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HOW "BIG" BECAME BAD: AMERICA'S UNDERAGE FLING WITH UNIVERSAL BANKS

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ABSTRACT

In little more than a decade gigantic new financial institutions have emerged in America. These organizations are quite different from their predecessors in that they share the highly complex, diversified characteristics of foreign “universal banks.” They are still in the process of developing experienced and mature operational and risk management systems. During this same period, the regulatory framework necessary to match the size, power and hazards generated by these new universal banks remains underdeveloped, and the primary framework around which the system is being constructed, namely Basel II, lies in tatters in the wake of the financial crisis of 2007-08. Given the size and interconnectedness of these universal banks, it is dangerous to permit their continued growth unless and until we develop a proper regulatory framework for supervising them. This article suggests that such a framework can only be developed fully once a single regulator, such as the Federal Reserve System, acquires comprehensive power to supervise large universal banks. Pending such reform, the article offers three actions that current regulators could take to slow the growth of universal banks down to a safe level. These are merger approval conditions that would require: (i) the filing and approval of a detailed, binding implementation and operation plan for any proposed combination; (ii) the filing and approval of a dissolution plan for the entity, should the combination run into difficulties; and (iii) the development and publication by the primary regulator of a regulatory plan for the new combination, detailing the resources required, where these resources would come from, and the methodology to be adopted in supervising the proposed entity.

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INTRODUCTION

In November 2009 Citibank Korea, Inc., learned that it was almost alone in the universe: Standard & Poor’s (S&P) downgraded Citibank Korea (CK) to standalone status because S&P believed there was “uncertainty” about whether the United States government wanted CK’s parent, Citigroup, to provide its subsidiary additional financial support. Citigroup itself enjoyed an A- rating (instead of BBB-) precisely because of its own receipt of government assistance.1

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Clearly the markets recognize that the presence of government support or subsidy\(^2\) should factor into the pricing of a company’s cost of funds. The extent of only a portion of this subsidy has recently been estimated at about $34 billion per year.\(^3\) This subsidy does not include retroactive tax allowances received for the losses suffered during the recent financial crisis. Stimulus legislation enacted in 2009\(^4\) is reported to permit companies to deduct from taxes paid in earlier years the losses they suffered during 2008-09; this benefit is particularly valuable to financial institutions, such as JP Morgan Chase & Co., that took over others that were failing, such as the huge thrift, Washington Mutual.\(^5\) Research even suggests that financial institutions have paid as much as $14 billion in additional merger premiums to acquire the status of too-big-to-fail (TBTF) and enjoy the public subsidy this status in effect accords.\(^6\) The existence of 30 or

\(^2\) This support comes not only from the implicit guarantee that the institution will not be allowed to fail, but also from other sources of support such as membership of the Federal Reserve System (and therefore privileged access to liquidity), federal deposit insurance, and special accounting treatment. See, e.g., Kenneth Jones & Barry Kolatch, *The Federal Safety Net, Banking Subsidies, and Implications for Financial Modernization*, 12:1 FDIC BANKING REV. 1 (1999).


\(^5\) See Scott Thurm & Dan Fitzpatrick, *Tax-Break Battle Flares*, WALL ST. J. Mar. 24, 2009, available at [http://online.wsj.com/article/SB10001424052748704896104575139830746680218.html](http://online.wsj.com/article/SB10001424052748704896104575139830746680218.html) (reporting that, in the case of JP Morgan Chase & Co., the value of this tax break could be as high as $2.6 billion because the company may be permitted to deduct losses incurred by Washington Mutual, which Morgan took over, against taxes paid in prior years. HSBC holdings would benefit by as much as $1.6 billion).

more such large financial institutions, viewed in the light of the damaging events of the past few years, adds fury to the debate over whether financial institutions should be constrained by size.

In the aftermath of the massive financial crisis the world has recently experienced, it seems anomalous that United States (US) policy makers would continue to tolerate a situation in which a heavily subsidized industry is able to produce great profits, a very large proportion of which are then paid out in the form of unprecedented levels of executive compensation, while enjoying government (i.e., US taxpayer) backup. In the specific context of the US, we have reached this situation because we have recklessly permitted the rapid growth of highly complex financial institutions—universal banks—without adequately tending to the risks these institutions

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7 See, e.g., Patrick Jenkins & Paul J. Davies, Thirty financial groups on systemic risk list, FIN. TIMES Nov. 29, 2009, available at http://www.ft.com/cms/s/d7c3f24-dd19-11de-ad60-00144feabdc0.dwp_uuid=f5d27f8a-a517-11dd-b4f5-000077b07658.print=yes.html. Two senior reserve bankers estimated that by October 2001 at least 34 banking conglomerates around the world should be considered large complex banking organizations (LCBO) and therefore closely correlated with TBTF: GARY H. STERN & RON J. FELDMAN, TOO BIG TO FAIL: THE HAZARDS OF BANK BAILOUTS 39 (2004). The current “list” includes at least five United States commercial and investment banks, see Jenkins & Davies, supra, and the “real list” might well be much longer because regulators do not openly acknowledge which financial institutions would not be allowed to fail. For the breadth of the potential TBTF problem in Europe, see the interactive graphic in the FINANCIAL TIMES at http://www.ft.com/cms/s/0/61d7e148-8f15-11dd-946c-0000779fd18c.dwp_uuid=9c837faa-0087-11dd-a0c5-000077b07658.html. For an attempt to quantify the means of identifying TBTF institutions, see James Kwak, Who Is Too Big To Fail? (unpublished paper on file with the author and cited with permission).

