation of Market Oversight*

In 2011, reflecting on the 2008 financial collapse, Janet Yellen, who succeeded Bernanke as Fed Chair, noted that “our system of regulation and supervision was fatally flawed.”²¹⁴ “The notion,” she explained, “that financial markets should be as free as possible from regulatory fetters . . . evolved into a conviction that those markets could, to a very considerable

²¹⁴ Janet L. Yellen, *Macroprudential Supervision and Monetary Policy in the Post-Crisis World*, 46 BUS. ECON. 3, 4 (2011).

extent, police themselves.”²¹⁵ Bill Dudley, the President of the Federal Reserve Bank of New York, the division of the Fed with day-to-day supervisory responsibility for twelve of the sixteen largest financial institutions in the U.S., resurfaced the traditional wisdom that “[f]inancial firms exist, in part, to benefit the public, not simply their shareholders, employees and corporate clients.”²¹⁶

This thinking is reflected in the development of a new philosophy, known as macroprudential regulation, which has emerged following the crisis. Macroprudential regulation eschews the notion that what is good for shareholders is good for the public at large. Instead, it holds that “actions that may seem desirable or reasonable from the perspective of individual institutions may result in unwelcome system outcomes.”²¹⁷

On this view, RFS, which seeks to promote market discipline, may hasten rather than hinder the onslaught of panic and distress. That is because “multiple individually rational decisions can aggregate into a collectively self-defeating—even calamitous—outcome.”²¹⁸ For example, a bank may seek to tighten its lending standards during a downturn to strengthen its balance sheet. But if all banks tighten their lending standards during a downturn, they will exacerbate the economic contraction, leading to a further deterioration in the value of each bank’s loan portfolio. (The exact opposite can happen during a boom, potentially fueling a credit-induced asset bubble.)

Macroprudential policy has its roots in monetary policy, which seeks to address similar problems affecting inflation and

²¹⁵ *Id.*

²¹⁶ William C. Dudley, President & Chief Exec. Officer, Fed. Reserve Bank of N.Y., Remarks at the Workshop on Reforming Culture and Behavior in the Financial Services Industry: Enhancing Financial Stability by Improving Culture in the Financial Services Industry (Oct. 20, 2014) (transcript available at <https://www.newyorkfed.org/newsevents/speeches/2014/dud141020a.html> [<https://perma.cc/9X2P-6CES>]).

²¹⁷ Andrew Crockett, Gen. Manager of the Bank for Int’l Settlements & Chairman of the Fin. Stability Forum, Bank for Int’l Settlements, Remarks Before the Eleventh International Conference of Banking Supervisors: Marrying the Micro and Macro-Prudential Dimensions of Financial Stability (Sept. 20, 2000) (transcript available at <https://www.bis.org/review/r000922b.pdf> [<https://perma.cc/3AG7-VA3Q>]) (distinguishing in a systematic way for the first time the difference between the two approaches).

²¹⁸ Robert Hockett, *The Macroprudential Turn: From Institutional ‘Safety and Soundness’ to Systematic ‘Financial Stability’ in Financial Supervision*, 9 VA L. & BUS. REV. 201, 207 (2015).

the money supply.²¹⁹ Specifically, when people's choices to spend or save all skew in the same direction, they can lead to vicious cycles of rising prices or crippling deflation. To correct these problems, the Fed routinely adjusts interest rates to lower asset values and tamp down on inflation, or vice-versa. Similarly, effective macroprudential policy requires the government to reduce risk-taking activity by banks in boom times and encourage it in downturns. The soundness of individual institutions, of course, is still important,²²⁰ but market discipline on its own can be quite harmful. Importantly, macroprudential policy requires government officials to make complex discretionary judgments in response to rapidly changing events.

