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Financial Holding Company Liability After Gramm-Leach-Bliley

by
Eric J. Gouvin

I. Introduction

In November, 1999, the United States was enjoying the fruits of seven years of unprecedented economic prosperity. In hindsight, although no one knew it at the time, that long economic expansion in United States history was beginning to falter. In the fall of 1999, however, things looked pretty rosy, especially in the financial services industry. In the securities sector, observers were noting the fact that a majority of U.S. households held stock either directly or through their retirement plans; 1 some folks were quitting their regular jobs to become day traders from home; 2 and some experts were beginning to wonder if the brokerage account would become the new core financial account for consumer finance. 3 In the mutual fund industry, commentators were favorably impressed with the quantity of inflowing funds and with the willingness of individual investors to stay the course through ups and downs of the market without bolting for the exits. 4 The insurance industry was moving aggressively into the variable annuity market, selling products

1 See, e.g., Worker Capitalists, WALL ST. J., Nov. 30, 1999, at A26 (noting with approval that some 80 million Americans, or 52% of households, own stocks, either directly or through their retirement plans).

2 See Rebecca Buckman & Ruth Simon, Day Trading Can Breed Perilous Illusions, WALL ST. J., Aug. 2, 1999, at C1 (noting, among other things that some day traders had quit their regular jobs to earn their living by trading on-line).

3 See Alan Levinsohn, Online Brokerage, the New Core Account?, ABA BANKING J., Sept. 1999, at 34 (discussing the economics of securities brokerage accounts and the opportunities for cross-selling financial services from that platform).

4 See E.S. Browning, What Moves Markets — New Forces Are Now Powering Surging Stocks — Ordinary Joes Move Market Toward Dow 10000 Mark With Aid From TV, Internet, WALL ST. J., Mar. 15, 1999, at C1 (dispelling the idea that the individual investor is the “dumb money” of the market); see also Pui-Wing Tam & Karen Damato, The First 10,000 Points, Mutual-Fund Cash Did Much to Wag the Dow, WALL ST. J., Mar. 30, 1999, at C14 (observing the important role that individual investors played in moving the Dow above 10,000).
that looked a lot like mutual funds.\textsuperscript{5} Finally, the banking sector was in the midst of a record quarter in terms of both return on equity and return on assets.\textsuperscript{6}

In 1999, despite some signs of weakness at small banks,\textsuperscript{7} the banking industry looked solid. The bank insurance fund was fully funded, and after the horrible years of the early 1990s, bank failures had slowed to a trickle, averaging fewer than five per year since 1995.\textsuperscript{8} Of course, some dark clouds had begun to appear on the horizon, such as the official savings rate going negative, but in general the fall of 1999 was a very good time to be in the financial services industry, especially in banking. Indeed, the crises of the 1980s and early 1990s in the banking and savings and loan industries seemed like a distant memory on November 12, 1999, when President Clinton signed the Gramm-Leach-Bliley Act\textsuperscript{9} (the "GLB Act") into law.

The GLB Act brought to an end decades of lobbying and deliberation over the shape and dimensions of the U.S. financial services industry. Among other things, the GLB Act broadened the permissible activities of banks and their affiliates. That aspect of the law received by far the most attention during its development in Congress and after its passage, yet the changes in activities in some ways merely formalized a change in the marketplace that had already been accomplished.\textsuperscript{10} So while the law has been hailed as a major landmark by many, its practical impact may be substantially overstated.\textsuperscript{11}

\begin{itemize}
\item \textsuperscript{5} See Bridget O'Brian, \textit{Variable-Annuities Business to Get Boost As More Price Competition Is Introduced}, \textit{WALL ST. J.}, Sept. 8, 1999, at C1 (discussing the aggressive marketing of variable annuity products in the insurance industry).
\item \textsuperscript{6} See Rob Garver, \textit{Bank Profits on Less Firm Foundation}, \textit{AM. BANKER}, Dec. 20, 1999, at 1 (reporting on the third quarter report from the Office of the Comptroller of the Currency that commercial banks had produced record earnings).
\item \textsuperscript{7} See Rob Garver, \textit{FDIC: 10\% of Small Banks Losers in Record Prosperity}, \textit{AM. BANKER}, Dec. 23, 1999, at 2 (noting that despite a third quarter in which commercial banks had produced record earnings, one in ten banks with assets of under $100 million lost money).
\item \textsuperscript{10} Banks and their regulators had been quite creative and innovative in figuring out ways to get around the various product line limitations that had been thrown in their way over the years. \textit{See infra} notes 22–23 and accompanying text.
\end{itemize}
reasonable minds can and do differ on the question of whether the GLB Act really reshapes the business of banking, everyone must agree on the proposition that the GLB Act made only modest changes to the regime for resolving failed banks. Essentially, the GLB Act added a couple of provisions to the existing bank resolution structure and let it go at that.

Given the late 90’s Zeitgeist and the political realities of passing the legislation, the fact that the GLB Act neglected to provide a new system to handle the prospect of bank failure should come as no surprise. The legislation did not address securities firm, mutual fund, or insurance company failure either. Given all of the various constituencies that had to be on board in order for the Glass-Steagall reform effort to get underway, no one wanted to bring up any possibly bad news that could rock the boat. Therefore, all of the details for resolving systemic threats were not worked out. Nevertheless, the neglected corner of banking policy concerning who should pay when a bank fails deserves to see the light of day. Good times do not last forever, and when the banking industry hits the skids it would be helpful to have some idea of how to handle the problems that inevitably will arise.

This paper examines how the cost of bank failure may be imposed on the corporate parents of bank subsidiaries in the Gramm-Leach-Bliley Act era. The paper begins with an overview of financial holding companies and the existing devices for imposing liability under the Bank Holding Company Act. The next section examines four open questions about the direction of banking policy as it relates to the resolution of failed banks. It concludes with the suggestion that further policy adjustments and refinement will be necessary to deal with the next round of bank failures.

II. Financial Holding Companies As Bank Holding Companies And The Tools For Resolving Failed Banks

Most of the commentary about the GLB Act has focused on the new powers permitted to financial institutions and the lifting of limits on traditional product lines by allowing the formation of financial holding companies (FHCs). We are already witnessing a turndown in the subprime banking market. See Paul Beckett & John Hechinger, “Subprime” Could Be Bad News For Banks, WALL ST. J., Aug. 9, 2001, at Cl (reporting on the problems in the risky “subprime” lending market as a result of the downturn in economic conditions).

The GLB Act radically changed the permissible activities of holding companies that own banks or other financial institutions and the permissible activities of national banks. The GLB Act created a new entity, the financial holding company (“FFHC”) to be the umbrella organization under which the expanded financial activities would take place. The GLB Act permits FHCs to engage in banking and activities “closely related” to banking (as previously permitted under

(Matthew Bender & Co., Inc.)
Issues about privacy protection and concerns about the application of the Community Reinvestment Act also got some significant attention after the adoption of the GLB Act. The buzz surrounding the legislation did not, however, include much talk about innovative ways to resolve failed banking institutions. That is probably because there wasn’t much to say.