8 For a short outline of the central issues in this debate, see Lawrence Baxter and Terence Hynes, Resolved: the federal government should ensure that no firm is too big to fail, in DEBATING REFORM: CONFLICTING PERSPECTIVES ON HOW TO FIX THE AMERICAN POLITICAL SYSTEM ch. 19 (Richard J. Ellis & Michael Nelson, eds., 2010). See also, e.g., SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN 153-88 (2010). Innumerable views have been expressed at all levels and on both sides of this debate by regulators, policy experts and bank CEOs. At long last, after a highly implausible denial before a congressional oversight committee by a senior Treasury official that TBTF operates (see Michael R. Crittenden & Matthias Rieker, Clash over ‘Too Big to Fail’, WALL ST. J. Mar. 4, 2010, available online at http://online.wsj.com/article/SB10001424052748704187204575101511215418730.html?mod=WSJ_hps_LEFTWhatsNews), the Chairman of the Federal Reserve System has acknowledged that the TBTF guarantee is a “pernicious” problem. See Ben S. Bernanke, Preserving a Central Bank Role for Community Banking (speech to the Independent Bankers of America, March 20, 2010, available online at http://www.federalreserve.gov/newsevents/speech/bernanke20100320a.htm).

9 It has been estimated that “substantial ‘rents’ above and beyond what would have been required to call forth the services of equally intelligent, well-trained individuals” are included in the compensation paid to financial industry employees, and that bonuses in the financial industry constitute a very substantial proportion of the total profits earned by the industry. See F. M. Scherer, A Perplexed Economist Confronts ‘Too Big to Fail,’ at 3 & Fig. 4 (unpub. paper available at http://law.fordham.edu/assets/CorporateCenter/Scherer_-_Perplexed_Economis.pdf). Compare also Thomas Philippon & Ariell Reshef, Wages and Human Capital in the U.S. Financial Industry: 1909-2006 Working Paper 14644 (Nat’l Bureau Econ. Res. Dec. 2008, available online at http://www.nber.org/papers/w14644.pdf (estimating rents—i.e. compensation over and above what might otherwise be generated by normal competition—in financial sector compensation from the mid-1990s to 2006 to run at between 30% - 50% when compared with the rest of the private sector).
generate, their own ability to manage these risks, or our regulatory capacity to monitor them. This situation is the premise upon which major reform efforts are underway in the US and around the world. Many of these efforts will take years to complete, if they are successful at all. In the mean time there are actions that can be taken to ameliorate the situation. This article targets the origins of the situation and what might be done in the near term.

Part I focuses on the emergence of extremely large and complex financial organizations (LCBOs) and concludes that extremely large financial organizations are not yet likely to have developed operations and management infrastructure that can reliably manage the risks involved. American universal banks are a very recent, precipitous development. The growth of the managerial infrastructure necessary to operate them safely was inhibited (rightly or wrongly) for more than six decades by the application of the Glass-Steagall Act. The decade since the hasty repeal of Glass-Steagall by the Gramm-Leach-Bliley Act is too brief a period within which to expect the full development of this infrastructure. The task of building necessary infrastructure for such complex organizations in so volatile a market as financial services is exceedingly difficult and will take a long time.

Part II develops the view that the regulatory system is not ready to supervise such organizations. The public subsidy enjoyed by insured depository institutions and other TBTF financial institutions demands a regulatory infrastructure able to cope with the complexity of modern universal banking. Far from building a regulatory infrastructure to match escalating complexity in operations and risk, we have degraded the one that already exists and relied upon inadequate surrogates in the hope that disasters can be avoided. In order to cope with very large universal banks, the regulatory infrastructure would have to become much more sophisticated. To be effective, this also implies that the regulation of LCBOs would have to be consolidated. This implication is tentatively addressed in Part IV of this article.

Part III advances the view that the risks of failure for these organizations are so great that we cannot safely rely on either the market or the regulatory system to confine the harms of failure to the organizations themselves. The historical success, in so many non-financial industries, of the American diversified conglomerate does not necessarily portend similar
success—at least without serious additional complications—in the realm of financial services. The role of financial institutions in the economy is much more complex and carries far greater dangers than is the case with other industries. The ramifications of the presence and growth of extremely large, diversified financial institutions are still not fully understood and they need to be before we can assume that large universal banks are safe.

Part IV turns to solutions. A fundamental requirement for the proper regulation of LCBOs is the creation or anointment, in the United States, of a regulatory agency with sufficient prestige, resources and capability that could focus on developing an adequate framework for universal banking and the resources for its safe and effective supervision. One such possibility has been incorporated into reforms pending in a bill before the United States Senate Committee on Banking, Housing and Urban Affairs, which would place the Board of Governors of the Federal Reserve (the “Fed”) squarely at the center of large, complex banking regulation.10

Fixing the framework properly might, however, take many years. This article leaves to other forums the continuing debate about regulatory structure and offers, instead, some practical, prophylactic regulatory steps that could be taken immediately by regulators, even without statutory authorization. These actions would be triggered at moments of further, potentially unsafe expansion by financial institutions. In effect, such steps would impose modified regulatory approval requirements for any new merger between financial institutions. Under these proposals, regulatory approval for mergers between financial institutions would have to be accompanied by:

1. *Integration and operation plans*, developed in detail by the institutions seeking approval and made binding in memoranda of understanding;