2. *The Persistence of Procedural Oversight*

This philosophical reorientation has only partially infiltrated the level of fundamental methods. Supervisory and regulatory policy, with one critical exception discussed below, still rely on elaborate balance sheet formulas combined with procedural oversight.

a. *Formulas*

Following the 2008 collapse, regulators recognized that the capital rules as written were insufficient to align bank activities with the public interest. Key aspects of safety and soundness judgments had been missing and had not been enforced through substantive oversight. To that end, the agencies promulgated a flurry of new formulas to govern other aspects of bank balance sheets such as the liquidity coverage ratio, a formula requiring banks to hold a certain percentage of liquid assets to cover potential funding shortfalls;²²¹ the net stable

²¹⁹ See Donald Kohn, Robert S. Kerr Senior Fellow in Econ. Studies & External Member of the Fin. Policy Comm. of the Bank of Eng., Brookings Inst., Remarks to the Federal Reserve Board's Boston Conference: Implementing Macroprudential and Monetary Policies; The Case for Two Committees (Oct. 2, 2015) (transcript available at <https://www.brookings.edu/on-the-record/implementing-macroprudential-and-monetary-policies-the-case-for-two-committees>) [<https://perma.cc/87TE-6997>] (discussing the need to create a macroprudential policy committee to parallel to the Fed's monetary policy committee); William. McChesney Martin, Jr., Chairman, Bd. of Governors of the Fed. Reserve Sys., Address Before the New York Group of the Investment Bankers Association of America (Oct. 19, 1955) (transcript available at https://fraser.stlouisfed.org/content/?item_id=7800&file_path=/files/docs/historical/martin/martin55_1019.pdf) [<https://perma.cc/T4HY-6D9B>] (outlining how monetary policy makers exercise discretion in their roles).

²²⁰ See Hockett, *supra* note 218, at 212.

²²¹ Liquidity Coverage Ratio: Liquidity Risk Management Standards, 79 Fed. Reg. 61,440 (Oct. 10, 2014) (to be codified at 12 C.F.R. pt. 249).

funding ratio, a formula requiring banks to maintain a certain minimum percentage of long-term liabilities to reduce the likelihood of runs;²²² and the G-SIB surcharge, a formula requiring larger, more complex firms to fund themselves with additional capital to compensate for the risks their distress poses to financial stability.²²³ These new rules all reflect aspects of safety and soundness that are not aligned with shareholder interests.

Regulators also strengthened and expanded the risk-based capital requirements and implemented an enhanced supplementary leverage ratio. These steps are consistent with the pre-crisis strategy of incentivizing market participants to oversee firms. They also increased loss absorbing capacity, reducing the likelihood of systemic crises.

b. *Procedural Oversight*

Rules remain the primary methods by which the agencies regulate outcomes. And RFS remains the official policy of the Fed and the OCC.²²⁴ Oddly, official Fed reviews of supervisory practice following the crisis did not consider the inconsistencies between the procedural approach, based on market discipline, and the post-crisis consensus that market discipline does not effectively advance monetary stability. As mentioned earlier, the OCC's *Large Bank Supervision: Comptroller's Handbook*, revised as recently as May 2017, still includes the statement that OCC supervisors "do not attempt to restrict risk-taking but rather determine whether banks identify and effectively manage the risks they assume."²²⁵

And, senior agency leaders continue to emphasize their procedural remit. In 2014, Governor Tarullo, one of the primary architects of the post-crisis regulatory regime, described day-to-day supervision of large firms as focused on risk man-

²²² Net Stable Funding Ratio: Liquidity Risk Measurement Standards and Disclosure Requirements, 81 Fed. Reg. 35, 124 (proposed June 1, 2016) (to be codified at 12 C.F.R. pt. 249).

²²³ Regulatory Capital Rules: Implementation of Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies, 80 Fed. Reg. 49, 082 (Aug. 14, 2015) (to be codified at 12 C.F.R. pts. 208 & 217).

²²⁴ BD. OF GOVERNORS OF THE FED. RESERVE SYS., *THE FEDERAL RESERVE SYSTEM: PURPOSES & FUNCTIONS* 63 (9th ed. 2005) ("The goal of the risk-focused supervision process is to identify the greatest risks to a banking organization and assess the ability of the organization's management to identify, measure, monitor, and control these risks."); see also OFFICE OF THE COMPTROLLER OF THE CURRENCY, *supra* note 16 at 2-3.