Any discussion of the GLB Act’s impact on holding company liability would have to start with an often unnoticed reality: the GLB Act did not repeal the Bank Holding Company Act (BHCA). Indeed, even after the GLB Act some bank holding companies (BHCs) may decide to maintain that status subject to the old rules on BHCs and not become a FHC. An institution planning to remain in the traditionally defined business of banking or which plans to develop new financial activities through subsidiaries of national banks need not form a FHC. On the other hand, for holding companies desiring to take advantage of the new activities permitted under the GLB Act by acquiring non-banking affiliates not satisfying the BHCA definition of “closely related to banking,” the GLB Act requires the establishment of a FHC. Despite all the changes wrought by the GLB Act, however, the federal banking regulatory scheme continues to regulate any organization that controls a “bank” as a “bank holding company” under the Bank Holding Company Act. Therefore, a FHC which controls a bank is technically a BHC as well as a FHC. Given the continuing application of bank holding company regulation, clarification of the legal consequences of bank failure for the parent company ought to be a high priority concern for policymakers.

Determining the extent of holding company liability for bank failure has never been a simple task. Over the years, federal banking regulators have developed a range of techniques designed to impose liability on bank holding companies in the event of bank failure. In the emerging financial services

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14 As defined by the Bank Holding Company Act, a “bank” is a financial institution “which (1) accepts deposits that the depositor has a legal right to withdraw on demand, and (2) engages in the business of making commercial loans.” 12 U.S.C. § 1841(c).

15 As defined by statute, a bank holding company is any company that has control over a bank or over a company that has control of a bank. 12 U.S.C. § 1841(a)(1). Typically, although not always, bank holding companies are corporations, but see 12 U.S.C. § 1841(b) (defining “bank holding company” to mean any “corporation, partnership, business trust, association, or similar organization.”).


17 These regulatory mechanisms include, among other things: the so-called source of strength doctrine, 12 C.F.R. § 225.4(a), cross-guarantee provisions, 12 U.S.C. § 1815(e), capital restoration plans, 12 U.S.C. § 1831o(e)(2)(C)(ii), regulatory agreements, the elaboration of a
marketplace these holding company obligations will be imposed on FHCs and could also indirectly affect nonbanking affiliates within the FHC structure. If ownership of a bank creates excessive liability for a FHC and its non-bank affiliates, however, that liability could reduce significantly the benefits of the broad changes ushered in by the GLB Act. The significance of this potential liability is even greater when one takes into account the possibility that nonfinancial commercial firms may eventually be permitted to own banks or that FHCs may acquire affiliates that push the envelope between banking and commerce.18

In any event, there do exist methods for imposing the cost of bank failure directly or indirectly onto the parent holding company. The three most important regulatory devices available to achieve that goal are: (1) the cross-guarantee provisions of FIRREA, (2) the “source of strength” doctrine, and (3) the “prompt corrective action” scheme. The usefulness of these devices will be affected by the GLB Act and by market trends in the financial services sector. I will examine each of them in turn.

A. Cross-guarantee Provisions

The cross-guarantee provisions were enacted as part of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA).19 During the early 1990s, the cross-guarantee was the most powerful tool available to banking regulators for indirectly shifting the costs of bank failure to holding companies. In a nutshell, the cross-guarantee provisions allow the receiver of a failed bank to make claims against the sister banks of the failed institution for the loss that the receiver incurs or anticipates that it will incur in disposing of or assisting the failed depositary institution.20

Although the cross-guarantee is a powerful tool, it is a limited one. It only allows a claim to be presented against other depositary institutions within the same holding company organization. In the current banking market, multi-bank bank holding companies are becoming increasingly rare. The decline of the multi-bank holding company is largely a function of reforms ushered in by


18 See infra notes 93–97 and accompanying text.

19 The cross-guarantee provisions are codified at 12 U.S.C. § 1815(e).

20 Id.
the Reigle-Neal Act of 1994\textsuperscript{21} that liberalized the branching regime and by the regulatory initiatives\textsuperscript{22} and judicial interpretations\textsuperscript{23} that loosened product line restrictions. In light of these changes, over the course of the 1990s fewer and fewer holding companies owned more than one bank subsidiary.\textsuperscript{24} The demise of the multi-bank holding company will render the cross-guarantee provisions less effective as a means of shifting the costs of resolving a failed bank. If the cross-guarantee device becomes ineffectual, bank regulators will in all likelihood look for other ways to protect the deposit insurance fund. Therefore, we may find that the Federal Reserve Board’s “source of strength” doctrine will have a new day in the sun.


\textsuperscript{22} During the mid-to-late 1990s the Office of the Comptroller of the Currency and the Federal Reserve Board engaged in a form of regulatory competition to allow institutions under their supervision to engage in an ever-widening array of financial activities. For example, the Comptroller of the Currency promulgated a regulation that permitted national banks to form operating subsidiaries that could engage in activities such as equipment leasing, insurance, real estate brokerage, real estate development, and securities underwriting. See 61 Fed. Reg. 60342-87 (1996). Not to be outdone, the Federal Reserve Board revised Regulation Y, which covers the activities of bank holding companies, to specify that “closely related” activities include such things as acting as investment advisor to mutual funds, leasing property, providing data processing services, providing courier services, performing real estate appraisals, providing investment advice on financial futures and options, and providing tax preparation services in addition to the activities already on the list or approved by court decision. 12 C.F.R. § 225.25. The Fed then went further and loosened the restrictions between banks and their securities affiliates within the holding company structure. See Review of Restrictions on Director and Employee Interlocks, Cross-Marketing Activities and Purchase and Sale of Financial Assets, 61 Fed. Reg. 57679 (1996); Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, 61 Fed. Reg. 68750 (1996).


\textsuperscript{24} KeyCorp is a prime example of this trend, going from twelve bank subsidiaries before Riegle-Neal to one afterward. See Brett Chase, As Milestone Nears, Banks Prepare to Centralize, AM. BANKER, May 15, 1997, at 4.

(Matthew Bender & Co., Inc.) (Rel.75A-04/02 Pub.052)
B. Source Of Strength

Under the source of strength doctrine as articulated in a Federal Reserve Policy Statement, bank holding companies are required to assist bank subsidiaries in difficult financial times by providing financial assistance to them.²⁵ Although as a legal matter the validity of the source of strength remains an open question,²⁶ the Federal Reserve Board continues to employ the source of strength idea in its decisions,²⁷ and the GLB Act treats the doctrine as if it were a well-established and settled aspect of banking law.

If the cross-guarantee provisions have been rendered ineffectual by changes in the banking industry, the Fed might turn to the source of strength as their backup position for extracting financial support from the holding companies that own troubled banks. A return to the source of strength doctrine could mean that bank holding companies and, indirectly, their affiliates will essentially become liable without limit for the losses that may occur when an insured bank fails.