2. *Resolution plans*, also developed by the institutions that are proposing to merge, to anticipate the possibility of future failures by the new combinations; and

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10 Title III of the bill pending before the Senate Committee, S. ____ , entitled the “Enhancing Financial Institution Safety and Soundness Act of 2010,” would make the Fed the primary regulator of all bank holding companies with depository institutions (i.e. banks) having assets greater than $ 50 billion. Savings association holding companies with the same size assets would also fall under Fed jurisdiction. According to the NATIONAL INFORMATION CENTER, there are about 32 such organizations in the United States as of the date of writing. See http://www.ffiec.gov/nicpubweb/nicweb/Top50Form.aspx. The AMERICAN BANKER lists about 38 (see online at http://www.americanbanker.com/rankings/bt-most-assets-1014159-1.html).
3. **Regulatory plans**, prepared by the lead regulators for the new combinations, detailing the anticipated methods and costs of adequate regulation.

**I. EVOLUTION OF THE AMERICAN UNIVERSAL BANK**

A universal bank is one that provides a diversified range of financial services to its customers and clients and operates on a very large scale. These services range from retail and commercial banking to investment banking, brokerage and trading, advisory, asset management, insurance, derivatives, private banking, proprietary trading and investing (hedge funds), and more. A universal bank stands in contrast to a specialized financial institution such as a credit card company or a standalone retail bank, though universal banks might well own such specialized institutions within their holding company structure.

**A. THE DIVERSIFIED BUSINESS ENTERPRISE**

This diversified model emulates the one deployed by many of America’s greatest companies, past and present: Du Pont, IBM, Standard Oil (now Exxon), General Motors, General Electric, and more. These diversified conglomerates represented, and in some cases still represent, some of America’s greatest economic triumphs, contributing to the development and refinement of what has been called the “modern multiunit business enterprise,” powered not only by huge potential markets but also by sophisticated “competitive managerial capitalism.”

Such companies succeeded in capturing economies of scale and scope that reduced unit costs,

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11 This article equates LCBOs and American universal banks, and delineates these institutions as ones having $500 billion or greater in average assets, a size that coincides roughly with the scale reached among the megamergers across the financial industry that occurred once commercial and investment banks and insurance companies were permitted to affiliate. See infra text accompanying notes 45-50.


15 Economies of *scale* result from the ability to leverage a business across greater numbers of customers, or across greater firm infrastructure, thereby reducing unit the cost of service or product and increasing profits. Economies of *scope* are those that can be secured as a result of the *combination* of businesses. In other words, being able to run one business in combination with another generates *synergies*. 
made products more affordable, and provided the space to make them better. They refined production and distribution to unprecedented levels, and they developed management infrastructures capable of coordinating the complexity of these new industrial forms.\textsuperscript{17} It took many decades to refine the complex managerial structures, methods and operations necessary to support these mammoth, diversified organizations.

Notwithstanding the admiration the great American diversified conglomerate have earned, it is not entirely clear that their “greatness” is always as clear as popular mythology would have us believe. In one of the most sophisticated empirical studies of firms that have consistently outperformed in the marketplace, Professor Jim Collins expresses substantial skepticism about diversified conglomerates: “Our study strongly suggests that highly diversified firms and conglomerates will rarely produce sustained great results.”\textsuperscript{18} We turn to consider whether it could be possible for universal banks to outdo their non-financial counterparts. So far the evidence suggests otherwise.\textsuperscript{19}

B. BUILDING BANK SCALE

1. Arrested Development

There were nascent parallels in the financial industry, such as JP Morgan & Co., but their evolution more or less came to a halt with the passage of the Glass-Steagall Act in 1933.\textsuperscript{20} It was believed that investment banking activities (involving the underwriting of securities) by commercial banks (whose traditional business is involved investing in assets such as loans, not investing in securities) had contributed to the Great Crash of ’29, and that the combination of commercial and investment banking created dangerous conflicts of interest.\textsuperscript{21} So Glass-Steagall

\begin{footnotesize}
\begin{enumerate}
\item The classic studies on the rise of competitive managerial capitalism in American history are by the late Alfred D. Chandler, Jr. See his SCALE AND SCOPE, supra note 14; THE VISIBLE HAND, supra note 13; and STRATEGIES AND STRUCTURE: CHAPTERS IN THE HISTORY OF THE AMERICAN INDUSTRIAL ENTERPRISE (1969).
\item See JIM COLLINS, GOOD TO GREAT: WHY SOME COMPANIES MAKE THE LEAP ... AND OTHERS DON’T 215 (2001). Professor Collins continues: “One obvious exception to this is GE, but we can explain this case by suggesting that GE has a very unusual and subtle Hedgehog Concept [i.e. single focused vision] that unifies its agglomeration of enterprises. What can GE do better than any company in the world? Develop first-rate general managers.” Id.
\item See infra text accompanying notes 38-45.
\item Banking Act of 1933, 48 Stat. 162.
\end{enumerate}
\end{footnotesize}
erected a wall between the two industries that lasted for 66 years and largely prevented further development of the sophisticated management infrastructure and corresponding regulatory framework necessary to operate safely a wide array of diversified, large scale financial services. Unlike many foreign counterparts, American banking was largely, though not entirely, confined to specialist, separate forms.\(^\text{22}\) The retail versions were already locked within small geographic regions through the operation of the McFadden Act of 1927.\(^\text{23}\) Only specialist financial institutions not impeded by geographical limitations or based in very large commercial centers, such as money center and investment banks and insurance underwriters, were able to achieve much scale, let alone scope.

