

# FDICIA V. DODD-FRANK: UNLEARNED LESSONS ABOUT REGULATORY FORBEARANCE

JONATHAN M. EDWARDS\*

*Regulatory forbearance was widely blamed for increasing losses to deposit insurance funds in the 1980s. As part of the legislative response, Congress created a system of Prompt Corrective Action and expanded the grounds for appointing the FDIC receiver of a bank—changes partially intended to limit regulators’ ability to forbear. The recent financial crisis similarly evidenced regulatory forbearance, but Congress did not have the same determination to limit regulatory forbearance. As an afterthought, Congress created a system of early intervention called Early Remediation for systemically important financial companies. Instead of developing a comprehensive system like it did for Prompt Corrective Action, Congress requires the Federal Reserve to create the Early Remediation system. The Federal Reserve is now empowered to create a system that is completely discretionary and relies on the same regulatory judgment that failed in the recent crisis. A system of subjective early intervention is no different from regulators’ safety and soundness authority and will not limit regulatory forbearance or prevent its catastrophic consequences. In a similar vein, Congress created a system of orderly liquidation for systemically important financial companies that uses a closure rule that is prone to regulatory forbearance. Without a congressional limit on regulatory forbearance, we are reliant on market discipline to check regulatory forbearance even though it can cause the same systemic consequences that the Dodd-Frank Act failed to address. We can only hope that, in order to prevent another financial crisis, the regulators who are implementing the Federal Reserve-created Early Remediation system are conscious of the consequences of their inaction.*

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## I. INTRODUCTION

“*[T]he tension between rules and discretion in bank regulation may reappear in some future period of widespread banking problems.*”<sup>1</sup>

Economic crises historically cause sweeping legislative reforms to financial institution regulation. In response to banking crises, the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) were both, in part, passed to improve the systems that deal with failing institutions. The Dodd-Frank Act created an early intervention system—Early Remediation (ironically, the acronym ER)<sup>2</sup>—and a new liquidation regime—Orderly Liquidation Authority (OLA)<sup>3</sup>—for systemically important financial companies. FDICIA similarly created a bank early intervention system known as Prompt Corrective Action (PCA)<sup>4</sup> and expanded the grounds that regulators can use to appoint the Federal Deposit Insurance Corporation (FDIC) receiver of a bank.<sup>5</sup>

These systems are functionally similar, but, in certain ways, the Dodd-Frank Act takes a fundamentally different approach from FDICIA. Whereas FDICIA takes an anti-regulator approach by creating a detailed system of Prompt Corrective Action to limit regulator discretion,<sup>6</sup> the Dodd-Frank Act empowers the Federal Reserve (Fed), with quite unlimited discretion, to create the system of Early Remediation. This is important because the breadth of discretion correlates with the likelihood that regulators will forbear from taking action. Giving the Fed such broad power to exercise discretion is a troubling development because PCA was created to limit regulatory forbearance—the discretionary practice of not applying an existing rule that is applicable to a regulated entity. This raises questions of whether regulatory forbearance is a cause for concern for systemically important financial companies and whether the Dodd-Frank Act sufficiently limits regulators’ ability to forbear.

To answer these questions, this Note uses the costly lessons from the 1980s and FDICIA as a baseline to critique the Dodd-Frank Act. Part I of this Note provides an overview of regulatory forbearance in the 1980s. Part II discusses FDICIA’s effect on limiting regulatory forbearance. Part III de-

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<sup>1</sup> Federal Deposit Insurance Corporation, *History of the Eighties—Lessons for the Future*, Volume I: An Examination of the Banking Crises of the 1980s and Early 1990s 83 (1997), <http://www.fdic.gov/bank/historical/history/index.html> [hereinafter FDIC].

<sup>2</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, § 166(a), 124 Stat. 1376, 1432 (2010) (Dodd-Frank Act).

<sup>3</sup> *Id.* at Title II.

<sup>4</sup> Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102–242, sec. 131, § 38, 105 Stat. 2236 (amending the Federal Deposit Insurance Act) (FDICIA).

<sup>5</sup> *Id.* § 133.

<sup>6</sup> Thomas Vartanian et al., *Living With FDICIA*, Practising Law Institute Litigation and Administrative Practice Course Handbook Series, PLI Order No. H4–5181, 283 (1993).

scribes the Dodd-Frank Act's ER system and the FDIC appointment requirements for OLA, compares them to FDICIA's approach, and discusses implications for regulatory forbearance. Part IV argues that regulatory forbearance is a cause for concern for systemically important financial companies, and that the Dodd-Frank Act fatally relies on regulators and market discipline to check regulatory forbearance. The Note concludes that, as a result, the U.S. financial system is more prone to the contagious consequences caused by a run by money market creditors.

## II. REGULATORY FORBEARANCE IN THE 1980S

Like many other legislative responses, FDICIA was passed after an economic crisis to correct perceived deficiencies in the banking system. One deficiency in the banking system was the use and abuse of regulatory forbearance. Thrift and bank regulators were blamed for increasing losses to the deposit insurance funds by failing to take timely corrective action and close insolvent banks.<sup>7</sup>

Regulatory forbearance came in many forms in the 1980s. Regulators engaged in *case-by-case forbearance*, which occurs when regulators permit an institution to "operate without meeting established safety and soundness standards for a limited period of time while taking remedial actions to reduce risk exposure and correct other weaknesses."<sup>8</sup> For instance, bank regulators often postponed appointing the FDIC receiver of an insolvent bank so that the bank could attempt to raise capital.<sup>9</sup> Proponents of regulatory forbearance argue that case-by-case forbearance is an essential tool of bank supervision.<sup>10</sup>

On the other hand, *wholesale forbearance* occurs when a large number of institutions are affected by regulatory forbearance.<sup>11</sup> Leading up to the thrift crisis, regulators engaged in wholesale forbearance by implementing a general policy of allowing a large number of thrifts to operate while insolvent or nearly-insolvent for many years.<sup>12</sup> Thrift regulators mainly did so by manipulating regulatory accounting principles (RAP) and using other gimmicks to create an illusion that thrifts were solvent<sup>13</sup>—for example, decreasing net worth requirements from 5% to 3%, allowing amortization of asset

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<sup>7</sup> FDIC, *supra* note 1, at 47.

<sup>8</sup> *Id.* at 46.

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> *Id.* at 46–47.

<sup>12</sup> *Id.* at 47; *see also* The Cost of Forbearance During the Thrift Crisis, Congressional Budget Office Staff Memorandum 2 (1991), [http://www.cbo.gov/ftpdocs/99xx/doc9927/1991\\_06\\_thecostofforbearance.pdf](http://www.cbo.gov/ftpdocs/99xx/doc9927/1991_06_thecostofforbearance.pdf) (last visited Feb. 6, 2011) ("Regulators did not violate statutes; rather, in altering agency regulations they interpreted those statutes in the most liberal way possible, thereby allowing themselves to avoid closing insolvent institutions.") [hereinafter CBO].