Indeed, the GLB Act contains some provisions that seem to indicate that the federal regulators are going to return to the source of strength doctrine. In particular, GLB Act Section 112(a)²⁸ adds a new provision designed to hem in the Fed’s ability to order a BHC/FHC to provide “funds or other assets” to a bank from an insurance company, broker/dealer, investment company or investment advisor. Implicit in the provision is the belief that the Fed as regulator of FHCs and BHCs possesses the power to order such transfers, either through an expanded cross-guarantee provision or through an open-ended source of strength power. The new provision seeks to modify this implied power by requiring that such orders be made in coordination with the appropriate insurance or securities regulators, who shall have a veto power if they find that the proposed Fed directive would have a “material adverse effect” on the financial condition of the non-bank financial entity.²⁹

Section 112(a) may only be a preemptive strike to make clear that neither the source of strength doctrine nor the cross-guarantee provisions cover

²⁸ Codified at 12 U.S.C. § 1844(g).
non-bank affiliates. Certainly the section can be seen as at least a signal from Congress that while the cross-guarantee provisions continue to apply to bank subsidiaries, they will not be extended in an unaltered form to non-bank affiliates. There is a catch, however. The Fed, as umbrella regulator of FHCs, can retaliate against financial services providers (and their non-banking regulators) who refuse to support failing banks. The provision allows the Fed to order divestiture of the bank if the securities or insurance regulator does not agree to the requested transfer. 30

Another provision of the GLB Act has also been discussed in connection with the source of strength doctrine. Section 730 of the GLB Act 31 adds a new provision to clarify the source of strength doctrine as it plays out in the insolvency proceedings of the holding company parents of failed banks. Often the regulators of a failing depositary institution extract resources from a bank holding company to prop up the failing bank. Sometimes the receiver of the failed bank denies claims against the bank presented by the holding company or by holding company affiliates on the grounds that those transactions were fraudulent or preferential or on the grounds that they ought to be subordinated on equitable grounds. If the holding company itself is near insolvency, some of those actions by the regulators and the receiver in extracting resources from the holding company or denying claims against the failed bank may be attacked by other creditors of the holding company under bankruptcy law.

Section 730 of the GLB Act strengthens the position of federal banking regulators in bank holding company bankruptcy proceedings and in doing so will likely embolden the Fed to exercise the power it believes it possesses under the source of strength doctrine. Under the new provision, federal banking regulators (including the FDIC when acting in the capacity of conservator or receiver of an insolvent federally insured financial institution) are insulated from any claims arising in bankruptcy proceedings with respect to assets transferred from the bankrupt holding company (or an affiliate or controlling shareholder of the holding company) to or for the benefit of an insured depository institution. 32

Specifically, the GLB Act shields every banking agency from any claim for the return of assets, monetary damages, or other relief, either legal or equitable, if the depository institution receiving the transfer was subject to a capital directive at the time of the transfer or was undercapitalized. 33 The

GLB Act makes clear that the protection for the banking agencies extends to claims based on state or federal law including preference or fraudulent transfer or conveyance, excluding, however, claims based on an actual intent to hinder, delay or defraud. In light of these provisions, it looks as if the source of strength doctrine will once again have its day in the sun.

C. Capital Restoration Plans/Prompt Corrective Action

Another approach to dealing with troubled banks was set out in the capital restoration scheme contained in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). FDICIA requires institutions defined as “undercapitalized” to submit a Capital Restoration Plan (CRP) to the institution’s federal banking agency. If a bank holding company controls the financial institution, FDICIA prohibits the banking agency from approving the CRP unless the holding company guarantees compliance with the CRP for one year and provides adequate assurances of compliance. This could be a very powerful tool for extracting support from a bank holding company.

But the CRP is not just useful to the banking regulators, it also provides some benefit to bank holding companies. By guaranteeing the subsidiary’s obligations under a CRP, a holding company limits its direct liability for the institution’s failure to the lower of either “an amount equal to 5 percent of the institution’s total assets at the time the institution became undercapitalized” or “the amount which is necessary (or would have been necessary) to bring the institution into compliance with all capital standards applicable” at the time the institution failed to comply with the plan.

On the other hand, if the financial institution fails to submit a plan or to implement a plan that has been submitted and approved, FDICIA provides the regulators with a number of sanctions to employ against the institution, including the power to seize the institution. It should be noted, however, that no provision of FDICIA expressly requires a holding company to guarantee compliance with a subsidiary’s Capital Restoration Plan.

This trio of devices, the cross-guarantee provisions, the source of strength doctrine, and the prompt corrective action scheme, remain the workhorses of the regulator’s approach to resolving failed banks. How these provisions will actually be employed in the next round of banking industry distress is an open question.

issue. The next section discusses some of the unanswered questions surrounding the future use of these devices.

III. Questions About Failed Bank Resolution Remaining After The GLB Act

Although the first section took pains to note that the GLB Act does not change the existing law in any major way, there are some big unanswered questions about the future resolution of failed institutions that ought to be addressed before we arrive at the next banking crisis.

A. How Much Deference Should Be Given To The Legal Form?

The first big problem about how to allocate the costs of resolving a failed bank has dogged this area of law since the beginning of time: how much deference should the legal form of the constituents of the holding company be given? Ordinarily under corporate law the liabilities of a corporation do not extend to its parent or to other corporations in the same group although there are occasions when it is appropriate to pierce the corporate veil of a subsidiary to reach the parent or to hold the parent liable for a subsidiary’s conduct by virtue of enterprise liability. In banking, however, it seems that our regulatory system obsesses about separate legal identity in chartering, capital, and operations, but then seeks to disregard separate legal forms in the resolution of failed banks. Indeed, prior to the GLB Act, regulatory approval for new activities generally included the erection of so-called “firewalls” to shield the bank from the activities of other firms in the holding company family.

While the GLB Act does not use the terminology of “firewalls,” the new law clearly still cares a lot about which corporate entities are delivering which financial products and services. The GLB Act is riddled with firewall-like corporate formalities that must be observed in order to proceed with new opportunities. Here is a non-exhaustive list of some of the new corporate formalities contained in the GLB Act:

1. In the area of new activities conducted through bank financial subsidiaries GLB Act Section 121 spells out the requirements for financial subsidiaries of national banks. Significantly, the parent bank must have reasonable procedures and policies in place to preserve the bank’s separate legal identity and limited liability.39

2. In addition, the parent bank must deduct the aggregate amount of its equity investment in the subsidiary from the assets and tangible equity of the bank and deduct the investment from its total risk-based capital. The consolidated total assets of all the bank’s financial subsidiaries, in aggregate, may not exceed the lesser of $50 billion or 45% of the bank’s consolidated total assets.40

3. When a national bank seeking to establish a financial subsidiary is one of the nation’s 100 largest insured banks, as measured by the bank’s consolidated total assets at the end of the calendar year, additional formalities come into play: (1) banks ranking in the top 50 largest will be required to have outstanding “eligible debt” carrying one of the three highest investment-grade ratings; (2) banks in the next 50 largest will have the option of meeting the requirement using alternative criteria.41 Parent banks may avoid the eligible debt requirement altogether, however, if the financial subsidiary being established acts solely in an agency role.42 These provisions show how the GLB Act cares about what is being done by which entities and the way in which the activity is carried out.