²²⁵ *Id.* at 3.

agement.²²⁶ Another senior supervisory official described the practice almost exactly as Governor Meyer had over a decade ago: “[s]upervision focuses on monitoring, oversight and enforcing compliance with law, and [setting] supervisory expectations for firms’ governance, internal processes and controls, and financial condition.”²²⁷ The official further noted: “[o]ne of our fundamental responsibilities is to ensure that each institution has in place the appropriate risk identification and risk management processes that are necessary for prudent banking.”²²⁸ Or as a recent Fed compendium argued:

Examiners look at key aspects of a supervised firm’s businesses and risk management functions to assess the adequacy of the firm’s systems and processes for identifying, measuring, monitoring, and controlling the risks the firm is taking. . . . In addition [supervision] evaluates the adequacy of a firm’s capital and liquidity.²²⁹

In other words, supervisors check to see if a bank’s risk management professionals reviewed investments and shared important information with their boards. Although an important part of risk-focused supervision is continuous monitoring, the stated purpose of the monitoring is not to correct excessive risks as soon as possible: it is to “develop and maintain an understanding of the organization, its risk profile, and associated policies and practices.”²³⁰ These are the same process checks that Greenspan and Meyer developed to facilitate market discipline.

Even in addressing the most egregious case of post-crisis “moral hazard,” an episode popularly known as the London Whale, the banking agencies explained the problem in proce-

²²⁶ Daniel K. Tarullo, Member, Bd. of Governors of the Fed. Reserve Sys., Remarks at the Association of American Law Schools Midyear Meeting: Corporate Governance and Prudential Regulation 15 (June 9, 2014) (transcript available at https://fraser.stlouisfed.org/content/?item_id=476716&filepath=/files/docs/historical/federal%20reserve%20history/bog_members_statements/tarullo20140609a.pdf) [<https://perma.cc/MVP8-CJVN>] (“Neither we nor shareholders should be comfortable with a process in which strategic decisions are made in one silo, risk-appetite setting in another, and capital planning in yet a third. . . .”).

²²⁷ Kevin Stiroh, Exec. Vice President, Fed. Reserve Bank of N.Y., Remarks at the SIFMA Internal Auditors Society Education Luncheon: The Theory and Practice of Supervision (Apr. 11, 2016) (transcript available at <https://www.newyorkfed.org/newsevents/speeches/2016/sti160411>) [<https://perma.cc/ENA2-434T>].

²²⁸ *Id.*

²²⁹ See Eisenbach, *supra* note 21, at 60.

²³⁰ BD. OF GOVERNORS OF THE FED. RESERVE SYS., FED. RESERVE, SR 08-9 / CA 08-12, SUPERVISORY LETTER ON CONSOLIDATED SUPERVISION OF BANK HOLDING COMPANIES AND THE COMBINED U.S. OPERATIONS OF FOREIGN BANKING ORGANIZATIONS (Oct. 16, 2008).

dural terms. Although JP Morgan Chase had lost \$6 billion²³¹ on a twelve-figure bet on exotic derivatives in its commercial banking subsidiary,²³² the Fed and OCC faulted JP Morgan merely for failing to adequately supervise their traders,²³³ properly value their investments,²³⁴ “implement adequate controls,”²³⁵ and “ensure significant information . . . was provided in a timely and appropriate manner to the examiners.”²³⁶ Officials made no mention of the excessive risk-taking or other substantive failings by the bank’s employees and executives.

The persistence of RFS is consistent with the Fed’s stated preference for using rules to govern permissible outcomes. As one Fed paper puts it:

The Federal Reserve’s prudential supervisory activities are closely related to its role as a regulator of these firms. . . . The two activities are linked because an important part of prudential supervision is verifying compliance with regulation, although as much of the preceding discussion [describing risk-focused supervision] suggests, the scope of supervision is much broader than compliance alone. . . . In particular, information about industry practice and institutional activities that is gained through prudential supervision can be used in developing regulations governing those activities. Regulation based on in-depth knowledge of industry practice can better achieve desired policy outcomes while reducing unintended consequences. . . . In other words, regulation guides supervisory activities, and supervision in turn pro-

²³¹ To put the loss in perspective, JP Morgan typically makes a profit of around \$5 billion per quarter across its entire business. See, e.g., BD. OF GOVERNORS OF THE FED. RESERVE SYS., CONSOLIDATED FINANCIAL STATEMENTS FOR HOLDING COMPANIES—FR Y-9C: JPMORGAN CHASE & CO. 3 (Jun. 24, 2016) (reporting nearly \$22 billion in annual net income). The Whale losses stand out for occurring in a benign credit market when interest rates were stable and interbank lending conditions were normal.

²³² See Stephanie Ruhle et al., *JPMorgan Trader’s Positions Said to Distort Credit Indexes*, BLOOMBERG NEWS (Apr. 6, 2012, 10:43 AM), <https://www.bloomberg.com/news/articles/2012-04-05/jpmorgan-trader-iksil-s-heft-is-said-to-distort-credit-indexes> [<https://perma.cc/84YP-ZWRF>].