<sup>13</sup> FDIC, *supra* note 1, 172–77.

losses instead of requiring immediate recognition, and reclassifying short-term liabilities as contra-asset accounts.<sup>14</sup> By manipulating the calculation of thrifts' net worths, regulators were able to postpone closing many market-value insolvent thrifts.<sup>15</sup> As a result, thrift regulators' wholesale forbearance policies are "widely judged to have increased the cost of thrift failures"<sup>16</sup> by an estimated \$66 billion.<sup>17</sup>

*Class of bank forbearance* was the other form of forbearance used in the 1980s.<sup>18</sup> These forbearance policies, generally aimed to allow a certain class of banks to survive a particular economic crisis, were "temporary in nature" and in response "to cyclical economic forces."<sup>19</sup> The FDIC speaks favorably about bank regulators' implementation of these programs, noting that 201 out of 301 banks from the Temporary Capital Forbearance Program were operating independently one year after leaving the program and that the asset loss rates were similar to non-participants that failed during a comparable period.<sup>20</sup>

There are many advocates of regulatory forbearance who believe that these types of forbearance policies are good when coupled with effective supervision and risk constraints.<sup>21</sup> Some of the biggest advocates of forbearance are bank regulators who believe that, by forbearing from imposing a closure rule while taking corrective actions, they can correct a bank's deficiencies, return the bank to solvency, and thus eliminate losses to the deposit insurance fund. The FDIC stated that:

The simple fact is that most FDIC-insured depository institutions identified as posing a definite threat of loss to the insurance fund are successfully restored to a safe-and-sound operating condition and do not ultimately fail. Effective supervision, including the use of discretionary supervisory forbearance, has proven to be a very

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<sup>14</sup> *Id.*

<sup>15</sup> It should also be noted that Congress is partly to blame for regulatory forbearance in the 1980s. Congress gave FSLIC inadequate financial and human resources needed to resolve insolvent thrifts and resisted regulator proposed reforms to correct FSLIC's budget and insolvency problems. EDWARD J. KANE, *THE S & L INSURANCE MESS: HOW DID IT HAPPEN* 97-98 (1989). Congressional leaders also exerted immense pressure on regulators to forbear and in certain cases passed laws mandating forbearance. *Id.* at 97.

<sup>16</sup> FDIC, *supra* note 1, at 47.

<sup>17</sup> CBO, *supra* note 12, at 1.

<sup>18</sup> FDIC, *supra* note 1, at 47.

<sup>19</sup> *Id.* at 47-49. For instance, the Net Worth Capital Program was created in response to high interest rates, and the Temporary Capital Forbearance Program was created to allow troubled banks that served the agricultural and energy sectors to survive "economic factors beyond their control." *Id.*

<sup>20</sup> *Id.* at 49.

<sup>21</sup> Robert A. Eisenbeis & Paul M. Horvitz, *The Role of Forbearance and its Costs in Handling Troubled and Failed Depository Institutions*, in *REFORMING FINANCIAL INSTITUTIONS AND MARKETS IN THE UNITED STATES: TOWARDS REBUILDING A SAFE AND MORE EFFICIENT SYSTEM* 60-61 (1994).

cost-effective loss prevention mechanism for the deposit insurance fund.<sup>22</sup>

When a forbearance policy is successful for a particular bank, forbearance is cost-effective in that instance because the bank did not fail, and therefore the FDIC did not incur any losses. However, many banks do fail and a forbearance policy can increase the aggregate costs of failure.<sup>23</sup> To implement a cost-effective forbearance policy, regulators must be able to “distinguish between institutions that will recover after a period of forbearance and those that will not recover and should therefore not be granted forbearance.”<sup>24</sup> The FDIC acknowledges this, but believes “regulators have the benefit of information derived from examination reports,”<sup>25</sup> making regulator predictions more accurate. On the other hand, several scholars conclude that regulators were unsuccessful at picking winners and losers<sup>26</sup> and that forbearance increases costs to the deposit insurance fund.<sup>27</sup> Similarly, even if one particular forbearance policy is cost-effective, not all forbearance policies are. To claim cost-effectiveness, forbearance programs need to net positive in the aggregate.

Others justify forbearance on the grounds that deregulation and improving economic conditions need time to take effect and correct industry-wide insolvencies. In the case of thrifts, the forbearance policies “grew out of the recognition that the combined effects of economic recovery, lower interest rates, and statutory deregulation would take some time to affect the financial health of the thrifts. Thus, it was argued, regulators should not necessarily close troubled thrifts as quickly as strict accounting measures of solvency would indicate.”<sup>28</sup> However, the ability to predict that deregulation and economic conditions will correct industry-wide insolvencies requires foresight and financial modeling that is beyond our government’s capabilities. The complexity of the financial system and uncontrollable economic forces render this regulatory forbearance rationalization unjustifiable.

Regulators also forbear because they fear that a bank is “too big to fail” and placing the bank into receivership would result in systemic consequences that will harm the macroeconomic stability of the country.<sup>29</sup> Proponents also point to the fact that placing a bank into receivership destroys asset and franchise value, and results in excessive costs.<sup>30</sup> Specifically, studies conclude that the direct costs of receivership average 10% of the bank’s

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<sup>22</sup> *Id.* at 60 (citing Federal Deposit Insurance Corporation, *Deposit Insurance For the Nineties: Meeting the Challenge* 162 (1989)).

<sup>23</sup> Eisenbeis & Horvitz, *supra* note 21, at 61–64.

<sup>24</sup> FDIC, *supra* note 1, at 49–50.

<sup>25</sup> *Id.* at 50.

<sup>26</sup> *Id.*

<sup>27</sup> Eisenbeis & Horvitz, *supra* note 21, at 61–64.

<sup>28</sup> CBO, *supra* note 12, at 2.

<sup>29</sup> Eisenbeis & Horvitz, *supra* note 21, at 52.

<sup>30</sup> *Id.*

assets<sup>31</sup> and there is typically a loss of more than 20% of the bank's assets in liquidation.<sup>32</sup> Additionally, some believe that forbearance is justified when management and not the FDIC is better able to manage certain bank assets, which may result in greater asset values and hence lower costs for the FDIC.<sup>33</sup>

Although regulatory forbearance may have some benefits, forbearance imposes costs on the financial system and increases moral hazard.<sup>34</sup> When an insured depository institution is insolvent or near insolvent, the bank is incentivized to “gamble for resurrection” by taking greater risks.<sup>35</sup> The bank receives all of the upside if successful, but if unsuccessful, the losses are borne by the deposit insurance fund and ultimately the taxpayer.<sup>36</sup> Safety and soundness regulation and supervision are intended to offset this moral hazard problem. When regulators forbear from using these measures, however, banks are given free rein to capitalize on excessive risk-taking.

Regulatory forbearance is also criticized because it results from perverse regulator incentives—incentives to take action contrary to the benefit of the deposit insurance fund. As Carnell identified:

[s]tringency risks immediate criticism—and perhaps even blame for causing the problem regulators seek to resolve. Forbearance is inconspicuous and defers unpleasant consequences, and is therefore less likely to draw criticism. Thus forbearance, although against the interests of the deposit insurance fund, may be in the regulators' self-interest.<sup>37</sup>

Professor Kane describes these incentives in terms of reputation and career costs that are a form of implicit wages.<sup>38</sup> He reasons that “completing a term of successful service in a top government post enhances an individual's résumé and professional reputation, which permits an undisgraced official to command a higher wage in post government employment.”<sup>39</sup> As a result, regulators may choose to hide regulatory failures or avoid public criticism and disgrace in order to reap post-government benefits.<sup>40</sup>

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<sup>31</sup> *Id.*

<sup>32</sup> *Id.* at 63.

<sup>33</sup> *Id.* at 52.

<sup>34</sup> *Id.* at 51.

<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

<sup>37</sup> Richard S. Carnell, *A Partial Antidote To Perverse Incentives: The FDIC Improvement Act of 1991*, ANN. REV. BANKING L. 322 (1993).

<sup>38</sup> KANE, *supra* note 15, at 102.

<sup>39</sup> *Id.*

<sup>40</sup> *Id.*

## III. FDICIA'S ATTEMPT TO REDUCE REGULATORY FORBEARANCE

Congress passed FDICIA to improve the system for appointing the FDIC receiver of a failed bank and to create a system of Prompt Corrective Action. Banks have been subject to FDIC receivership since 1933, and, as part of the legislative reforms, FDICIA changed the mechanisms that trigger receivership. In the 1980s, banking regulators were limited to taking over a bank in the narrow circumstances of regulator-defined insolvency.<sup>41</sup> In certain situations, this limited standard made it impossible for regulators to close a bank because the standard was too restrictive—both because regulations were too confined and because legislation did not grant broader take-over authority.