4. The provisions dealing with financial subsidiaries of national banks allow some activities, but require that others be conducted only through holding company affiliates, again indicating an implicit premise that it matters which corporate entity is delivering which services.43

5. The GLB Act extended the prohibitions on inter-affiliate transactions contained in Sections 23A and 23B to transactions within a bank/financial subsidiary setting.44 If the holding company enterprise were

43 Compare 12 U.S.C. § 24a(a)(2)(B) (specifying the types of activities that financial subsidiaries of national banks may conduct) with 12 U.S.C. § 1843(k)(4) (describing the types of activities that holding companies may engage in through subsidiaries).
just one big undifferentiated operation where corporate form did not matter, the need for inter-affiliate restrictions would not exist.

6. The GLB Act also resulted in new regulations covering the proper sharing of customer information among affiliates.\textsuperscript{45} This too indicates that different corporate actors within the holding company have different rights depending on the corporate form.

It is clear, therefore, that the GLB Act believes that the separate corporate entities in a financial conglomerate have some significance. How much is the big question. I have argued elsewhere that it seems a bit unfair for the banking regulatory scheme to insist on banks' adherence to myriad corporate formalities, including most significantly, capital requirements, and then to attempt to disregard the corporate forms within the holding company structure when it comes time to resolve a failed bank subsidiary of a bank holding company.\textsuperscript{46}

\textsuperscript{45} As a follow-up to the inter-affiliate information-sharing study required by Section 509 of the GLB Act and the authorization in Section 506 of the GLB Act for the federal banking regulators to clarify the operation of the Fair Credit Reporting Act, in October 2000, the Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision jointly proposed regulations to implement the provisions of the GLB Act dealing with information sharing among affiliates. See 65 Fed. Reg. 63120 (Oct. 20, 2000); see also 66 Fed. Reg. 16624 (March 27, 2001) (update). The regulations establish rules permitting affiliates to share certain information among themselves without being obligated to meet the regulatory restrictions imposed on consumer reporting agencies under the Fair Credit Reporting Act (FCRA). The information-sharing regulations build on the earlier regulations implementing the FCRA and the 1996 amendments to the FCRA contained in the Consumer Credit Reporting Reform Act (the "1996 Amendments"). The 1996 Amendments had permitted financial institutions to share "other information," such as character and credit worthiness information not based solely on transactional experience between the institution and the consumer, provided the financial institution gave the consumer an opportunity to opt out of the information-sharing arrangement. The 1996 Amendments, however, expressly prohibited the banking agencies from promulgating regulations to implement the changes in the law. The new information-sharing regulations, therefore, provide long overdue guidance to make clearer what "other information" is and how to provide an appropriate opportunity to opt out. In general, the regulations say that a financial institution may share what is now defined as "Opt Out Information" with affiliates if prior to such sharing the financial institution has: (1) provided a "clear and conspicuous" opt out notice to the consumer, (2) given the consumer a reasonable opportunity and means to opt out, and (3) taken steps to make sure the consumer has not opted out. Failure to observe these requirements will result in the shared information being considered a "consumer report" for FCRA purposes, which would also mean the full set of FCRA requirements would apply. The new regulations are located in the Code of Federal Regulations as follows: 12 C.F.R. Part 41 (Office of the Comptroller of the Currency), 12 C.F.R. Part 222 (Federal Reserve System), 12 C.F.R. Part 334 (Federal Deposit Insurance Corporation), and 12 C.F.R. Part 571 (Office of Thrift Supervision).

\textsuperscript{46} See Gauvin, Market Discipline, supra note 17.
Conceptually, the argument for respecting the separate corporate existence of banks rests most solidly on the capital requirements imposed on banks. Although securities firms and insurance companies are subject to capital requirements, those schemes are designed to accomplish different ends. Bank capital is driven in large part over concern for systemic risk. This is less important in the insurance industry and to a lesser extent the securities industry, where capital requirements seem to be designed primarily to protect customers.

Banks also are subject to the international capital adequacy guidelines promulgated by the Basle Committee. In January 2001, the Basle Committee proposed revisions to the existing risk-based capital scheme currently in place. The new scheme responds to criticism that the 1988 Accord, as modified over the years, was too blunt an instrument and one which sometimes created perverse incentives. The new Accord recognizes the devilishly difficult task of correctly calibrating capital and risk in the modern financial world where derivative securities and securitized loan portfolios are available to ameliorate (or aggravate) the inherent risk in a given portfolio. It addresses the problem by doing a daring thing — deferring to the bankers who, if they are good bankers, don’t need formal capital guidelines to tell them what to do because over the long run a properly capitalized firm is a successful firm.

The Basle proposals unveiled in 2001 have three key components: (1) a more sophisticated method of translating credit risk into capital requirements; (2) increased regulatory supervision; and (3) enhanced disclosure requirements designed to promote market discipline. Some banking commentators and academics had been urging the Basle Committee to incorporate mandatory subordinated debt into the global capital standards as a mechanism for creating greater market discipline for banking organizations, but that change was not included in the final proposal.

47 For a general discussion of capital standards in the various financial services industries, see United States General Accounting Office, Risk-Based Capital: Regulatory and Industry Approaches to Capital and Risk, GAO/GGD-98-153 (July 1998).

48 Id. at 8.

49 Id. at 5–6.


52 Id.
Although the Basle Committee did not incorporate a subordinated debt requirement into the new capital requirements, current research suggests that such a requirement would make good sense. A recent empirical study using data from European banks found that holders of subordinated notes and debentures are capable of discriminating between the different risk profiles of various banks; that policy changes, such as repudiation of “Too Big To Fail” implicit guarantees, affects the spread on the debentures; and that requiring banks to issue subordinated debt would likely enhance market discipline of banks and supplement regulatory discipline. This study joins several other studies showing a statistically significant correlation between subordinated debt spreads and bank risk, after early studies found no such correlation.

For a scheme of market discipline to work, however, several prerequisites need to be in place: (1) a market for the security that is going to serve as the discipline-sending signal; (2) useful information about the health of the bank so the holders of the security can make appropriate pricing decisions; and (3) a credible threat of failure (i.e., no secret TBTF doctrine lurking in the wings) that forces the valuations to be based on the performance of the institution and not on the discounted possibility of a government bailout. This last point provides a bridge to the next big question.

B. Do We Really Believe In Market Discipline, Or, In Other Words, Is Too Big To Fail Really Relegated To Truly Extraordinary Situations?

An issue that has haunted banking policy for a long time revolves around whether banking regulators will really allow market discipline to work. That is, if the market is to send a message to bank management and to the regulators, the purchasers of bank securities need to believe that they could lose their investment. The fear of being completely wiped out is lost, however, where government bank resolution practices provide an implicit guarantee for investors and depositors.