²³³ Order of Assessment of a Civil Money Penalty Issued Upon Consent Pursuant to the Federal Deposit Insurance Act, as Amended 4, JPMorgan Chase & Co., No. 13-031-CMP-HC (Sept. 18, 2013) (“JPMC exercised inadequate oversight . . .”) [hereinafter Federal Reserve Board Order]; Consent Order for a Civil Money Penalty 3, JP Morgan Chase Bank, N.A., No. AA-EC-2013-75 (Sept. 18 2013) (“The Bank’s oversight and governance . . . were inadequate . . .”) [hereinafter OCC Order].

²³⁴ OCC Order, *supra* note 233, at 3 (“The Bank’s valuation control processes and procedures . . . were insufficient to provide a rigorous and effective assessment of valuation”).

²³⁵ Federal Reserve Board Order, *supra* note 233, at 4 (“JPMC . . . failed to implement adequate controls . . .”).

²³⁶ *Id.* at 4.

vides information that allows the Federal Reserve to develop and maintain regulations that more effectively address its public policy objectives.²³⁷

On this view, rule-writing is used to influence outcomes and supervision to check whether the rules are being followed and achieving their goals.

3. *Stress Testing as Substantive Oversight*

At the same time, the Fed has implicitly acknowledged that the formula-based system of procedural oversight is, on its own, insufficient. As Tarullo put it, though “fostering sound risk-management practices serves the overlapping interests of both shareholders and regulators,” the “divergence of interests comes not in the architecture of risk management but in substantive decisions on risk appetite.”²³⁸ Therefore, he argues that “prudential regulation [must] influence the processes of risk-taking within regulated financial firms as a complementary tool to capital requirements and other substantive measures.”²³⁹ The Fed has taken some steps to revive targeted substantive oversight along these lines.

a. *CCAR*

The most significant change in the post-crisis approach to overseeing the banking system has been the Fed’s use of stress testing, particularly through a program it calls the Comprehensive Capital Analysis and Review (CCAR). Stress testing is a forward-looking, risk-mitigation exercise that uses a hypothetical macroeconomic path for the next six to eight quarters, historical data, and regression analysis to forecast capital and liquidity outcomes for individual institutions under adverse conditions.²⁴⁰ Supervisors independently project values for each line of a bank’s business, calculate the bank’s hypothetical future interest income and fee income, its noninterest expense and charge-off rates. In cases where historical data is potentially unreliable or features limited variation, supervisors may manually impose shocks to mimic past crises in other asset classes. All these variables are then added together to paint a holistic picture of a bank’s financial health.²⁴¹

²³⁷ Eisenbach et al., *supra* note 21, at 60.

²³⁸ Tarullo, *supra* note 227, at 10.

²³⁹ *Id.* at 9–10.

²⁴⁰ See FIN. STABILITY OVERSIGHT COUNCIL, 2011 ANNUAL REPORT 134 (2011).

²⁴¹ See BEVERLY HIRTLE ET AL., FED. RESERVE BANK OF N.Y., STAFF REPORT NO. 663, ASSESSING FINANCIAL STABILITY: THE CAPITAL AND LOSS ASSESSMENT UNDER STRESS SCENARIOS (CLASS) MODEL (rev. 2015).

The Fed pioneered stress testing during the crisis,²⁴² and the Dodd-Frank Act required the Fed to continue these stress tests for large institutions going forward.²⁴³ Drawing on safety and soundness authority and the ISLA, the Fed then developed CCAR, a more stringent regime used to determine whether to allow large banks to pay dividends to shareholders or conduct share repurchases.²⁴⁴ Over the last several years, many banks have been forced to reduce their payouts and alter their business strategies to comply with these new supervisory requirements.²⁴⁵

Consistent with the turn toward macroprudential policy described above, CCAR allows policy makers to increase the severity of stressed scenarios and limit the ability of banks to raise their leverage in periods of expansion. CCAR also serves microprudential goals, and in those respects, it closely resembles Quiet Period oversight. For example, it helps to address regulatory arbitrage and controls for uncertainty by allowing supervisors to incorporate new scenarios not originally envisioned when the rules were written.

b. *CCAR as a Rule*

CCAR is designed to be a discretionary exercise, with the power to, as former Chairman William McChesney Martin put it, take away the punch bowl “just when the party [is] really warming up.”²⁴⁶ Unsurprisingly, banks have resisted CCAR, and some members of Congress are pushing the Fed to eliminate it entirely.²⁴⁷ Those who are proposing less radical steps are targeting the very aspects of the exercise that are discretionary. They argue that the Fed should be forced to publish its

²⁴² See FIN. STABILITY OVERSIGHT COUNCIL, *supra* note 240, at 134–35 (characterizing stress testing as a forward-looking risk mitigation tool).