2. Technology and Waning Geographic Constraints

As technology developed and geography seemed less and less relevant, American retail banks began to realize the opportunities to be gained by access to consumer markets new regions. Once regional markets were broken open through a patchwork of regional state compacts, the constitutionality of which was upheld by the United States Supreme Court in 1985,\(^\text{24}\) many banks were able to demonstrate that greater economies of scale might be attained via geographic expansion, albeit within the constraints of a costly holding company/subsidiary framework.\(^\text{25}\)

3. Efficiencies of Scale?

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\(^{22}\) Foreign banks have even been permitted to operate as universal banks to a certain degree within the US. This lack of parity between foreign and US banks has been one of the motivators for permitting US banks to diversify into investment banking and insurance. The lack of parity was also a driving force behind the enactment of the International Banking Act of 1978, Pub. L. 95-369 (1978), which was designed to bring some order and competitive parity to US regulation of foreign banking within the US. See, e.g., CARL FELSENFELD, INTERNATIONAL BANKING REGULATION 20-21 (2 ed. 2007).

\(^{23}\) Pub. L. 69-630 (1927).


\(^{25}\) A subsidiary, as opposed to a branch, is separately capitalized and regulated. If a bank is required to enter a market through a subsidiary, it must pay an acquisition premium (to buy a bank in the new region) or, if permitted, establish a new, separately capitalized bank. The size of the subsidiary acts as a constraint on the scale of business the bank may conduct from that unit. If able to enter via a branch, the bank avoids these costs and can, for example, leverage the capital of the whole bank for extending credit in the new market.
In 1994 piecemeal geographic deregulation, gave way to major reform with the passage of the Riegle-Neal Interstate Banking and Branching Efficiency Act.\textsuperscript{26} This legislation in effect paved the way for much more efficient branch (as opposed to subsidiary) networks. Branch networks, operating on improving technology platforms, allowed for greater economies of scale.\textsuperscript{27} Once banks were permitted to open branches in new states, or convert the banks they acquired in such states into branches within their existing branch systems, they were also able to save supervision costs by interfacing with one set of regulators as opposed to separate regulators for each subsidiary, and increase their lending power by leveraging the capital of the common bank.

Studies during the early stage of this development suggested that banks quickly exhausted such economies of scale.\textsuperscript{28} Later research, however, appeared to indicate that it would only be a matter of time until retail and commercial banks, which most needed geographic deregulation, would figure out how to develop large-scale, efficient distribution across broad geographic networks.\textsuperscript{29}

The realization of such efficiencies at very large scale, however, still appears to be a long way off. Commercial and retail banks measure use as a measure their “efficiency ratio,” which

\textsuperscript{26} Pub. L. 103-328 (1994).
\textsuperscript{27} For example, expensive automated general ledger systems could be leveraged across a greater customer base. A bank might be able to use the same modular format for branches (“model branches”) across larger geographic expanses, thereby reducing planning costs and enabling bulk contracts. One head office might supervise many more branches in new regions. Only one board of directors is needed for the system as a whole. For studies of the effects of these economies, see, e.g., Allen N. Berger & Robert DeYoung, \textit{Technological Progress and the Geographic Expansion of the Banking Industry}, 38:6 J. MONEY, CREDIT & BANKING 1483 (2006); Allen L. Webster, \textit{The Impact of Technological Change on Bank Performance}, 21:3 J. ECON. & FIN. 41 ((1997); Sherrill Shaffer & Edmond David, \textit{Economies of superscale in commercial banking}, 23 APP. ECON. 283 (1991); William C. Hunter & Stephen G. Timme, \textit{Technical Change, Organizational Form, and Structure of Bank Production}, 18:2 J. MONEY, CREDIT & BANKING 152 (1986).
\textsuperscript{28} The Shaffer & David study, \textit{supra} note 25, considered “superscale” (at which banks could perhaps reach unprecedented economies of scale) to involve banks of between $15 billion and $37 billion in total assets—a far cry from the $2 trillion asset banks we now have less than two decades later. \textit{Compare} David C. Wheelock & Paul W. Wilson, \textit{New evidence on returns to scale and product mix among U.S. commercial banks}, 47 J. MONETARY ECON. 653 (2001) (finding economies exhausted at the $300 - $500 million in assets, with “some” evidence that efficiencies could be attained up to the $1 billion level).
is the ratio of expenses to revenue. An “efficient” bank, for example, will have a lower efficiency ratio in a range below about 60%. While rapid increases in scale will always tax the abilities of managers, the geographic extension of specific businesses that managers already knew well is not insurmountably difficult and geographic consolidations (market extension mergers) appear to be realistic methods of enhancing efficiency when based on the right technology platforms.

In the case of large-scale banks with average assets between $100 billion and $500 billion the data does seem to suggest that during a period in which bank consolidations were able to focus on refining their infrastructures and delivery systems they were able to gain significant efficiencies of scale. The author’s research identifies an eight point improvement in the average efficiency of such banks during the period 2000 to 2003, during which time many banks that had expanded geographically and within market but had remained focused on traditional banking activity were able to consolidate branches, supplement physical delivery with electronic delivery, and refine back office operations. Indeed, banks within the $100 billion to $500 billion average asset range appeared able to deploy larger distribution networks and technology platforms even to outperform smaller banks.

C. UNIVERSAL BANKS

30 The efficiency ratio should be carefully distinguished from return on average assets and return on average equity, and it is not necessarily a measure of profitability. The significance of the ratio for investors must be determined within the overall context of business mix, degree of leverage, and other factors that might well make a financial institution very profitable despite a poor efficiency ratio.