The problem of the implied guarantee is not news. In earlier rounds of banking reform Congress tried to effectively eliminate the “Too Big to Fail Doctrine” (“TBTF”) by strengthening the requirement of “least cost resolution” that is imposed on the FDIC’s actions. The least cost resolution requirement,

54 Id. at 2–6 (surveying the literature).
however, exists side-by-side with a provision giving authority to the FDIC to make payments in excess of the insurance coverage amounts if necessary to avoid systemic risk. 56 Granted, the exercise of the "systemic risk" authority has been made intentionally very politically costly, 57 but the mere existence of the provision provides evidence that TBTF is not dead. How these two provisions will work together in the future remains to be seen.

Bank regulators like to talk the talk of market discipline, and the new Basle Accord relies on market discipline as its third pillar, but by definition invoking "market discipline" also means embracing the idea that some banks will fail — even big banks. Indeed, we really cannot have both market discipline and routine TBTF at the same time. But real market discipline is politically awkward. To close down a bank and leave some claimants unpaid will be a political as well as a financial decision.

The system would work better if we had lots of participants chiming in with their two cents worth on what the bank was doing. We have regular review by regulators, of course, and shareholders provide some feedback to bank management as well. Providing a role for debtholders might be the missing piece of the market discipline system.

The previous section noted that the New Basle Capital Accord almost prescribed a requirement for mandatory subordinated debt in the capital structure of banks. Proponents of mandatory subordinated debt claim that the publicly traded market for that debt could act as an early warning system for risky activity in a banking organization because the subordinated debt holders, unlike the equity holders, would not share in the gains of any unduly risky activity and so would be likely to demand a higher risk premium when the banking organization veers off into dangerous levels of risk-taking.

The idea has received some attention domestically. In a couple of places, the GLB Act takes notice of the concept. First, as noted above, in some circumstances, national banks that plan to establish a financial subsidiary must maintain the requisite amount of "eligible debt." 58 Second, the GLB Act

57 Congress imposed an extensive and politically difficult procedure that must be carried out before the systemic risk payments can be made: Among other things, the process to expend funds must be initiated by a two-thirds majority of either the FDIC board or the Federal Reserve Board; the non-initiating board must approve the initiative of the other board; the Secretary of the Treasury must determine that the systemic risk concern is justified; and the FDIC must recover the costs of TBTF by way of a special assessment to the members of the insurance fund. Id.
required the Fed to prepare a study on the advisability of including subordinated debt in the capital requirements of banks.59 When the Fed released the study, it is fair to say that they gave the idea of mandatory subordinated debt a mixed reception.60 The Fed report determined that subordinated debt would provide five primary benefits to the economy: (1) it would improve direct market discipline; (2) it would supplement the “indirect” market discipline exerted by government regulators and secondary market participants; (3) it would encourage transparency and disclosure by banking organizations; (4) it would increase the size of the financial cushion for the deposit insurance funds; and (5) it might reduce the risk of slow regulatory response to crisis situations.61 Despite these anticipated benefits, however, the Fed recommended against implementing a subordinated debt requirement at the present time. The study concluded that while the creation of a mandatory subordinated debt capital structure for the largest U.S. banking organizations would likely increase the safety and soundness of the financial system, the cost to banks of implementing the regime did not justify a policy change at the present time.62

The results of the subordinated debt study seem to suggest a small amount of backsliding on the market discipline issue: the Fed recognizes that mandatory subordinated debt would enhance market discipline, yet at the same time backed away from it. The agency has taken that tack even while preparing to implement the Basle Accord with its new emphasis on market discipline. One wonders what other policies might be articulated in one place and undercut in another, which leads to the next question.

A. Will Prompt Corrective Action (Be Allowed To) Work?

The third big question concerns the prompt corrective action regime. It has yet to be tested under serious stress and one cannot help but wonder if the system will work as intended and whether the regulators will allow it to work as intended. One way to look at the PCA system is as an option. Bank holding companies that own undercapitalized institutions are given a choice: put up more capital and cap your losses, or refuse to put up more capital and declare your intention to let the bank fail.63 The optional aspect of these plans may

59 GLB Act § 108.
61 Id. at 24–36.
62 Id. at 56–57.
63 See Gauvin, Market Discipline, supra note 17, at 338–39.
have been designed to facilitate early resolution of the insured institutions by requiring the holding company to either face up to its commitments or signal that it is not willing to do so.

While this arrangement provides the holding company with some flexibility regarding the commitment to the troubled subsidiary, failure to back a CRP could have catastrophic results for the holding company. Without the limitations created by the guarantee of the CRP, holding company liability for the bank’s failure could be great, and failure to back up the CRP could raise the ire of the regulators who could find ways to punish an uncooperative holding company. So, when viewed in a more skeptical light, that apparent leeway afforded by the CRP provisions could in reality be nothing more than an invitation to play a high stakes game of “chicken” with the regulators.

This may be especially true in light of recent experience in the savings and loan industry where PCA did not work well because the capital reporting from the covered institutions indicated the institutions’ solvency up to the last months before closure. Existing accounting rules, trends in the banking industry, and the risk profiles of covered institutions undermined the reliability of the capital data in the months leading up to failure.64 Yet while it is true that PCA has not been in place through a full blown banking crisis, some empirical evidence points to PCA as being effective in improving bank capital ratios and portfolio risk levels.65

So, while PCA may prove to be a useful tool in addressing losses from failed banks, we cannot be sure that it will work as planned.

B. What Are We Trying To Accomplish When We Resolve A Failed Bank?

Finally, the most difficult problem facing banking regulators in formulating a coherent and justifiable policy for imposing liability on bank holding companies is to articulate what exactly the imposition of that liability is supposed to achieve. I have discussed elsewhere66 that the rationale that currently informs policy choices is murky and rarely articulated with clarity. If the law is going to impose liability on holding companies for debts of their

64 See Pamela Atkins, Bank Failures: Prompt Corrective Action Not Enough in Recent Bank Failures, OTS’s Seidman Says, 73 BNA BANKING REP. 987 (Dec. 20, 1999).
banking subsidiaries, there needs to be a legitimate policy justification for doing so. There have been some policy justifications offered over the years, but they generally do not withstand close scrutiny very well.

Obviously, the first guiding principle for resolving a failed bank is to make the insured depositors whole. This goal is relatively uncontroversial and relatively easily achieved. We have a deposit insurance system that charges risk-related premiums to cover the insured peril and the insurance funds are sound. This goal cannot fully explain why the law seeks to impose liability above and beyond the limits of the banks’ corporate form. Indeed, if protecting insured depositors were our only concern, we would see a serious policy pushing toward the so-called “narrow bank” idea that would be very low risk for depositors and low return for banks. But we have not really explored the narrow bank, instead we continue to allow banks to use insured deposits to fund lending and other activities.