²⁴³ See 12 U.S.C. § 5365(a)(1) (2012).

²⁴⁴ See 12 C.F.R. § 225.8 (2015) (although the Fed does not specify the statutory authority for this specific provision of Regulation Y, known as the “capital planning” rule, any plausible reading of the statutes that the Fed does specify as providing their authority for promulgating Part 225 overall, such as 12 C.F.R. § 225.1 (2015) (“Authority, purpose, and scope”), indicates that § 225.8 is promulgated pursuant to 12 U.S.C. § 1818 and 12 U.S.C. § 3907, the latter section having been enacted by the ILSA to buttress capital actions under § 1818.

²⁴⁵ Barney Jopson & Alistair Gray, *Deutsche Bank and Santander Fail Fed Stress Tests Again*, FIN. TIMES (June 29, 2016), <https://www.ft.com/content/9a018afe-3e37-11e6-9f2c-36b487ebd80a> [<https://perma.cc/HC2T-HFDG>].

²⁴⁶ Martin, Jr. *supra* note 219, at 12.

²⁴⁷ See Elizabeth Dexheimer & Jesse Hamilton, *Yellen Urged to Abolish Stress Tests as GOP Pursues Banks’ Wish List*, BLOOMBERG NEWS, (Feb. 10, 2017, 9:58 AM), <https://www.bloomberg.com/news/articles/2017-02-10/yellen-urged-to-nix-stress-tests-as-gop-pursues-banks-wish-list> [<https://perma.cc/4LL6-XTCA>].

scenarios in advance for notice and comment and to publish the supervisory models that anchor the exercise. The Treasury Department endorsed these recommendations and also recommended that the Fed drastically downsize the exercise.²⁴⁸

The current administration envisions stress tests that are essentially additions to the Basel III risk-based capital rules: another form of asset weighting that determines *ex ante* how much equity financing a firm must use in its business. But this would eliminate the benefits of substantive oversight that the current program provides. There is no reason to think that macroprudential policy can be conducted in concert with the industry, just as there is no reason to think that monetary policy can be conducted by publishing proposals to raise the Federal funds rate for notice and comment.

Indeed, the Treasury Department's rationale for objecting to CCAR threatens to eliminate all substantive oversight. As the Treasury explains,

Subjective assumptions built into the Federal Reserve's CCAR models have resulted in an improperly calibrated stress test, which risks skewing capital requirements and bank activity away from what market-based decisions would otherwise dictate and in favor of activity favored by regulators resulting in excess capital retained by banks, which reduces lending capacity.²⁴⁹

The Treasury's current thinking is a version of Greenspan's market oversight philosophy. Part of Treasury's concern may derive from the fact that today's financial conglomerates are engaging in nonmonetary activities for which there may be serious policy reasons to question a broad government role. But rolling back CCAR to reduce the government's influence over the nonmonetary activities of systematically important financial institutions (SIFIs) also means that the government is unable to exercise discretion over the monetary aspects of these banks' activities, those which are backstopped by the government's full faith and credit.

It is worth briefly noting that efforts to constrain post-crisis agency discretion are not limited to the CCAR program. Other reforms that introduced substantive oversight have faced sig-

²⁴⁸ U.S. DEPT OF THE TREASURY, A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES: BANKS AND CREDIT UNIONS 53 (2017) (recommending that "the Federal Reserve subject its stress-testing and capital planning review frameworks to public notice and comment, including with respect to its models, economic scenarios, and other material parameters and methodologies").