FDICIA expanded regulators' takeover powers to include thirteen independent grounds for receivership.<sup>42</sup> These grounds for receivership can be loosely categorized as (1) insufficient capital; (2) insolvency; and (3) violation of laws or regulations. Additionally, PCA requires the primary federal regulator to appoint the FDIC receiver within ninety days after the bank becomes critically undercapitalized, or to take an alternative action (with the concurrence of the FDIC) that the regulator determines would better achieve the purpose of PCA.<sup>43</sup> Because FDIC concurrence is required for the regulator to take an alternative action, the FDIC functionally has veto power over a decision not to appoint the FDIC receiver of a critically undercapitalized bank.

With FDICIA, Congress also created a system of capital-based PCA that was partly "designed to limit regulatory forbearance by requiring: (1) more timely closure of failing banks and (2) earlier intervention in problem banks."<sup>44</sup> PCA works by imposing increasingly stringent restrictions and requirements on banks as their capital declines below five capital-based thresholds.<sup>45</sup> As a bank's capital declines, FDICIA specifically states what

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<sup>41</sup> FDIC, *supra* note 1, at 181. Before the enactment of FDICIA, the OCC was authorized to close a national bank "whenever the comptroller shall become satisfied of the insolvency of the bank." *Id.* at 52 (citing former code 12 U.S.C. § 191). During the period of widespread bank failures in the 1980s, the OCC's definition of insolvency was the exhaustion of primary capital (equity plus loan-loss reserves). *Id.* Thrift regulators had to wait until a thrift was insolvent under RAP accounting standards to close a thrift. *Id.* at 181.

<sup>42</sup> Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, sec. 133(a), § 11(c)(5), 105 Stat. 2236 (amending the Federal Deposit Insurance Act) (FDICIA).

<sup>43</sup> *Id.* sec. 131(a), § 38(h)(3)(A). The agencies are required to make periodic redeterminations about not appointing the FDIC receiver of a critically undercapitalized bank. *Id.* sec. 131(a), § 38(h)(3)(B). If the FDIC is not appointed receiver 270 days after the bank becomes critically undercapitalized, the FDIC must be appointed receiver unless the FDIC and primary federal regulator make certain determinations and certify that the bank is "viable and not expected to fail." *Id.* sec. 131(a), § 38(h)(3)(C).

<sup>44</sup> FDIC, *supra* note 1, at 452.

<sup>45</sup> FDICIA sec. 131(a), § 38. The five capital thresholds are: well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. *Id.* sec. 131(a), § 38(b)(1). Although FDICIA defined the capital categories, regulators set the

action the bank and regulators must or may take in order to improve the bank's financial health.<sup>46</sup> In theory, PCA should limit regulatory forbearance and decrease losses that a bank's failure will impose on counterparties, the economy, and the deposit insurance fund.<sup>47</sup>

Although PCA did not eliminate regulatory forbearance altogether—the system still gives regulators considerable discretion making it inherently prone to forbearance—PCA does include several measures that rein in regulators' ability to forbear. To backstop regulatory forbearance, PCA relies on capital ratios to trigger regulatory action. The use of a capital trigger is partly intended to correct problems present during the 1980s—when regulators allowed banks to remain open, while insolvent, for many years. Because closing a bank is now linked to a bank's capital, regulators cannot easily allow balance-sheet insolvent banks to remain open indefinitely. Although promising in theory, capital-based triggers contain significant deficiencies in limiting regulators' ability to forbear. Most importantly, regulator discretion is greatest in determining a bank's capital;<sup>48</sup> regulators set the capital levels, calculate a bank's capital, and control the accounting rules used to calculate capital.<sup>49</sup>

PCA also decreases regulatory forbearance by specifying certain actions depending on a bank's capital. Although most safeguards are *not* mandatory, the degree of discretion that regulators have varies significantly. PCA's *mandatory restrictions* apply automatically without regulators making any discretionary judgments. These restrictions “apply immediately without agency action,” and thus decrease the potential for regulatory forbearance.<sup>50</sup> For instance, banks cannot make a capital distribution or pay a management fee if doing so would result in the bank becoming undercapitalized after making the payment.<sup>51</sup> Although mandatory restrictions do the most to limit regulatory discretion and thus the ability to forbear, PCA only includes these two mandatory restrictions.

*Discretionary safeguards* are on the other end of the spectrum and are the most prone to regulatory forbearance because the safeguards are not required, but rather implemented solely on regulatory judgment. For instance, when a bank becomes significantly undercapitalized, the regulator has the discretion to apply additional safeguards, such as restricting risky activi-

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actual capital ratios—risk-based capital ratio and leverage limit—for each capital category. *Id.* sec. 131(a), § 38(c).

<sup>46</sup> *Id.* sec. 131(a), § 38(d)–(i).

<sup>47</sup> See RICHARD CARNELL ET AL., BANKING LAW AND REGULATION 284 (2001).

<sup>48</sup> Carnell, *supra* note 37, at 350.

<sup>49</sup> *Id.* at 350–51.

<sup>50</sup> *Id.* at 337.

<sup>51</sup> FDICIA sec. 131(a), § 38(d).

ties,<sup>52</sup> requiring divestiture of the institution or any subsidiary or affiliate,<sup>53</sup> or further restricting the institution's transactions with affiliates.<sup>54</sup>

Falling somewhere in the middle between mandatory restrictions and discretionary safeguards, *presumptive safeguards* "couple a mandatory rule with some regulatory authority to make exceptions to that rule."<sup>55</sup> For example, when a bank becomes significantly undercapitalized, there are three presumptive safeguards that the agency must apply: (1) requiring the bank to sell enough stock or subordinated debt to recapitalize, or to undergo a merger or acquisition; (2) denying the bank the sister-bank exemption in section 23A of the Federal Reserve Act; and (3) prohibiting the bank from paying more than the prevailing regional rates of interest on deposits.<sup>56</sup> Because regulators can exercise their discretion to opt out of taking the corrective action, presumptive safeguards do little to limit regulators' ability to forbear.

Of the three types of corrective actions, mandatory restrictions do the most to prevent regulatory forbearance by eliminating regulator discretion to take action. Discretionary safeguards, on the other hand, do the most to increase the potential for regulatory forbearance because regulators have wholesale discretion. Although critics argue that PCA unwisely eliminates regulator discretion, the overwhelming majority of PCA's requirements fall into the discretionary and presumptive safeguard categories. As a result, it is questionable whether PCA has done much to reduce regulatory forbearance.

Although intended to improve the system of bank intervention and limit regulatory forbearance, FDICIA has been criticized as unsuccessful at limiting losses to the deposit insurance fund and requiring earlier intervention. Opponents contend that PCA imposes a draconian set of rules that limit regulators' ability to correct a troubled bank's problems.<sup>57</sup> Once a capital category is triggered, regulators are required to take or prohibit certain actions, which may not be in the best interest of correcting a bank's deficiencies.<sup>58</sup> This mechanistic system hinders regulatory discretion to prevent failure and, at its worst, PCA requires regulators to take over a bank and "block[ ] the chance that a bank might work out its problems with little regulatory forbearance, and thus not leave any mess at all for the taxpayer."<sup>59</sup> However, PCA mostly imposes discretionary requirements and minimally mandates regulator action. The most severe mandate requires regulators to appoint the

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<sup>52</sup> *Id.* sec. 131(a), § 38(f).

<sup>53</sup> *Id.*

<sup>54</sup> *Id.*

<sup>55</sup> Carnell, *supra* note 37, at 342.