Another reason we may turn to holding company liability is to prevent systemic risk caused by a chain reaction of failing financial institutions. This rationale is repeated so often it is taken as true. Indeed it is said that the bank capital requirements are concerned with systemic risk. It is, however, hard to find solid evidence that individual bank failure is a likely source of systemic risk. Hal Scott and George Kaufman recently wrote a provocative paper about whether bank regulation contributes to or retards systemic risk. One of their biggest challenges in writing about the topic came in trying to pin down what we mean when we use the term “systemic risk.” On closer examination of the available evidence, however, the fear of a bank failure expanding into the potential failure of the entire banking system appears unjustified. Historically, such a catastrophic domino effect is in reality a very rare event. It is much more likely that a bank run would result in the redepositing of funds from weak banks into strong banks.


69 Id. at 2–5.

70 Id. at 8.

71 See Anthony Saunders, Bank Holding Companies: Structure, Performance and Reform, in RESTRUCTURING BANKING AND FINANCIAL SERVICES IN AMERICA 159 (William S. Haraf & Rose Marie Kushmeider eds., 1988) (citing study that concluded that most runs on individual banks would result in redepositing to sound banks).
Another explanation for why the banking regulators have developed extensive holding company liability rules is what Prof. Howell Jackson has called the "cost-defraying hypothesis." In short, the deposit insurance funds are not inexhaustible, and the regulatory scheme has developed ways to recapitalize those depleted funds from sources other than the taxpaying public. Such a justification could be grounded on the reasoning that since holding companies benefit from the deposit insurance that covers their banking subsidiaries, they should pay the price as well. If this is the basis for holding company liability one would think that the fair limit of liability should be the value of the benefit received, although that has never been seriously proposed.

Yet another justification for imposing liability on bank holding companies is what Prof. Jackson calls the "hungry wolf" hypothesis, which posits that holding companies prey upon and exploit their regulated subsidiaries so they therefore should be made to relinquish the unfair gains they have extracted from their bank affiliates. The potential conflicts of interest that tempt bank holding companies to exploit their subsidiaries and their customers are known in the banking world as "subtle hazards." While there may be some anecdotal

73 Id. at 559; but see Alfred J.T. Byrne & Judith Bailey, FDIC Addresses Three D&O Lawsuit Issues, ABA BANKING J. 47 (Oct. 1992) (the FDIC officially denies that it sues all deep pockets).
74 An underlying premise of this position is the idea that banks (and indirectly bank holding companies) receive a subsidy from the federal government. In the words of Federal Reserve Chairman Alan Greenspan:

In this century the Congress has delegated the use of sovereign credit — the power to create money and borrow unlimited funds at the lowest possible rate — to support the banking system. It has done so indirectly as a consequence of deposit insurance, Federal Reserve discount window access, and final riskless payment system transactions. . . . [As a result of the government's major role in protecting the banking system, banks get an unfair advantage over other financial services providers because banks] determine the level of risk-taking and receive gains therefrom, but do not bear the full costs of that risk. The remainder of the risk is transferred to the government.

75 Jackson, supra note 72, at 564.
76 Investment Company Institute v. Camp, 401 U.S. 617 (1971) (coining the term). Possible subtle hazards that have been identified in the scholarly treatment of the subject include: the
evidence that bank holding companies take advantage of their subsidiaries, there is no clear empirical evidence that holding companies in fact exploit their banks to the extent feared by the hungry wolf model. To the extent the hungry wolf justification cannot withstand empirical scrutiny, however, it loses a great deal of persuasive effect.

Another common justification for holding company liability is that it helps impose "market discipline" on bank management. The goal of market discipline is to create financial incentives for holding companies to monitor the managers of their banking subsidiaries and thereby dampen the risk-taking tendencies of the bank. The market discipline idea relies on the holding companies' financial interest in preventing losses at the holding company level to create incentives for monitoring the risk taking of their bank managers. While heightened oversight of bank management may result in a more conservative bank management, it seems unlikely that increased monitoring potential for biased advice to clients designed to benefit the holding company's non-banking operations; uneconomical transfers, such as bank loans to troubled holding company subsidiaries; bank trust department securities transactions designed to bolster the offerings of an investment bank affiliate; predatory practices and collusion between the bank and other affiliates designed to injure other competitors of the affiliates; and the possibility of tying arrangements by which bank services and products would only be available in conjunction with the purchase of affiliates' products and services, perhaps at an above-market price. See Daniel R. Fischel et al., The Regulation of Banks and Bank Holding Companies, 73 VA. L. REV. 301, 323–30 (1987) (discussing the "subtle hazards" suggested by the Camp decision); see also James R. Smoot, Striking Camp and Moving to Higher Ground: The Hazardous Subtleties of "Subtle Hazards" in Bank Regulation, 4 GEO. MASON L. REV. 1, 38–40 (1995) (discussing "subtle hazards" in light of the Camp decision and the history of the Glass-Steagall Act).

77 See Kieran J. Fallon, Note, Source of Strength or Source of Weakness?: A Critique of the "Source of Strength" Doctrine in Banking Reform, 66 N.Y.U. L. REV. 1344, 1383 (1991) (listing several ways in which bank holding companies might take advantage of their banking subsidiaries); see also Eric J. Gouvin, Resolving the Subsidiary Director's Dilemma, 47 HASTINGS L.J. 287, 289–90 (1996) (noting the many situations in which parent corporations may take advantage of their subsidiaries).

78 Jackson, supra note 72, at 573–76 (reviewing and summarizing various studies concerning the affect of bank holding company ownership on bank performance and finding "there is little evidence supporting, and a considerable amount rebutting, the hungry wolf justification. . ."). This has been true historically as well. Even back in the free-wheeling 1920's, large commercial banks and their investment bank affiliates fared much better than smaller banks that were only engaged in commercial banking. See George J. Benston, The Separation of Commercial and Investment Banking: The Glass-Steagall Act Revisited and Reconsidered 32 (1990) (noting that national banks which engaged in both commercial and investment banking had a lower failure rate than those that just engaged in commercial banking.)

by holding companies will result in fewer run-of-the-mill, non-negligent lapses of judgment that unavoidably plague all human activity.\textsuperscript{80} It seems obvious that a certain number of mistakes will occur just because humans make mistakes, and bank directors are humans. Ultimately, the market discipline hypothesis may overstate the role that directors realistically can play in insuring the safety and soundness of the institutions they run.\textsuperscript{81} There is a limit as to what we can expect directors to do. Their role is to set policy and to oversee the officers, not to engage in a hands-on supervision of operations.\textsuperscript{82} In light of that reality, the directors may be ineffectual in stopping operational problems.\textsuperscript{83} If heightened management oversight is the goal, then liability ought to be limited to those losses that could have been avoided by diligent management and should not include losses resulting from macroeconomic trends or simple, non-negligent, lapses of judgment. Again, that has never been seriously proposed.