²⁴⁹ *Id.*

nificant industry opposition. For example, the Treasury Department has also recommended that the Consumer Financial Protection Bureau (CFPB) scale back its use of its discretionary authority to prohibit “unfair, deceptive, or abusive acts or practices.”²⁵⁰ The industry has targeted the Financial Stability Oversight Council’s (FSOC) non-bank designations process in an effort to prevent the government from using its discretion to expand oversight to systemically important firms.²⁵¹ The OCC is facing criticism for raising its CAMELS ratings following the crisis, and both the Fed and the OCC are under pressure to reduce their oversight of senior bank managers and directors.²⁵² Given the political and legal pressures that SIFIs exert on government actors, are today’s conglomerates simply too big and complex to supervise?

B. Practical Constraints on Supervising SIFIs

Substantive oversight is difficult—it requires technical expertise and institutional independence. The dual role of SIFIs as monetary institutions and full service financial intermediaries makes substantive oversight more difficult; it demands expertise in areas that are technically complex, and it is more politically challenging for the agencies to justify intensive government oversight of financial activity that is not closely related to basic government monetary objectives. By contrast, rules offer benefits; they clarify permissible outcomes in advance, thereby reducing costs to industry and easing enforcement.

The socially optimal mix of tools, then, is not necessarily the same as the optimal mix of tools from the perspective of the bankers, legislators, and regulators involved in formulating a legal regime. There are at least four reasons why supervisors of

²⁵⁰ *Id.* at 81.

²⁵¹ For example, the industry has challenged the FSOC’s exercise of its authority to designate non-bank financial institutions for enhanced prudential supervision by the Federal Reserve. *See e.g.*, *MetLife, Inc. v. Fin. Stability Oversight Council*, 177 F. Supp. 3d 219, 242 (D.D.C. 2016) (finding “fundamental violations of established administrative law”); *see also* *PHH Corp. v. CFPB*, 839 F.3d 1, 8 (D.C. Cir. 2016) (seeking to strike down a Dodd-Frank provision that provided that the President could only remove the CFPB’s director for cause).

²⁵² *See Examination of the Federal Financial Regulatory System and Opportunities for Reform Before the Subcomm. on Fin. Insts. & Consumer Credit of the H. Comm. on Fin. Servs.*, 115th Cong. (2017) (testimony of Greg Baer, President, The Clearing House Association) (transcript available at <https://financialservices.house.gov/uploadedfiles/hrg-115-ba15-wstate-gbaer-20170406.pdf> [<https://perma.cc/2D2D-JB5Y>]) (suggesting CCAR, CAMELS ratings, and board engagement are deleterious).

banks might *choose* to focus on compliance instead of outcomes.

The first is ideological—some policymakers oppose discretionary action because they subscribe to a certain political philosophy concerning the proper relationship between private business and the state. Under this view, call it *rule absolutism*, regulators should be permitted to write rules to advance safety and soundness, but bankers should be allowed, indeed encouraged, to take whatever steps they see fit to maximize their profits as long as they comply with the rules. The problem with discretionary oversight, then, is not its goals but its methods. By making law at the point of application it jeopardizes first-order liberty interests.

The absolutist view has a certain appeal: it preserves a sense of fairness and non-arbitrariness, reduces the power of government officials, and minimizes chilling effects. It is particularly attractive with respect to the nonmonetary financial activities of SIFIs. The theoretical case for having these functions disciplined by the market is far stronger than the case for having monetary functions governed in that manner. Yet because the two are combined and the former is subsidized by the central bank, it is impossible to oversee them separately. On the other hand, a rules-only regime for monetary institutions can be quite costly if the rules are poorly crafted or banks seek to evade them. For absolutists, the only acceptable response to this problem is for the government to write better rules. The burden, in other words, is on the state to get the rules right, not on the market to infer the state's purposes.

The second reason is practical—supervisors may believe that it is simply too technically challenging to assess the permissibility of certain private activity. Again, this is a problem with respect to the nonmonetary activities of financial conglomerates. For example, LCBOs have hundreds of thousands of employees in dozens of countries. They buy and sell bespoke financial instruments in opaque markets. Accordingly, the costs of discretionary oversight may outweigh its benefits. Agencies may pursue procedural oversight because it is more tractable. Assuming the same technical difficulties apply to rule writing, adherents to this view may be fatalists, believing, for example, that banks will inevitably extract public wealth and impose costs on others. They may also be structural reformers, advocating for reduced complexity and new activities restrictions.