31 Banks exclude net interest cost as an expense beyond their control.

32 Evidence relating to cross-border mergers involving market extensions also suggests that scale economies in traditional banking are also attainable, particularly if efficient banks are able to extend their operations to inefficient targets. See Donald R. Fraser & Hao Zhang, Mergers and Long-Term Corporate Performance: Evidence from Cross-Border Bank Acquisitions, 41 J. MONEY, CREDIT & BANKING 1503 (2009).

33 This is not the case, however, for even larger, universal banks, where diseconomies of scope appear to outweigh any gains in economies of scale. See infra text accompanying notes 37-42.


35 Efficiency ratio data shows that smaller banks struggled to remain efficient in the face of their larger ($100-500 billion) competitors as the latter began to exploit their larger distribution networks and greater technology investment. See infra Appendix, Chart 1.
The rise of universal banking is a different story.\textsuperscript{36} The idea is attractive to bankers because it suggests the possibility of economies of \textit{scope}, attainable through “one-stop shopping” and the ability to provide a wide array of products to the bank’s customers.\textsuperscript{37}

1. Efficiencies of Scope?

Yet universal banking also presents the challenge of diseconomies of scope. Evidence suggests that this challenge has proven greater than that of mastering economies of scale,\textsuperscript{38} and that this might also be the case even beyond US shores where the tradition of universal banking is more established.\textsuperscript{39} The average efficiency ratio of ultra large banks with assets greater than $500 billion has remained consistently substantially higher (i.e. worse) than that of smaller counterparts. With the exception of a brief period from 1998-2000 before their not-so-large counterparts (i.e., assets <$500 billion) were able to consolidate deliver networks and implement

\textsuperscript{36} The Wheelock & Wilson study, \textit{supra} note 34, fails to draw a distinction between traditional commercial banks and universal banks, yet the distinction is a vital one: while technology can drive economies across larger customer and product bases, it is a different question entirely whether economies can be driven across \textit{disparate} businesses and systems. \textit{See also} the refutation of data relied upon by a leading American proponent of universal banking, Professor Calomiris, for his assumption that universal banks are more efficient than niche counterparts: Charles Calomiris, \textit{In the World of Banks, Bigger Can Be Better}, WALL ST. J., Oct. 19, 2009, available at \url{http://online.wsj.com/article/SB10001424052748704500604574483222678425130.html?KEYWORDS=Calomiris#.articleTabs%3Darticle; contra JOHNSON & KWAK, \textit{supra} note 8, at 211-12)

\textsuperscript{37} \textit{See, e.g.}, Sherrill Shaffer, \textit{Scale Economies in Multiproduct Firms}, 36:1 BULL. ECON. RESEARCH 51 (1984). The ability, for example, to offer deposits, mutual funds (securities) and annuities (insurance) to savers and investors widens the array of choice to the customer and provides “one-stop shopping,” which, it is hoped, will enable a bank to gain greater “share of wallet” and therefore more profits per customer. One of the leading American proponents of universal banking relies on the supposed advantages of great scale combined with broad scope as an important reason to permit universal banking. \textit{See} CHARLES W. CALOMIRIS, U.S. BANK DEREGULATION IN HISTORICAL PERSPECTIVE at 215, 267, 342 (2000).


\textsuperscript{39} \textit{See} Gianni De Nocoló, \textit{Size, Charter Value and Risk in Banking: An International Perspective}, International Finance Discussion Paper # 689 (Bd. Gov. Fed. Res. Sys. 2000) (“Size-related diversification benefits and/or economies of scale in intermediation are either absent or, if they exist, are more than offset by banks’ higher risk taking . . . absent future structural changes in the fundamentals of technologies and incentive structures in banking markets in developed countries, bank consolidation is likely to result in an average increase in banks’ insolvency risk”).
other efficiencies, the ultra large financial institutions have demonstrated significantly poorer efficiency ratios than the next-largest, generally less “universal” tier of financial institutions. This would suggest that without substantial leverage such behemoths could not possibly be as profitable. Nor does there appear to be much improvement in service levels. The recent, authoritative AMERICAN CONSUMER SATISFACTION INDEX (ACSI) shows a continuing decline in retail customer satisfaction on the part of very large bank customers, which are far outperformed by their smaller counterparts.

2. Siren Song From Abroad

Once able to construct or acquire much larger, more efficient branch networks and operations, many “super-regionals” had entered a golden era of prosperity. Yet, despite their vastly additional business complexities, the siren calls of the mammoth foreign universal banks in Germany, Switzerland, France, Britain, Japan and Canada rang ever more loudly in the ears of the leaders of American finance. Pressure to dismantle the Glass-Steagall framework and permit combinations across industry lines in financial services became relentless in the late 1990s. Eventually repeal was precipitated by the dramatic announcement in April 1998 of a merger between Travelers Group and Citicorp. Faced with the fait accompli of this new universal bank in America, Congress passed and President Clinton signed into law the Gramm-