<sup>56</sup> FDICIA sec. 131(a), § 38(f)(2)–(3). The PCA requirements to appoint the FDIC receiver of a bank 90 days or alternatively 270 days after the bank becomes critically undercapitalized are also presumptive safeguards.

<sup>57</sup> John P. Danforth & Christie A. Sciacca, *Shortcomings Include No Discretion For Bank Supervisors*, BANKING POL'Y REP. 1 (1992).

<sup>58</sup> *Id.*

<sup>59</sup> CARNELL, *supra* note 47, at 292–93 (quoting THE ECONOMIST, Feb. 15, 1992, at 97).

FDIC receiver 270 days after a bank becomes critically undercapitalized.<sup>60</sup> However, even this safeguard includes an exception<sup>61</sup> and hence provides for regulator discretion and forbearance.

PCA is also criticized because it links intervention to a bank's capital, which is a lagging indicator of problems,<sup>62</sup> and therefore PCA's capital categories are late in alerting regulators that enforcement actions are needed.<sup>63</sup> However, if capital is not the correct trigger, then other forward-looking mechanisms could be used to require action. PCA critics also claim that capital is not the most important indicator regulators use to identify a troubled bank.<sup>64</sup> Specifically, regulators are more reliant on other CAMEL components such as asset and management quality to determine a bank's stability.<sup>65</sup> However, regulators are supposed to use other supervisory tools to identify and correct failing banks' problems before failure. Capital-based triggers backstop regulatory forbearance and PCA is "the last line of defense for the regulators, not the first."<sup>66</sup>

PCA has also had questionable success in limiting losses to the deposit insurance fund. Before the enactment of PCA, several studies reported that losses to the insurance fund ranged from 18–26% of failed banks' assets—with an extreme case at 58%.<sup>67</sup> Losses on banks' assets post-FDICIA still remain around 17%<sup>68</sup>—indicating that PCA is not correcting the problem it was created to solve. However, the fundamental concept of capital-based PCA may not be flawed, but rather the capital requirements may be too low. To be critically undercapitalized, a bank must have a mere 0% risk-based capital and a 2% leverage ratio.<sup>69</sup> Most importantly, given that banks' assets

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<sup>60</sup> FDICIA sec. 131(a), § 38(h)(3)(C)(i).

<sup>61</sup> *Id.* sec. 131(a), § 38(h)(3)(C)(ii).

<sup>62</sup> Part of the reason capital is considered a lagging indicator of problems is because banks' assets are valued using the book value method of accounting. See CARNELL, *supra* note 47, at 267. This accounting method does not reflect the current market value of assets but rather the assets' historical cost with certain adjustments. *Id.* As a result, assets and capital are often overstated.

<sup>63</sup> FDIC, *supra* note 1, at 461. Supporting this argument, an FDIC publication compares the FDIC's efforts to correct failing banks' problems during the 1980s to FDIC actions PCA would have required and generally found that the FDIC's actions were more prompt and severe than what PCA would have required. *Id.* The FDIC report states that "supervisors had identified most problem banks and had some enforcement actions in place at significantly earlier stages than might have been required under the PCA provisions." *Id.* Similarly, the FDIC report claims that the PCA restrictions are weaker and less comprehensive than the enforcement actions the FDIC took pre-FDICIA. *Id.*

<sup>64</sup> Danforth, *supra* note 57, at 1.

<sup>65</sup> *Id.*

<sup>66</sup> George G. Kaufman, *What Have We Learned From the Thrift and Banking Crises of the 1980s?*, in THE SAVINGS AND LOAN CRISIS: LESSONS FROM A REGULATORY FAILURE 7 (2004).

<sup>67</sup> Eisenbeis & Horvitz, *supra* note 21, at 63.

<sup>68</sup> George G. Kaufman, *FDIC Losses in Bank Failures: Has FDICIA Made a Difference?* 16 (2004), available at [http://www.chicagofed.org/digital\\_assets/publications/economic\\_perspectives/2004/ep\\_3qtr2004\\_p2\\_Kaufman.pdf](http://www.chicagofed.org/digital_assets/publications/economic_perspectives/2004/ep_3qtr2004_p2_Kaufman.pdf); see also John C. Dugan, *Remarks Before the Exchequer Club*, 5 (July 21, 2010), available at <http://www.occ.treas.gov/news-issuances/speeches/2010/pub-speech-2010-84a.pdf>.

<sup>69</sup> 12 C.F.R. § 325.103(b)(5) (2005).

are valued using the RAP book value method of accounting (and therefore capital is a lagging indicator of problems), it is questionable why the capital requirements are not significantly higher. Higher capital requirements and thus earlier intervention could decrease losses. The poor results could also be the product of regulatory forbearance, indicating that PCA does not dictate enough mandatory actions. Additionally, significant losses may be unavoidable because liquidation inherently destroys value<sup>70</sup> and asset values can continue to deteriorate post-receivership. Whether receivership is triggered at 10% capital or 0% capital, asset value losses appear imminent upon receivership.

#### IV. THE DODD-FRANK ACT'S FAILED CHECK ON REGULATORY FORBEARANCE

As part of the legislative response to the recent financial crisis, Congress created systems of early intervention (Early Remediation) and liquidation for systemically important financial companies (Orderly Liquidation Authority) that, despite some similarities, are significantly different from those used for banks.

##### A. *Early Remediation*

The Dodd-Frank Act's Early Remediation authority is an early intervention system functionally similar to PCA. Unlike PCA, Congress did not create the system but rather requires the Federal Reserve to develop "requirements to provide for the early remediation of financial distress" for systemically important financial companies through the rulemaking process.<sup>71</sup> The purpose of ER "is to establish a series of specific remedial actions to be taken by a [systemically important financial company] that is experiencing increasing financial distress . . . ."<sup>72</sup> The regulations must:

define measures of the financial condition of the company, *including* regulatory capital, liquidity measures, and other forward-looking indicators [and must] establish requirements that increase in stringency as the financial condition of the company declines, *including* requirements in the initial stages of financial decline, *in-*

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<sup>70</sup> Paul Tucker, Deputy Governor for Financial Stability at the Bank of England, at the European Commission Conference, Resolution of Large and Complex Financial Institutions: The Big Issues, Address at the European Commission Conference: Building a Crisis Management Framework for the Internal Market 2 (Mar. 19, 2010), *available at* <http://www.bis.org/review/r100322c.pdf>.

<sup>71</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 166(a), 124 Stat. 1376, 1432 (2010) (Dodd-Frank Act). This Note uses the term systemically important financial companies to refer to nonbank financial companies supervised by the Federal Reserve and bank holding companies with more than \$50 billion in assets.

<sup>72</sup> *Id.* § 166(b).

cluding limits on capital distributions, acquisitions, and asset growth . . . and . . . requirements at later stages of financial decline, including a capital restoration plan and capital-raising requirements, limits on transactions with affiliates, management changes, and asset sales.<sup>73</sup>

This is the biggest legislative punt in the Dodd-Frank Act. Almost twenty years earlier, Congress thoroughly created, in more than ten pages, a detailed system of actions and restrictions for a functionally similar system. In the Dodd-Frank Act, Congress provided—in half of a page—vague directions that can be directly traced to FDICIA’s headers. Congress committed the infamous pass-the-buck and passed the blame while solidifying the extinction of the non-delegation doctrine.

Part of the reason for this legislative about-face is due to different congressional motivations. During the 1980s, regulators were widely blamed for forbearing from taking corrective action and placing banks into receivership, while allowing these banks to operate while insolvent for many years.<sup>74</sup> The breadth and detail of the PCA legislation was partially because Congress made it a point to ensure that regulators’ decisions would fit into a somewhat predefined formula when dealing with failing banks. In contrast, Congress did not have the same determination to curtail forbearance when passing the Dodd-Frank Act,<sup>75</sup> even though regulators were guilty of forbearance in the recent crisis.<sup>76</sup> This lack of determination may partially explain Congress’ failure to create a more comprehensive ER system. It may also be the case that Congress is ill equipped to create a system with specificity for complex financial companies.