The third reason is professional. Many regulatory agencies are run by lawyers and administrators. Unlike financiers, who are well-equipped to think about risk-taking and risk management, lawyers are trained to think about controls and compliance. It is much easier for lawyers to police processes, than it is for them to assess the extent of a bank's financial exposures.²⁵³

The fourth reason is political.²⁵⁴ Substantive oversight is contentious. Procedural oversight, like rules, generally does not require deciding fundamental, value-laden issues over and over. Regulators, bankers, and the public may agree on the value of the process, despite disagreeing on the desirability and acceptability of various outcomes. It is likely to be far less difficult to fault a bank for failing to conduct a timely audit of its books, or failing to inform the board about significant high-risk ventures, than to analyze a set of trades and force the bank to divest them.²⁵⁵ This is particularly problematic in the case of nonmonetary activities, which are much harder for the government to assess and which have not historically been subject to the same sort of government oversight and control.

Because substantive oversight constrains profitable outcomes, it can create conflict over the distinction between permissible and impermissible activities, and lead to lawsuits. Banks may mount a political campaign against their supervisors, and agencies are vulnerable to punishment by Congress through hearings, funding cuts, and the appointment of new political leadership. The individuals who bring enforcement actions may face professional consequences for challenging powerful industry interests, and senior Washington officials may balk at the exercise of discretion by regional Reserve Banks and local OCC offices.

Richard Spillenkothén, who was the senior supervisory official at the Fed during the Deregulatory Era, noted that part of the reason for RFS was that it "was less confrontational."²⁵⁶

²⁵³ I am indebted to Professor Macey for drawing my attention to this dynamic.

²⁵⁴ See John C. Coffee, Jr., *The Political Economy of Dodd-Frank: Why Financial Reform Tends to be Frustrated and Systemic Risk Perpetuated*, 97 CORNELL L. REV. 1019, 1022 (2012).

²⁵⁵ See Dan M. Kahan, *The Secret Ambition of Deterrence*, 113 HARV. L. REV. 413, 416 (1999) (arguing that citizens defend their positions in deterrence terms not because these arguments have an impact on their policy choices but because the alternative rhetoric is a highly contentious expressive idiom, which social norms, strategic calculation, and liberal morality all condemn).

²⁵⁶ RICHARD SPILLENKOTHEN, NOTES ON THE PERFORMANCE OF PRUDENTIAL SUPERVISION IN THE YEARS PRECEDING THE FINANCIAL CRISIS BY A FORMER DIRECTOR OF BANKING SUPERVISION AND REGULATION AT THE FEDERAL RESERVE BOARD 24 (2010) <http://fcic->

There was “a desire,” he explained, “not to inject an element of contentiousness into what was felt to be a constructive or equitable relationship with management.”²⁵⁷ Thus, even if supervisors have the necessary technical expertise and believe that rules are not sufficient to ensure safe banking, they may shy away from incurring these costs.²⁵⁸

One reason substantive oversight of LCBOs has reappeared in the form of CCAR is that CCAR shields agencies from some of these pressures. For example, CCAR is centralized in Washington, with Fed Governors making the major decisions; it uses econometric models and draws on the expertise of dozens of Ph.D. economists; it assesses all the major firms simultaneously, creating winners at the same time as it creates losers; it publicly releases the results; it relies upon the authority of the central bank qua central bank; and it has its roots in a widely-lauded crisis-response mechanism that is credited with mitigating the financial panic in 2008.

Outside of CCAR, we might expect supervisors, facing political, professional, and legal risks from the exercise of discretion, to be drawn to the bureaucratic safe harbor offered by procedural interpretations of safety and soundness and the inarguable clarity of bright-line rules. Proceduralism, after all, reduces conflict between supervisors in the field and senior officials in Washington, as well as with bank executives, Congressional representatives opposed to supervisory discretion, and agency lawyers, who themselves prefer the certainty of rules.

C. Consequences of a Rules-Only Regime

As memory of the crisis recedes and political winds shift, we might expect these pressures and drivers of proceduralism to increase further. This could be cause for concern as Martin, Yellen, Dudley, and others have suggested that we need macroprudential discretion to properly oversee monetary affairs. A system without discretion is incompatible with the

static.law.stanford.edu/cdn_media/fcic-docs/2010-05-31%20FRB%20Richard%20Spillenkothen%20Paper-%20Observations%20on%20the%20Performance%20of%20Prudential%20Supervision.pdf [https://perma.cc/7J4F-Q8RE].