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40 See supra text accompanying notes 33-34; and Appendix, chart 1.
41 See infra Appendix, chart 1. This is also the view of experienced commentators in the industry. See, e.g., Peter Thai Larsen, Global, Universal, Unmanageable? Why many are wary of bank mega-mergers, FIN. TIMES, Mar. 29, 2007 (available online at http://www.ft.com/cms/s/0/403af614-dd92-11db-8d42-000b5df10621.html). See also the reviews of efficiency studies by JOHNSON & KWAK, supra note 8, at 211-13; Scherer, supra note 9, at 12-13.
42 For return on average equity, see infra Appendix, chart 2.
44 Between 2001 and 2006, the second tier ($100-500 billion assets) experienced dramatic improvements in their profitability. See infra Appendix, chart 2.
45 The discussions regarding universal banking in the US made specific reference to the supposed advantages enjoyed by foreign universal banks. See, e.g., CALOMIRIS, supra note 37, at 267-70. Compare BENTSTON, supra note 12, at 179-214; For a more conservative analysis, see Saunders & Walter, supra note 12, at 4-9.
Leach Bliley Act in 1999.\textsuperscript{47} The era of American universal banking was born,\textsuperscript{48} driven by a hopeful pursuit of economic efficiency\textsuperscript{49} and perhaps even more by a determination to be able to “compete” with foreign counterparts.\textsuperscript{50} A major change in the structure of US financial services organizations immediately took place, shaped by a series of “mega-mergers” within the broader industry.\textsuperscript{51} Within a few short years we found ourselves with a number of major universal banks.\textsuperscript{52}

**D. BUILDING UNIVERSAL BANKS**

In 2006 the CEO of one of its most successful exemplars, Wachovia Corporation, celebrated the new model:\textsuperscript{53}

[T]here is great value in the universal bank model for both customers and shareholders. . . . [I]t is not an easy model to execute, but if you can knit disparate businesses together in a way that brings great value to customers, you will undoubtedly also deliver exceptional value to shareholders. . . . Done right, size enhances competitive power. . . . [A] universal bank . . . has much more to offer customers. . . . With economies of scale, a company can better afford the technology and longer branch hours that customers demand.


\textsuperscript{48} Professor Macey notes some minor limitations on the post-Gramm-Leach-Bliley model as compared with European universal banking, see id. at 721-22, but these differences are immaterial to the present discussion.

\textsuperscript{49} Perhaps a classic triumph of hope over experience: see supra text accompanying notes 38-43.

\textsuperscript{50} The “unfair” competition posed by foreign universal banks featured prominently in advocacy favoring reform of Glass-Steagall.

\textsuperscript{51} See DeYoung, Evanoff & Molyneux, supra note 27, at 89-90 (charting the rapid intrasectoral consolidation of US banks, insurance companies and securities companies, particularly during the 1997 – 2001 era).

\textsuperscript{52} See Id. 90-92 (charting the spike in cross-sector financial firm consolidation).

\textsuperscript{53} Speech by G. Kennedy Thompson, CEO of Wachovia Corporation, to the Federal Reserve Bank of Chicago’s Bank Structure Conference, May 18, 2006, as reported by Barbara A. Rehm, Wachovia Chief’s Vision: Handful of Dominant Firms, 171:96 AM. BANKER May 19, 2009. Ironically, these comments were made just a few days after Wachovia’s acquisition of Golden West, which ultimately led directly to Wachovia’s own demise because the risk management of the Golden West loan portfolio had failed to take into account changes in borrower behavior following the collapse of real estate values in California in 2007-08.
But therein lies the rub: “it is not an easy model to execute.” So within the span of this past decade the new universal banks set about developing their management infrastructure—sometimes even self consciously borrowing from great counterparts outside of financial services such as Motorola and General Electric. These companies had pioneered and successfully deployed a rigorous management performance system known as Six Sigma, for example; some large financial companies, including most prominently Bank of America, also enthusiastically invested in Six Sigma training for their workforces.

1. “Hyper-Combination”

This effort to develop American universal banks took place, however, amidst the chaos of hasty growth propelled by sudden, game-changing mergers among widely disparate players across the financial industry. Results were sometimes disastrous, as was demonstrated by the Citigroup. The denouement of the Travelers/Citicorp merger illustrated well the enormous challenges and risks involved with these combinations: the combination collapsed only four years after its creation and at least in part as a result of the dramatically different management styles and cultures between the two constituents.

54 Writing on the eve of the repeal of Glass-Steagall, Professor Canals presciently observed that “[t]he chief problem facing universal banks in the 1990s is the tremendous complexity that universal banks must deal with when operating in businesses which, while sharing as common denominator the provision of financial services, differ considerably in their internal dynamics and distinctive features. Basically, the most important challenge a commercial bank must face in the 1990s is that of increasing management complexity, a challenge that is heightened by the competition from banks specializing in certain businesses.” CANALS, supra note 12, at 82.

55 Six Sigma, one of many performance management strategies, is a quality management system that identifies shortcomings in business processes that cause defects in product or service delivery and then applies improvements across production to achieve near error-free business performance. In particular, the methodology focuses on improving the capabilities and discipline applied by people who manage and operate the processes. See generally, e.g., THOMAS PYSEK & PAULL KELLER, THE SIX SIGMA HANDBOOK 3 (3 ed. 2010) (the leading manual for Six Sigma training).