Comparing Early Remediation to Prompt Corrective Action reveals that ER is prone to regulatory forbearance. To begin with, Early Remediation’s “financial condition” measurement significantly differs from PCA’s reliance on a leverage limit and risk-based capital ratios. ER’s financial condition measurement must include “regulatory capital, liquidity measures, and other forward-looking indicators.”<sup>77</sup> The Fed could easily interpret “forward-looking indicator” to mean any quantitative or qualitative data, and the Fed could use the capital, liquidity and forward-looking measurements individually or collectively (a formula that numerically quantifies an institution’s financial condition based on a composite of each quantitative and qualitative measure-

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<sup>73</sup> *Id.* § 166(c) (emphasis added).

<sup>74</sup> FDIC, *supra* note 1, at 172–77.

<sup>75</sup> Rather, Congress was determined to end “too big to fail” and bailouts. Dodd-Frank Act Preamble.

<sup>76</sup> *Infra* Part IV; see also David Zaring, *A Lack of Resolution*, 60 EMORY L.J. 97, 145 (2010) (citing Yves Smith, *Citi and Bank of America “Encouraged” to Get More Capital as Result of Stress Tests*, NAKED CAPITALISM (Apr. 27, 2009, 11:19 PM), <http://www.nakedcapitalism.com/2009/04/citi-and-bank-of-america-e.html>).

<sup>77</sup> Dodd-Frank Act § 166(c).

ment).<sup>78</sup> It is questionable, however, whether any quantitative data or calculation could accurately define a company's financial condition or predict the potential for failure. The complexity of financial companies, the ever-changing nature of asset portfolios, and unpredictable macroeconomic events make any predictive measurement inherently flawed. A more complex measurement of financial stability may not be a better predictor of financial trouble than PCA's capital categories and its complexity may result in manipulation by regulators. Additionally, the Fed's degree of discretion to determine an institution's "financial condition" highlights the Dodd-Frank Act's critics' fears of abuse.<sup>79</sup> A more complex and less definitive calibration provides a populist regulator the power to inflict arbitrary restrictions in the name of protectionism.

Using the ER "financial condition" measure, the Fed must "establish requirements that increase in stringency as the financial condition of the company declines."<sup>80</sup> Unlike FDICIA, the Dodd-Frank Act does not include five legislatively-defined financial condition categories that trigger increasingly stringent requirements; the Dodd-Frank Act does not even require the Fed to create categories that trigger action. Rather, the Fed has the power to determine how restrictions are imposed based upon what the Fed considers to be the "initial stages of financial decline" and "later stages of financial decline."<sup>81</sup> The Fed could create quantitative-based categories that trigger action similar to PCA as some scholars have suggested,<sup>82</sup> but it seems unlikely that the Fed will create quantitative triggers that will limit the Fed's discretion and require the Fed to take action. Instead of limiting its own discretion, the Fed is more likely to create open-ended standards. If an early intervention system is partially intended to limit regulatory forbearance, then firm, objective thresholds are necessary to curtail forbearance. Without such thresholds to backstop regulatory forbearance, ER will be similar to regulators' discretionary safety and soundness powers.

The Dodd-Frank Act also minimally specifies what restrictions the Fed must take to surgically repair an institution. FDICIA sets forth a detailed

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<sup>78</sup> However, capital is not as much of a lagging indicator of problems for financial companies because many assets are valued using mark-to-market accounting. See CARNELL, *supra* note 47, at 267.

<sup>79</sup> Critics of the Dodd-Frank Act are concerned about the breadth of power and discretion the Dodd-Frank Act gives the Fed, which these critics claim, gives way to the possibility of abuse. See PETER J. WALLISON, *The Dodd-Frank Act: Creative Destruction, Destroyed*, in AEI FINANCIAL SERVICES OUTLOOK, July-Aug. 2010, at 3.

<sup>80</sup> Dodd-Frank Act § 166(b).

<sup>81</sup> *Id.* § 166(c).

<sup>82</sup> Zaring, *supra* note 76, at 123 (stating that "the Administration has the power, following the FDICIA rating system described earlier, to require more action when financial companies appear to be undercapitalized"). However, it seems unlikely that the Fed will follow FDICIA's rating system when (1) the Dodd-Frank Act does not require it to, (2) ER requires the Fed to use other measurements besides capital to define a financial institution's "financial condition"—therefore "undercapitalized" etc. are not appropriate descriptions, and (3) the Dodd-Frank Act does not require the Fed to create thresholds that trigger action.

plan of actions and restrictions that includes standards regulators must use to make decisions.<sup>83</sup> The Dodd-Frank Act, on the other hand, only indicates what ER requirements the Fed must *include*. Early Remediation must “*includ[e]* requirements in the initial stages of financial decline, *including* limits on capital distributions, acquisitions, and asset growth . . . and . . . requirements at later stages of financial decline, *including* a capital restoration plan and capital-raising requirements, limits on transactions with affiliates, management changes, and asset sales.”<sup>84</sup> This broad grant of power gives the Fed the ability to create a system that is much less complete and mandatory than PCA. PCA’s effectiveness in reducing regulatory forbearance is already limited because there are only two mandatory requirements. More mandatory requirements and less discretion are essential to limiting regulatory forbearance. Instead of improving PCA, Congress went in the opposite direction and gave the Fed complete discretion to create ER, and nearly complete discretion to determine what actions to take. It seems unlikely that the Fed will create many mandatory restrictions, but instead will use presumptive or discretionary safeguards. Regulators are historically opposed to limiting their discretion,<sup>85</sup> even though mandatory requirements are essential to decrease the potential for regulatory forbearance.

Finally, unlike PCA, ER does not include a requirement to appoint the FDIC receiver at a quantitative threshold.<sup>86</sup> In fact, ER is not linked in any way to appointing the FDIC receiver. Congress instead created a multi-factor set of highly discretionary findings. Overall, Congress created ER in a way that grants regulators significantly more power than PCA. Critics of PCA can proclaim victory in this legislative battle; ER is not solely reliant on capital categories to trigger regulatory actions, and the legislation gives regulators unfettered discretion. However, the 1980s’ lessons about regulatory forbearance may well prove to be invaluable lessons that Congress overlooked.

### B. *Orderly Liquidation Authority*

PCA and ER are intended to correct an institution’s problems before failure, but when all else fails, the FDIC can be appointed the institution’s receiver for liquidation. The Dodd-Frank Act created a liquidation regime

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<sup>83</sup> *Supra* Part II.

<sup>84</sup> Dodd-Frank Act § 166(c) (emphasis added). It is interesting that a capital restoration plan and capital-raising requirements are not required at the initial stage of decline but rather at later stages of financial decline. PCA’s undercapitalized category (the first category that requires action) includes both. Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102–242, sec. 131, § 38(e), 105 Stat. 2236 (amending the Federal Deposit Insurance Act) (FDICIA). Additionally, the Fed would ideally require a bail-in or require contingent capital bonds that convert when the company’s “financial condition” triggers a certain threshold.

<sup>85</sup> *Supra* Part I.

<sup>86</sup> Danforth, *supra* note 57, at 1.

known as Orderly Liquidation Authority<sup>87</sup> for systemically important financial companies that parallels the FDIC receivership regime for banks, but has a strikingly different procedure for appointing the FDIC receiver.