I have argued elsewhere that to the extent some degree of market discipline from the equityholders is desirable, the enhanced capital standards that banks

\textsuperscript{80} Although there is some evidence that the business judgment rule as applied in the banking context has been modified to hold bank directors to a higher standard than directors generally have been subject to, see Patricia A. McCoy, A Political Economy of the Business Judgment Rule in Banking: Implications for Corporate Law, 47 CASE W. RES. L. REV. 1, 10–12 (1996), historically, bank directors have not been liable for simple lapses of judgment. See, e.g., Muller v. Planter's Bank & Trust, 275 S.W. 750 (Ark. 1925) (holding that bank directors must exercise good faith and diligence in managing a bank, but are not liable for mere exercise of poor judgment); Warren v. Robinson, 70 P. 989 (Utah 1902) (holding that directors will not be responsible for depreciation in value of bank stock when such depreciation results from errors of judgment). Although at the time of FIRREA's adoption a debate ensued about the standard by which directors actions should be judged, the standard was never lower than negligence, that is, we never seriously considered strict liability or a standard of mere poor judgment if the decision-making process itself was not negligently defective.

\textsuperscript{81} See John D. Hawke, Jr., The Limited Role of Directors in Assuring the Soundness of Banks, 6 ANN. REV. BANKING L. 285 (1987) (arguing that bank directors typically neither have access to information nor the banking skills necessary for the effective prevention of bank failure).

\textsuperscript{82} Delaware corporate law seems, however, to be pointing in the direction that directors should have some system of compliance review in place to monitor corporate activities. See In re Caremark Int'l, Inc., 698 A.2d 959 (Del. Ch. 1996) (in a memorandum decision, Chancellor Allen suggested that Delaware law and the dictates of federal sentencing guidelines, among other things, weigh in favor of requiring a corporation to have in place some form of legal compliance oversight); but see Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125 (Del. Ch. 1963) (setting forth the view that a corporation need not have in place "a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists.").

\textsuperscript{83} For example, if the officers of the bank are committing fraud or even just covering their mistakes, it will be extremely difficult for any monitor to detect, be it the board of directors or the holding company, because the officers can conceal information relatively easily. Hawke, supra note 81, at 287.
must comply with put enough at stake for the equityholders to monitor bank
management as well as they can.\textsuperscript{84} The biggest problem with the current
extensive array of holding company obligations is that they are not well
calibrated to exact the maximum amount of monitoring without over­
penalizing the holding companies. In my mind, beyond the heightened
attentiveness that the capital standards create, it seems doubtful that the
enhanced holding company obligations can make the monitoring process any
more effective or make the role that management plays in maintaining a safe
and sound bank any more meaningful. Everything after the increased capital
requirements results in diminishing returns in terms of enhanced monitoring.\textsuperscript{85}

Another rationale for imposing subsidiary obligations on the parent would
be that in reality the two formally distinct legal entities are in fact a single
economic unit and should therefore be regulated as one enterprise. Prof. Phillip
Blumberg's extensive treatise, The Law of Corporate Groups, explores this
line of reasoning as it plays out through many different legal techniques and
in many different areas of law.\textsuperscript{86} Viewed through the lens of enterprise
liability, the fiction of separate corporate personality for each subsidiary in
a corporate group must give way to the reality of a single economic enterprise.
Proponents of enterprise liability argue that in order to deal effectively with
the legal issues of subsidiaries, the law needs to break out of traditional
paradigms and embrace the idea of a corporate enterprise that cuts across
particular legal entities.\textsuperscript{87}

In the bank holding company context, however, the enterprise idea does
not hold up as well as its supporters might hope. Banks that are part of a bank
holding company must meet the same requirements that all banks must comply
with — capital requirements and regulatory restrictions among them — that
prevent banks from being merely a component part of a larger enterprise.
Because our banking scheme insists on treating the legal entity which is the
bank with great formality, it does not comport well with the strong form of

\textsuperscript{84} See Gouvin, Market Discipline, supra note 17. There appears to be a strong connection
between capital levels and thrift failure. See Lawrence R. Cordell et al., Corporate Ownership
and the Thrift Crisis, 36 J. L. & ECON. 719, 724–27 (1993) ("The ability to take on riskier
investments at higher leverage ratios directly benefitted stock S&L owners, who could capitalize
these benefits directly through appreciation of their stock holdings.").

\textsuperscript{85} See Gouvin, Market Discipline, supra note 17, at 350–53.

\textsuperscript{86} See Blumberg, supra note 38.

\textsuperscript{87} See Adolph Berle, The Theory of Enterprise Entity, 47 COLUM. L. REV. 343, 350 (1947)
("In effect what happens is that the court, for sufficient reason, has determined that though
there are two personalities, there is but one enterprise; and that this enterprise has been so
handled that it should respond, as a whole, for the debts of certain component elements of it.").
the enterprise liability idea. Banks are a very special kind of corporation. In a throwback to an earlier time, banking remains one of the few businesses where one must seek a charter from a governmental authority before engaging in business. Banks are also special in that they must comply with capital requirements imposed by regulators. In addition, as noted above, regulators insist that certain activities only be carried on by certain affiliates. Yet despite all of the separateness of banks and the restrictions on their ability to work together with other holding company affiliates, the law is quick to disregard the corporate form of the bank and try through every means available to impose liability on the holding company for the obligations of the bank. In light of the special chartering, capital, and regulatory treatment of banks, they seem to deserve more respect as impermeable corporate entities than the typical corporation, but they actually receive less. The current regulatory scheme makes the elaborate efforts to set banks off as independent entities within the holding company structure appear to be nothing but a charade.

Unfortunately, as we enter the GLB Act era, the regulatory scheme lacks a principled rationale for ignoring the separate corporate entities in the holding company system. We should reconsider the reasons why we think it is necessary to impose liability on holding companies and develop a principled policy for determining when such liability would be appropriate and how great the liability should be.

IV. Why These Issues Matter

These unanswered questions will become important as the financial services industry continues to evolve. Although banks are subject to capital requirements, the history of banks failure resolution suggests that holding companies will be liable for the costs of bank failure above and beyond the loss of the capital invested in the bank. As currently articulated, banking policy does not establish a consistent and coherent rule for holding company liability in excess of the capital invested in the bank. If the true costs of owning a bank are not

88 Modern banks seem to be products of the ancient “artificial entity” or “concession” theory of corporation. See generally Samuel Williston, History of the Law of Business Corporations Before 1800, 2 HARV. L. REV. 105, 106 (1888). In a nutshell, that theory of corporateness holds that only the sovereign can give life to a new corporate being, and that the sovereign sometimes may create such a person if, as a quid pro quo, the new corporate person promises in its charter to perform some socially useful activity for the sovereign. Id. at 113–14.

89 See 12 C.F.R. pt. 208 App. A.

90 See supra note 43 and accompanying text.

91 See generally Gouvin, Market Discipline, supra note 17 (discussing the myriad ways of imposing liability on bank holding companies).

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transparent, potential suppliers of capital to the banking system may be reluctant to acquire banks, thereby weakening demand for bank capital and increasing the cost of that capital.