57 See supra text accompanying notes 46-47.

58 For a general review of the collapse of the Traveler’s-Citi combination, see, e.g., Eric Dash, A Stormy Decade Since Travelers Merger, N.Y. TIMES Apr. 3, 2008, available at http://www.nytimes.com/2008/04/03/business/03citi.html). The Co-Ceo of the ill-fated Citigroup combination, John Reed, now believes the combination “created a monster.” See Rob Blackwell, Joe Adler & Steven Sloan, Older and
It is important to reiterate that diversified combinations among financial institutions occurred through rapid, complex growth, or what might be termed “hyper-combinations.” This process of sudden, jump-shift growth exacerbated the already daunting challenges facing diversified large universal banks. While it is dangerous and even misleading to generalize, companies that grow organically and carefully over long periods of time tend to extend their core competencies in a manner that does not introduce significant new leadership and management challenges, demand the hasty acquisition of new skill sets, or the wide-ranging displacement of valuable and experienced, yet suddenly cost-redundant, employees from acquisition targets. Nor does organic growth commonly introduce major cultural conflicts into the growing organization. Dominant technology platforms can often be leveraged because the existing ones are already designed for the kinds of businesses being added to the growing enterprise.

Hyper-combinations, on the other hand, involve sudden, dramatic growth and adjustment for the enterprise as a whole. The organization undergoes substantial shocks in many directions. This experience generates whole new layers of risks and points of potential failure across the realms of management, operations, and technology.

The descriptions that follow, which are based on the author’s direct experience and observations within the consolidating banking industry (and are not confined to his own former employer), touch on the discipline of organizational theory and design, about which there is a large literature. For some classics in the field, see, e.g., JAMES MARCH & HERBERT SIMON, ORGANIZATIONS (2 ed. 1993); GARETH MORGAN, IMAGES OF ORGANIZATION (2006); AND CHARLES PERROW, COMPLEX ORGANIZATIONS: A CRITICAL ESSAY (3 ed. 1986).

See EDITH T. PENROSE, THE THEORY OF THE GROWTH OF THE FIRM (rev. ed. 2009) (describing the role of organic growth in lasting organizations). Professor Penrose’s work is the classic study of the limits of organic growth, the advantages of growth by merger and acquisition, and the important distinction between the growth of the firm as a whole and the growth of the plant.

As Professor Penrose observed, “empire building” can serve an important function when it is designed to acquire the capabilities for further business expansion. See id., at 163-66. But important decisions must be made: for example, it is easier to expand the physical platform of a business than the management capacity to lead a complex and diversifying business, and it is sometimes very important to make an acquisition to acquire new talent and capability. The question is how carefully and thoughtfully the choices can be made and executed. See id., at 78-89 (discussing the relationship between “technological economies” and “managerial economies”).

For a general review by a leading business authority of how even once-great companies can fail as a result of human foibles, see JIM COLLINS, HOW THE MIGHTY FALL (2009).
2. Internal Politics, Culture Clashes and Executive Capabilities

For hyper-combinations, the core leadership and management of the acquiring institutions are often exposed to new businesses very different from those with which they are familiar. For example, if the merger is based on an ambition to cross-sell products across banking and securities platforms and on a very large scale, a traditional banker might be the surviving executive for a new business division yet might also have to become familiar with the brokerage business. Biases driven by corporate politics rather than assessments based on merit tend to govern assignments in new combinations, as victorious executive teams prefer to retain trusted and loyal managers and those who are not chosen are recruited away by competitors. It is not uncommon to see bankers with experience in one kind of banking being placed in charge of very different, major business units. Even within their traditional fields of expertise, executives and managers can be plunged overnight into far greater and more complex scale businesses than those within which they might have spent the greater portions of their careers. The learning curves can be very steep.

Other factors also challenge the development of the right kind of management for large universal banks. Executive compensation costs can escalate out of proportion to the increased size of the combination, often driven by a vanity that the recipients are performing at vastly increased levels in the new environment. Studies indicate that executives caught up in the swirl of exponential corporate growth can often overestimate their capabilities. Agency costs become almost unavoidable, leading to detachment and abstraction in the executive suite. The combination of detachment, diversity, scale, even hubris, and an increasing reliance on pseudo-

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63 It should not be assumed that just because the various components of the business have to be structured within different legal entities that the business itself is organized that way. A business executive might well find herself in command of a cluster of legal entities, all compliant with the law yet nevertheless pursuing a common market objective.

64 See DeYoung, Evanoff & Molyneux, supra note 27, at 95 (citing studies that indicate increases in compensation driven more by empire building than value creation). Another type of vanity—corporate envy—has also been postulated in a recent study: see Anand M. Goel & Anjan V. Thakor, Do Envious CEOs Cause Merger Waves? 23:2 REV. FIN. STUD. 487 (2010).

65 See id. See also R. Roll, The Hubris Hypothesis of Corporate Takeovers, 59 J. BUS. 197 (1986).


scientific management reporting systems, lead to an illusion of control in which measurement becomes a substitute for actual management.68

Potential flaws can show up at different levels within the new organization. To maintain coherence, every large company must evolve its own corporate culture. Yet large horizontal acquisitions are likely to bring very different cultures into collision, some highly risk-averse and others very risk-taking. A merger can run aground on the rocks of radically conflicting cultures of commercial and investment banking.69 The separation of commercial and investment banking under the Glass-Steagall framework probably intensified a distinction in cultures between the two industries, with “traditional” commercial banking breeding over the six decades a fairly conservative, risk-averse culture even as investment banking encouraged a culture that ultimately “rewarded excessive risk taking and leverage.”70 In hyper-combinations among these industries the attempts to create a single corporate culture—necessary in order to realize the “synergies” upon which the combination is premised—have usually involved the suppression of the culture of the target acquisitions or the pressure-cooked illusion of a new culture. Senior and middle management in the target companies are vulnerable to being displaced to make way for the management teams of the victorious acquirer. At the highest levels, commercial bankers can be placed in charge of investment banking or large brokerages. At intermediate levels havoc can be wrought: indeed, the corporate layoffs and early retirements necessary to achieve the “cost synergies” supporting the combinations often reach massive scale. This creates significant loss of intellectual capital to the residual institution.71 Blows to morale can even lead to increased