OLA applies to “covered financial companies”<sup>88</sup> for which a “systemic risk determination” has been made.<sup>89</sup> To make this determination, two-thirds of the FDIC Board of Directors, two-thirds of the Federal Reserve Board of Governors, and the Treasury Secretary, in consultation with the President, must determine that the FDIC should be appointed receiver of a financial company.<sup>90</sup> The Dodd-Frank Act sets forth a list of highly discretionary findings that must be made by regulators to make this determination, including, among others, that (1) bankruptcy would have serious adverse effects on financial stability, (2) the company is in default or in danger of default, (3) there is no viable private sector alternative, (4) OLA’s effect on a financial company’s counterparties is appropriate, and (5) an orderly liquidation would avoid or mitigate such adverse effects on the financial stability of the United States.<sup>91</sup> Once a systemic risk determination is made, the Treasury Secretary must petition the Washington, D.C. District Court for an order authorizing the Treasury Secretary to appoint the FDIC receiver.<sup>92</sup> A strictly confidential hearing is held, and the covered financial company is given the opportunity to challenge the Treasury’s petition.<sup>93</sup> The Treasury Secretary cannot appoint the FDIC receiver until he receives a court order.<sup>94</sup>

Differences between the Dodd-Frank Act’s and FDICIA’s FDIC appointment procedures raise concerns about OLA’s effectiveness. In 1947, the Supreme Court recognized the need to take over a bank without a pre-deprivation hearing because of the “delicate nature of [banks] and the impossibility of preserving credit.”<sup>95</sup> Banks are delicate because they engage in maturity transformation and it is impossible to preserve credit because depositors can obtain their cash on demand—collectively subjecting banks to debilitating runs.<sup>96</sup> For a bank takeover, the FDIC undertakes a secretive takeover intended to avoid spooking the market, which would cause a pre-takeover run on the bank, and also to prevent bank managers from having the time to cover up their failures or take actions to further deteriorate the bank’s financial condition.<sup>97</sup> The bank is not given notice prior to takeover and there is no pre-takeover court hearing, and FDIC employees use alias

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<sup>87</sup> Dodd-Frank Act §§ 201–17.

<sup>88</sup> *Id.* § 201(a)(8).

<sup>89</sup> *Id.* § 203.

<sup>90</sup> *Id.*

<sup>91</sup> *Id.* § 203(a)(2), (b).

<sup>92</sup> *Id.* § 202(a).

<sup>93</sup> *Id.*

<sup>94</sup> *Id.*

<sup>95</sup> *Fahey v. Mallonee*, 332 U.S. 245, 253–54 (1947).

<sup>96</sup> CARNELL, *supra* note 47, at 46–47.

<sup>97</sup> *Id.* at 701.

names when traveling, are forbidden from discussing the takeover, and take over the bank at the end of the business day on Friday.<sup>98</sup>

In contrast, OLA's FDIC appointment procedures are not secretive and could cause the systemic consequences that bank takeover procedures are intended to prevent. If the market finds out that regulators are contemplating taking over a systemically important financial company, money market creditors will stage a run on the company before the FDIC is appointed receiver. To prevent a run, regulators must prevent information leaks in the days preceding a FDIC takeover of a covered financial company. However, OLA's pre-appointment notice to the financial company, pre-appointment court hearing, the involvement of three agencies (with different interests and incentives that could require extensive deliberation), and the required systemic risk determination findings will likely result in a leak of information before the FDIC is appointed receiver. Too many parties are involved and too much information is required for a leak to be effectively prevented.<sup>99</sup>

It also appears that regulators must negotiate with other financial companies before making a systemic risk determination. Specifically, the Dodd-Frank Act requires the Treasury Secretary to determine that "no viable private sector alternative is available."<sup>100</sup> This should at least require discussions with potential third party acquirers. Commentators speculate that this provision will be used to strong-arm other systemically important financial companies into creating a private solution for the failing company: either buy the failing company now (and possibly incur no losses) or pay for the FDIC's losses later (with no possibility of recouping losses).<sup>101</sup> This is another non-secretive step in the process that makes an information leak and a run by money-market creditors likely.

A final, interrelated point of comparison concerning OLA and bank receivership is the difference between the grounds for receivership and the regulators who make the decision to appoint the FDIC receiver. In the 1980s, the primary federal regulators were limited to taking over a bank in the narrow condition of regulator-defined insolvency.<sup>102</sup> In certain circumstances, this limited standard made it impossible for regulators to close a bank because the standard was too impermissive—both because of narrow regulations and restrictive legislative authority.<sup>103</sup> As part of FDICIA, Con-

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<sup>98</sup> Chana Joffe-Walt, *Anatomy of a Bank Takeover*, NPR (Mar. 26, 2009), <http://www.npr.org/templates/story/story.php?storyId=102384657>.

<sup>99</sup> Congress attempts to mitigate the possibility of a leak by holding the party responsible for the leak criminally liable. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 202(a)(1)(C), 124 Stat. 1376 (2010) (Dodd-Frank Act).

<sup>100</sup> *Id.* § 203(b)(3).

<sup>101</sup> Skadden, Arps, Slate, Meagher & Flom, *Analysis of the Orderly Liquidation Authority, Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, [http://www.skadden.com/newsletters/FSR\\_A\\_Analysis\\_Orderly\\_Liquidation\\_Authority.pdf](http://www.skadden.com/newsletters/FSR_A_Analysis_Orderly_Liquidation_Authority.pdf).

<sup>102</sup> FDIC, *supra* note 1, at 181.

<sup>103</sup> *Id.*

gress vastly expanded the circumstances under which a bank can be taken over.<sup>104</sup> In effect, regulators can take over a bank at any time for any reason.

The Dodd-Frank Act, in contrast, only allows a systemically important financial company to be taken over under one set of highly discretionary findings.<sup>105</sup> Although there is only one multi-factor standard for making the appointment, regulators will not be limited like regulators were in the 1980s because the required findings are not based on a narrow rule but instead on broad, discretionary findings. This means that OLA can be both over-inclusive and under-inclusive: over-inclusive because the findings are so broad that in nearly any distressed situation regulators could make a systemic risk determination, and under-inclusive because there is no hard and fast rule requiring action thus allowing regulators to exercise their discretion to forego using OLA.

The risk of OLA being under-inclusive is heightened by the fact that three different agencies, with different incentives and motivations, must each make the systemic risk determination. In the case of banks, only the primary federal regulator must make the decision to close a bank,<sup>106</sup> and if the FDIC disagrees with a decision to not close a bank, the FDIC can appoint itself receiver.<sup>107</sup> Under OLA, on the other hand, if regulators disagree, then the FDIC is not appointed receiver. It is quite possible that the Fed—a regulator interested in monetary policy and financial stability—can reach a different conclusion than the FDIC—a regulator traditionally interested in reducing losses to the deposit insurance fund. The Fed could reasonably be concerned, along with many OLA critics, that OLA will cause the systemic consequences it is intended to correct and forego making systemic risk determinations.<sup>108</sup> Ultimately, requiring multiple agencies to make a joint decision increases the potential for regulatory forbearance.

## V. REGULATORY FORBEARANCE IS A CAUSE FOR CONCERN

The 1980s taught the country costly lessons about regulatory forbearance and the need to reduce regulators' ability and incentives to forbear. However, Congress disregarded these lessons when it created the systems of Early Remediation and Orderly Liquidation Authority. This troubling development leaves our financial system subject to the same flawed discretionary judgment that failed us in the previous crisis.

Reports about the failure of Lehman Brothers (Lehman) and Bear Stearns expose the need for a check on regulators' ability to forbear from taking action to correct the problems of systemically important financial companies. Although regulators knew of Lehman's problems as early as

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<sup>104</sup> *Supra* Part II.

<sup>105</sup> Dodd-Frank Act § 203(a)(2), (b).

<sup>106</sup> *See, e.g.*, 12 U.S.C. § 1464(d)(2)(A).

<sup>107</sup> 12 U.S.C. § 1821(c)(1).

<sup>108</sup> MATTHEW RICHARDSON ET AL., REGULATING WALL STREET 232 (2011).