In the new era of financial services competition being ushered in by the GLB Act, our policies should be careful not to tip the playing field to favor one type of financial services provider over another. If the owners of banks are subject to liability that the owners of other types of financial institutions will not be subject to, banks will be placed at a relative disadvantage. Financial services supplied by different types of financial services providers ought to be subject to the same constraints regardless of the provider. Yet it seems obvious that our system will continue to impose on entities owning banks an additional potential cost of doing business — holding company liability to resolve a failed bank. The holding company will face uncertain contingent liabilities if a bank subsidiary fails, thereby making ownership of a bank relatively more expensive than owning, say, an insurance company or securities firm, because of the possibly open-ended liability from the source of strength doctrine and other devices in the hands of federal banking regulators. If banks will be at a disadvantage, some financial services providers will evolve to provide bank-like services without crossing the line and actually becoming BHCs.

It may be argued that the increased cost of the bank capital brought about by the possible liability for bank failure is offset by the great safety net subsidy bestowed upon banks.92 The safety net subsidy/burden debate has been ongoing for years with no clear winner. In my humble opinion, the subsidy bestowed by the safety net is probably offset by the regulatory costs, capital requirements, and insurance premiums borne by banks. Assuming the costs and benefits of the safety net are a wash, the added cost of bank ownership resulting from liability for bank failure will make banks relatively less attractive to possible owners.

As the GLB Act’s reforms take root and mature, the fuzzy limits of exposure for bank ownership may discourage financial services companies with extensive assets, and especially commercial firms, from becoming bank owners because the exposure will be too great. Although outright ownership of a bank by a commercial firm is not permitted at the present time, we may eventually cross that bridge.93 The suggestion that commercial firms be allowed to own

92 See Gouvin, Hungry Wolves, supra note 66, at 963–66.

93 Since the GLB Act did not address all issues of financial modernization to everyone’s satisfaction, we may witness some additional legislation to work out the details and to complete “unfinished business” left over from the legislation, such as ending the distinction between

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banks was advocated seriously in the public policy debates in the years leading up to the passage of the GLB Act.\textsuperscript{94} Indeed, the "unitary thrift" loophole has already permitted commercial firms like General Electric and General Motors to operate huge financial businesses within their existing corporate structures.\textsuperscript{95} Even though Title IV of the GLB Act prevents the creation of new S&L holding companies with commercial affiliates, it did grandfather the existing unitary thrifts and those applications to establish a unitary thrift pending as of May 4, 1999.\textsuperscript{96}

Yet even with the unitary thrift loophole in abeyance, the GLB Act leaves open some possibilities for mixing banking and commerce. First of all, the definition of activities that are "financial in nature" or complementary thereto that spells out the kinds of affiliates that a FHC may have is extremely broad.\textsuperscript{97} As a regular user of the Quicken\textsuperscript{©} personal finance software, I think of it as being part of my interface with the banking system. Could a FHC acquire Intuit, Inc., the maker of Quicken\textsuperscript{©}, on the theory that the software is either "financial in nature" or incidental or complementary thereto? Taking it a step further, I rarely encounter a teller at the bank, but frequently use ATM machines. Could an FHC acquire Diebold, Incorporated, one of the world's leading ATM manufacturers? These will remain academic inquiries for only a short time. FHC will push the envelope on permissible activities in just the same way BHCs pushed the definition of "closely related to banking" under the Bank Holding Company Act. If the costs of bank ownership are not made clear, FHCs that have wide-ranging activities may be reluctant to acquire banks because of the potentially open-ended exposure for bank failure.

In order to keep the costs of bank failure from skewing the price for bank capital, policy makers ought to consider two ideas. First, they ought to allow the prompt corrective action provisions to work in their pure form. Essentially, “commercial” and “financial” firms. See, e.g., R. Christian Bruce, Financial Modernization: More Financial Services Legislation Needed in Wake of Gramm-Leach-Bliley, Experts Say, 75 BNA Banking Rep. 827 (Dec. 11, 2000); Dunne, Financial Modernization — Unfinished Agenda, 117 BANKING L. J. 97 (2000).


\textsuperscript{95} See Steve Cocheo, Special Briefing: The Banking-Commerce Debate, ABA BANKING J., July 1997, at 7 (giving an overview of the history and current status of the intermingling of banking and commerce).

\textsuperscript{96} See 12 U.S.C. § 1467a(c)(9)(C).

\textsuperscript{97} See 12 U.S.C. §§ 1843(k)(1) (noting that affiliates of a financial holding company must be engaged in business that is "financial in nature" or "incidental to such financial activity" or "complementary to a financial activity"), 1843(k)(4) (providing a long laundry list of activities that are "financial in nature").

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the provisions should operate as an option that will force bank holding companies to "put up or shut up." Compliance with the capital directive will be the cost of exit. These laws are already on the books, they just need some signaling from key regulators that they will be allowed to work as designed.

There should also be some signal sent clarifying what happens if the holding company refuses to inject more capital into the failing bank. Currently, the bank may be placed into receivership, but not much has been said about the potential liability of the holding company. I have developed in other articles an approach to bank holding company liability that would work well in this situation. Under my approach a bank holding company should be liable for the failure of its bank subsidiary above and beyond the value of the capital lost, only to the extent the bank holding company is found to have used the bank subsidiary for purposes that benefit the holding company at the expense of the bank as a separate legal and business entity. I believe my approach strikes the right balance between respecting the legal forms of the entities and imposing liability for acts that unfairly shift the cost of bank failure to constituents other than the holding company.

V. Conclusion

The GLB Act makes only relatively minor changes in the existing scheme of bank holding company liability for the costs of a failed bank. Therefore, the existing devices for imposing liability on bank holding companies for bank failure will be applied to financial holding companies that own banks, since under the Bank Holding Company Act, those financial holding companies will be considered bank holding companies as well.

Although the GLB Act added little to the regulatory tool box, some of the devices available in the past have been made less attractive to the regulators because of changes in the financial services marketplace. Regulators may be tempted to fall back on the source of strength doctrine as an open-ended method for imposing liability on bank holding companies. Using such an open-ended device, however, will affect the attractiveness of bank ownership. A broad ranging liability regime that puts all the holding company's assets at stake in the event of bank failure will increase the cost of owning a bank relative to other financial intermediaries and therefore make bank ownership less attractive. On the other hand, a regime that limits the holding company's liability to the amount invested in the bank will make bank ownership relatively more attractive, but could result in some costs of bank failure being shifted away inappropriately from the shareholders on to other parties.

98 See Gouvin, Hungry Wolves, supra note 66.
propose that liability for bank failure be governed by the prompt corrective action scheme and that the limitations on holding company liability contained therein be allowed to work as designed. Stopping at the statutory limit may be politically difficult, but in order for the scheme to be credible, the regulators should signal that they will respect it. With regard to holding companies that refuse to guarantee a capital directive, the law should impose liability on the holding company only to the extent the holding company improperly employed the bank for the benefit of the holding company without regard to the best interest of the bank as a separate legal and business entity.