²⁵⁷ *Id.*

²⁵⁸ Some literature suggests that these costs may be insurmountable, depending on the size and political power of the industry. See generally Gary S. Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 98 Q.J. ECON. 371 (1983); Jonathan R. Macey, *The Political Science of Regulating Bank Risk*, 49 OHIO ST. L.J. 1277 (1989); Saule T. Omarova, *Bankers, Bureaucrats, and Guardians: Toward Tripartism in Financial Services Regulation*, 37 J. CORP. L. 621 (2012).

government backstop provided to banks as monetary institutions. Without substantive oversight, we might expect to see, for example:

1. **More Regulatory Arbitrage.** The existence of deposit insurance and liquidity insurance incentivizes bankers to defeat rules. With access to nonmonetary financial instruments such as high-risk securities and derivatives, it is almost trivially easy for firms to design ways to outsmart static rules. Rules cannot possibly be written to cover the wide range of risks SIFIs can engage in.
2. **Staleness.** Rules can only be written in advance. The attempt to hard code differences between assets and liabilities on a bank's balance sheet is unlikely to account for changes in markets and economic conditions.
3. **Cultural Deterioration.** A rules-based regime, in which regulated actors do not expect substantive oversight may, perversely, incentivize greater risk-taking and loop-holing behavior, leading to decreased compliance and increased misconduct.²⁵⁹
4. **Depleted Regulatory Morale.** The absence of substantive oversight may drain meaning from the underlying norms and lead to confusion about the purpose of the legal regime, reducing compliance with the rules.²⁶⁰
5. **Increased Inefficiency.** In the absence of substantive oversight, excessive proceduralism may encourage wasteful process-development by banks to satisfy supervisors.
6. **Less Macroprudential Discretion.** Macroprudential efforts will be hampered if supervisors are not able to use CCAR and other tools to restrict lending during expansionary periods.

²⁵⁹ See FIN. STABILITY B., STOCKTAKE OF EFFORTS TO STRENGTHEN GOVERNANCE FRAMEWORKS TO MITIGATE MISCONDUCT RISKS 60 (2017); Tom R. Tyler & Steven L. Blader, *Can Businesses Effectively Regulate Employee Conduct? The Antecedents of Rule Following in Work Settings*, 48 ACAD. MGMT. J. 1143, 1144 (2005).

²⁶⁰ "Regulatory morale" is a term I am drawing from the tax literature, which discusses a concept called "tax morale." See generally Ronald G. Cummings et al., *Tax Morale Affects Tax Compliance: Evidence from Surveys and an Artefactual Field Experiment*, 70 J. ECON. BEHAVIOR & ORG. 447 (2009); Erzo F.P. Luttmer & Monica Singhal, *Tax Morale*, 28 J. ECON. PERSP. 149 (2014); see also TOM R. TYLER, *WHY PEOPLE OBEY THE LAW* (1990) (arguing that the perceived legitimacy of the legal regime drives compliance with it).

Thus, some degree of discretion is likely needed to maintain a stable and resilient monetary system. But substantive oversight may only be feasible if banks are focused on banking; that is, if they are focused on issuing money-like instruments, facilitating payments, investing in sovereign debt obligations, and originating high-quality credit assets. Although Greenspan was wrong about the ability of the market to regulate LCBOs, he may have been right about the inability of the government to supervise them, effectively and consistently over time, in the face of technical complexity, political pressure, and other practical constraints.

CONCLUSION

Banking law has always featured both rules and standards. By distinguishing between two ways of writing rules and two ways of enforcing standards, this Article reveals how a group of policymakers fundamentally transformed banking law in the 1980s and 1990s. These officials allowed specialized monetary institutions to grow into diversified financial conglomerates by removing bans and developing a new supervisory policy, which relied on *ex ante* risk-based capital rules to facilitate market discipline. They all but eliminated discretionary oversight. After the crisis, policymakers repudiated the market-based approach, but largely retained the market-based methods. Today, banking law exhibits a mix of pre-crisis formulas, procedural oversight, and stress testing, although this discretionary exercise is under sustained assault. Given the critical monetary functions banks perform in our economy, and the problems with relying entirely on rules and on the market to oversee those functions, we must reconsider the sustainability of our current legal strategies. We should focus on the ways in which the current regime unsustainably and inappropriately combines the oversight of monetary institutions with the oversight of unrelated financial activity. Ultimately, we need a monetary architecture that is properly supervised—after all, monetary functions have long been the responsibility of the state and are still backstopped by its full faith and credit.