2007, the SEC failed to take action. Anton Valukas' Lehman report repeatedly states that the SEC's inspections of Lehman revealed significant problems, but the SEC "never raised significant objections or directed that Lehman take any corrective action."<sup>109</sup> A report by the SEC's Office of Inspector General about the SEC's oversight of Bear Stearns similarly found that the SEC did not take action "despite the many potential red flags," that were present and did not require changes even though the SEC was aware of Bear Stearns' deficient risk management.<sup>110</sup>

The SEC was the primary regulator of Lehman and Bear Stearns under the Consolidated Supervised Entities (CSE) Program. This voluntary program gave the SEC supervisory powers over the holding companies of investment banks, and "liquidity risk was the SEC's foremost concern."<sup>111</sup> CSE participants "were required to implement liquidity models that ensured a level of liquidity sufficient to sustain themselves on a stand-alone basis for a minimum of one year without access to unsecured funding and without having to liquidate a substantial position."<sup>112</sup> The SEC did not enforce this one-year standard, as evidenced by Lehman's and Bear Stearns' failure from a liquidity crisis. Additionally, as part of the SEC's liquidity oversight, the SEC examiners were supposed to verify that CSE participants' liquidity pools were "available to the parent without restrictions" and that the liquidity pools could be monetized "immediately, usually within twenty-four hours."<sup>113</sup> However, Lehman used a five-day monetization standard, and the SEC never required Lehman to comply with the twenty-four hour standard.<sup>114</sup> In effect, the SEC was guilty of regulatory forbearance before the recent crisis.

After the Dodd-Frank Act, regulators still have many justifications for regulatory forbearance. OLA will inflict deadweight bankruptcy costs and destroy asset values,<sup>115</sup> even though the FDIC is required to maximize the "net present value return from the sale or disposition of such assets."<sup>116</sup> Regulators may also believe that effective supervision and risk-constraints are cost-effective substitutes to liquidation. Lastly, individual regulators may want to preserve a favorable relationship with healthy financial conglomerates with which the regulator expects to obtain a lucrative post-government career. When the FDIC is appointed receiver of a systemically important

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<sup>109</sup> Report of Anton R. Valukas, Examiner, *In re Lehman Brothers Holding Inc., et al.*, No. 08-13555, 1482 (Mar. 11, 2010) [hereinafter Valukas Report]. One example of the SEC's failure to take corrective action occurred when Lehman failed two liquidity stress tests and the SEC did not require any action. *Id.* at 1489.

<sup>110</sup> *Id.* at 1490-91.

<sup>111</sup> *Id.* at 1486.

<sup>112</sup> *Id.* at 1486 (emphasis added).

<sup>113</sup> *Id.* at 1508.

<sup>114</sup> *Id.* at 1509.

<sup>115</sup> RICHARDSON, *supra* note 108, at 233.

<sup>116</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 210(a)(9)(E)(i), 124 Stat. 1376 (2010) (Dodd-Frank Act).

financial company, the Dodd-Frank Act holds other systemically important financial companies liable for potentially substantial FDIC losses,<sup>117</sup> which can be a disincentive for self-interested regulators.

Alternatively, regulators could have less reason to forbear in the case of systemically important financial companies than banks because there is no deposit insurance fund to protect from losses. This reasoning, however, does not take into account regulators' concerns about protecting the country's macroeconomic stability and taxpayers from bailouts. Regulators, especially the Federal Reserve, are more concerned about the macroeconomic effects of a systemically important financial company's failure than a specific company's losses. As the recent financial crisis proved, macroeconomic consequences are more costly than the direct losses of failure. With this in mind, OLA has been criticized for attempting to preserve the enterprise value of a failed financial company without limiting the contagious consequences of a systemically important financial company's failure.<sup>118</sup> The systemic fallout that could result from appointing the FDIC receiver could outweigh any benefits of OLA and incentivize regulators to avoid using it. As a result, regulators may fear that a financial company is "too big to fail" and prefer a bailout or forbearance. A bailout, however, may not be a politically viable option; the backlash from bailouts in the recent crisis will likely deter the next administration from bailing out Wall Street.

Even though regulatory forbearance can be justified, the lack of deposit insurance for financial companies may nearly eliminate regulators' ability to forbear. In the context of banks, insured depositors do not have an incentive to monitor their bank's activities because they are guaranteed payment.<sup>119</sup> This causes moral hazard because bank managers and owners have an incentive to take additional risks without having to pay interest commensurate with the bank's risk profile.<sup>120</sup> If deposits were not insured, more depositors would monitor their bank's financial condition and would have an incentive to stage a run at the first sign of financial difficulty.<sup>121</sup> This lack of market discipline requires regulators to use safety and soundness measures to counter moral hazard and protect the deposit insurance fund and taxpayers. If regulators do not take corrective action when the financial condition of a bank deteriorates, no one will.<sup>122</sup> When a bank is insolvent, it can continue operations without a run by depositors if regulators do not appoint the FDIC receiver.<sup>123</sup> In effect, regulators are a check against the lack of market discipline, but in the 1980s there was no check on regulatory forbearance. Regulatory forbearance is therefore partially a product of the lack of market

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<sup>117</sup> *Id.* § 204(d).

<sup>118</sup> RICHARDSON, *supra* note 108, at 232.

<sup>119</sup> CARNELL, *supra* note 47, at 309.

<sup>120</sup> *Id.*

<sup>121</sup> *Id.* at 330–32.

<sup>122</sup> *Id.*

<sup>123</sup> *Id.*

discipline. Currently, PCA imperfectly serves as a check on regulatory forbearance by using a basic capital-based approach to trigger regulatory action.

In the case of systemically important financial companies, money market creditors are not insured and therefore have an incentive to monitor debtors and stage runs. If regulators do not take corrective action, money market creditors will require more collateral or interest from financially troubled companies. Similarly, if regulators do not enforce the OLA closure rule, money market creditors will stage a run and force a financial company into bankruptcy. In effect, the market serves as a check on regulatory forbearance. This check on regulatory forbearance is limited, however, because of moral hazard. Moral hazard is present in the case of systemically important financial companies because of the government's historic use of bailouts.<sup>124</sup> According to Professor Richardson, "moral hazard from [bailouts] is thus ultimately one of lack of sufficient market discipline and risk-sensitive pricing from creditors of the financial sector."<sup>125</sup>

Moral hazard and the lack of market discipline were present in the recent crisis and have garnered much commentary.<sup>126</sup> As part of the legislative response to the crisis, Congress attempted to correct this problem by eliminating and restricting regulators' ability to use their bailout authority. Congress limited the Treasury's Exchange Stabilization Fund,<sup>127</sup> which was used to guarantee the money market mutual fund industry in the recent crisis.<sup>128</sup> The Federal Reserve's 13(3) lender of last resort authority now requires the Treasury Secretary's approval and cannot be used to bailout a specific institution.<sup>129</sup> Similarly, the FDIC's open bank assistance power has been severely limited and now requires an act of Congress.<sup>130</sup> The elimination and politicization of regulators' bailout power may make it more difficult to orchestrate a bailout, but regulators still possess the power to bailout failing financial companies, and it is unlikely that the Dodd-Frank Act will instill market discipline or reduce moral hazard.

More importantly, the market is not in an adequate position to take necessary actions to check regulatory forbearance. As shown by the recent crisis, regulators are often privy to information to which the market does not have access. Leading up to the failure of Lehman, the SEC knew that the integrity of the information that Lehman was reporting to the public was an

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<sup>124</sup> RICHARDSON, *supra* note 108, at 234.

<sup>125</sup> *Id.*

<sup>126</sup> *See, e.g., id.* at 232–34.

<sup>127</sup> Emergency Economic Stabilization Act of 2008, Pub. L. 110–343, § 131(b), 122 Stat. 3765, 3798.

<sup>128</sup> Owen F. Humpage, *A New Role for the Exchange Stabilization Fund* (2008), available at <http://www.clevelandfed.org/Research/commentary/2008/0808.cfm>.

<sup>129</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, sec. 1101(a)(6), § 13(B)(iv), 124 Stat. 1376 (2010) (Dodd-Frank Act).

<sup>130</sup> *Id.* § 1105(c)(1).

inaccurate picture of its true financial position.<sup>131</sup> Specifically, the SEC applied discounts to assets it believed were illiquid but did not require Lehman to make similar haircuts in its public disclosures.<sup>132</sup> The SEC also found that Lehman's asset-valuation methods were deficient but did not inform the market until after Lehman's failure.<sup>133</sup> The SEC "was very comfortable living with a world where the numbers in the public were the ones the firms worked out with their accountants."<sup>134</sup> In effect, the SEC had information about Lehman's financial troubles but hid these troubles from the market. If the SEC required Lehman to report its true financial condition, the market would have imposed discipline on Lehman more quickly. However, it is common for regulators to have access to information that the market does not.<sup>135</sup> As a result, market discipline is limited because the market does not have a complete picture of a failing financial company. By relying on market discipline, we are relying only on public information to check regulatory forbearance when non-public information increases regulators' ability to forbear.

Leading up to the failure of Lehman and Bear Stearns, the SEC failed to take corrective action, and the market did not sufficiently check regulatory forbearance. The market did impose discipline on regulatory forbearance by staging a run on Lehman and forcing regulators to pressure Lehman to file for bankruptcy.<sup>136</sup> The market similarly enforced market discipline on Bear Stearns by staging a run and forcing a government-orchestrated merger.<sup>137</sup> However, market discipline did not force regulators to take corrective action that could have saved these companies from failure; market discipline only forced their failure. Market discipline cannot force regulators to take corrective action under the current system. The market can require additional collateral and charge higher interest rates, but such market actions do not force regulators to take corrective action. The only time the market can force regulators to take action is when a company is on the brink of failure and financial instability is inevitable. In this respect, market discipline does check regulatory forbearance from imposing the OLA closure rule; market participants will deplete the financial company's liquidity and cause the company to fail. Regulators will have no choice but to either ap-

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<sup>131</sup> Valukas Report, *supra* note 109, at 1489–90.

<sup>132</sup> *Id.* at 1487. In August 2008, the government believed that "Lehman had \$7 billion less in liquidity than reported." *Id.* at 1515.

<sup>133</sup> *Id.* at 1489–90.

<sup>134</sup> *Id.* at 1510.

<sup>135</sup> Agency records that qualify for a Freedom of Information Act exemption are not generally disclosed to the public. For banks, the trade secrets exemption and the examination exemption would restrict information banking agencies can release to the public. 5 U.S.C. § 552(b)(4), (8).

<sup>136</sup> The Financial Crisis Inquiry Commission, Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, 328–39 (2011).

<sup>137</sup> *Id.* at 283–91.

point the FDIC receiver using OLA, force the company to file for bankruptcy, orchestrate a private solution, or bail out the financial company.

When the market imposes its discipline on regulatory forbearance, the systemic consequences are those that Congress did not address and therefore failed to eliminate. When regulators fail to take corrective action to prevent failure, the market will impose its will not only on the failing financial company, but also on other healthy financial companies that are presumed guilty by association. The recent financial crisis proved that Litan and Rauch were wrong when predicting that the market is smart enough to distinguish between healthy and failing companies.<sup>138</sup> Contagious panics are not caused by informational asymmetries about a particular financial company, but rather informational asymmetries about what other creditors may do.<sup>139</sup> It is a collective action problem that results from individual creditors rationally choosing to be the first in line to collect their money. Regulators could preempt a run on a failing financial company by appointing the FDIC receiver, but this will have little effect on creditors' actions with other healthy financial companies. Preempting a run on a failing financial company may preserve the franchise value of the financial company, but the systemic consequences will already be set in motion and a government bailout will be necessary to prevent catastrophic macroeconomic consequences.

Regulator discretion will always be a part of our financial system; limiting discretion, however, is an essential component to prevent regulatory forbearance and its disastrous consequences. The SEC was guilty of regulatory forbearance before the recent financial crisis by failing to take corrective action. This forbearance led to the modern day bank run that forced the government to spend hundreds of billions of dollars to prevent what could have been the next Great Depression. Regulatory forbearance was not the sole cause of the financial crisis, but regulatory forbearance was instrumental in increasing the severity of the crisis.

## VI. CONCLUSION

The concept of regulatory forbearance was a topic of considerable discussion after the banking crises of the 1980s. Regulators were guilty of forbearing from taking timely action to correct failing banks' problems and close insolvent banks. Congress responded by enacting FDICIA, which was partly created to limit regulators' ability to forbear. The legislation created an extensive system of capital-based Prompt Corrective Action that requires bank regulators to impose increasingly severe restrictions as a bank's capital

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<sup>138</sup> Cf. ROBERT E. LITAN & JONATHAN RAUCH, *AMERICAN FINANCE FOR THE 21ST CENTURY* 127 (1997).

<sup>139</sup> Ben S. Bernanke, Chairman, Fed. Reserve Board of Governors, Address at the Federal Reserve Bank of Kansas City's Annual Economic Symposium: Reflections on a Year of Crisis 5 (Aug. 21, 2009).

declines below five capital-based thresholds. Although PCA has flaws, it provided a basis upon which Congress could potentially improve.

Instead of improving PCA when creating ER for systemically important financial companies, Congress went in the opposite direction (with the Dodd-Frank Act) and did everything but limit regulators' ability to forbear by giving regulators complete discretion to implement a system of early intervention in, and timely closure of, failing financial companies. Apart from an abdication of responsibility, Congress failed to place a check on regulatory forbearance. Congress gave the Fed minimal instructions and few mandates on how the Fed must create ER. The Fed can now create an early intervention system that is not objective, requires no mandatory action, and solely relies on regulators' discretion. Regulators will have discretion to determine how the "financial condition" is measured, when action is triggered, and what action is required.<sup>140</sup> The system will likely be a mere extension of the typical safety and soundness powers that failed in the recent financial crisis. Although we can hope that the Fed-created ER system will objectively mandate when and how action must be taken, it is unlikely that the Fed will limit its own discretion when Congress does not require it. As a result, we must now rely on the market to impose market discipline on regulators even though market discipline can lead to the systemic consequences present in the recent financial crisis, which the Dodd-Frank Act failed to eliminate. When regulatory forbearance allows money market creditors to stage a run on a failing systemically important financial company before the FDIC is appointed receiver, the systemic consequences may be irreversible.

Ultimately, regulatory forbearance is a major cause for concern, and the size of financial companies may be the biggest cause for concern. In the 1980s, Continental Illinois National Bank and Trust Company was the classic example of a thrift that was "too big to fail."<sup>141</sup> With approximately \$40 billion in assets, however, Continental's size was trivial, even after adjusting for inflation, compared to the large interconnected conglomerates we know as Financial Holding Companies such as Bank of America, JPMorgan, and Goldman Sachs.<sup>142</sup> Without an adequate check on regulatory forbearance, the costly lessons from the 1980s may reappear in the future. It is nearly a year after the passage of the Dodd-Frank Act and the Fed has yet to issue a notice of proposed rulemaking about how it will create ER. We can only hope that the Fed creates ER with an objective of limiting its own ability to forbear.

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<sup>140</sup> *Supra* Part III.

<sup>141</sup> CARNELL, *supra* note 47, at 303.

<sup>142</sup> Bank of America is the largest US Financial Holding Company with nearly \$2.4 trillion in assets. See Bank of America Corporation Form 10-Q, Third Quarter at 4 (2010).