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68 See also James Montier, Was it all just a bad dream? Or, Ten Lessons Not Learned, WHITE PAPER (GMO Feb. 2010, available at http://www.scribd.com/doc/27051632/GMO-Was-It-All-Just-a-Bad-Dream-or-Ten-Lessons-Not-Learnt-James-Montier) (“[w]henever calculus is brought in, or higher algebra, you could take it as a warning that the operator was trying to substitute theory for experience,” quoting Ben Graham). Mr. Montier is a highly regarded investment banker; he also notes Keynes’ warning against over-quantification and proposes that we abandon our obsession with quantification in favor of trying to understand the true nature of the risks involved.

69 See also the reporting on Mr. Reed’s views concerning the Travelers’/Citicorp merger, supra note 58.

70 Report of Anton R. Valukas, Examiner, In re Lehman Brothers Holdings Inc., vol. 1 at 3 (Chapter 11 Case No. 08-13555(JMP), U.S. Bankruptcy Court S.D.N.Y. Mar. 11, 2010)

71 See DAVID W. DELONG, LOST KNOWLEDGE: CONFRONTING THE THREAT OF AN AGING WORKFORCE 223 (2004) (“In the past 20 years endless rounds of downsizing and reorganizations have encouraged early retirements and other departures to enable changes deemed essential by leadership (e.g., cutting costs, changing culture, pursuing new business opportunities). But these decisions have left many organizations dangerously thin in many areas of expertise.”). See also Lack of Knowledge Retention: The Hidden Cost of Corporate Downsizing, 14cp.com News, Feb. 2, 2009 (reporting on a study by the Institute for Corporate
silo behavior: instead of synergistic collaboration, employees faced with threat of displacement attempt to demonstrate their indispensability to the corporation. The impairment to the organization and various associated dysfunctions develop precisely at the moment that a more sophisticated management infrastructure should instead have been under construction.

3. Technology

Much is also presumed of the ability of large combinations to leverage technology platforms. Yet hyper-combinations involve bringing together multiple, diverse product lines and disparate businesses. These almost certainly run on different IT platforms, drawing off separate, self-contained and differentially coded databases that are usually highly customized for the specific products or businesses they support. Such incompatible platforms and databases either have to be run independently of each other, in which case they deliver few synergies and can even increase costs, or they have to be combined through difficult conversions into single platforms that are often not designed for some of the lines of business being migrated to them. In order to be brought into line with the needs of the new, much larger combination, technology platforms very often also require large-scale new capital investment. Almost certainly there will also be a need for new risk management systems. Yet cost efficiencies, which are often touted as the rationale of a merger, can militate against incurring new costs so capital investment must stand in line with other priorities (such as creating a new brand and culture and developing and attracting new executive talent). Significant underinvestment, as veterans of the merger IT engine rooms will attest, is thus not uncommon.

4. Outsourcing and Off-Shoring

Another shockwave also surged through financial services, particularly very large institutions, during the past decade: this is the outsourcing of just about any dimension of the business that previously had been performed internally. In its most complex form—off-shored outsourcing—the challenges faced by management have been stark indeed. Culturally


72 Because disparate technology platforms must be made to interoperate in order to ensure that the synergies of the diverse organization can be captured.
accustomed to building technology in-house, providing their own networks of distribution and processing, and managing their own employees, many large bank managers have had to acquire a whole new range of skills in order to deal with the complexity of multi-partner production. These skills include negotiations with outside parties instead of managing down the line, profit-sharing arrangements, 24x7 operations to follow the global clock, more complicated performance level and security arrangements, and so on, all the while having to enlist the assistance of employees who might be well aware that their assistance will have the ultimate effect of putting themselves out of jobs. Corporate leadership has had rapidly to acquire the skills of managing the fissures, fractures and complex new business process layers created by outsourcing within a diversified modern organization. In the process management has to become accustomed to leading enterprises that are as much complex networks as traditionally recognizable corporate entities.73

It is not the purpose of this article to argue that many of these challenges can never be met, or that they will always defeat attempts to extract efficiencies of scale and scope. It is that, even if success can be a realistic goal, much time, considerable energy, trial and error is needed, just as was the case over many decades for America’s nonfinancial industries, to achieve the level of sophistication necessary to ensure that the modern universal bank can be operated with safety and prosperity. Yet while Americans have been tolerant of failures in general industrial enterprise,74 mistakes made along the road to financial consolidation can have very serious consequences for the economy and Americans as a whole because the costs of learning by experience are inevitably externalized beyond the evolving financial institutions themselves.75

73 The pitfalls associated with outsourcing and off-shoring are well known to those with experience in these endeavors. See, e.g., David Brown, Top 10 Hidden Costs of Outsourcing, CIO/INSIGHT (Sept. 09, 2008, available at http://www.cioinsight.com/c/a/Bottom-Line/Top-10-Hidden-Costs-of-Outsourcing/).
74 See THOMAS K. MCCRAW, AMERICAN BUSINESS SINCE 1920: HOW IT WORKED (2 ed. 2009) at 253 (“American . . . were more forgiving of failure . . . and were remarkably tolerant of bankruptcy . . . in America [bankruptcy] was often regarded as a phase through which entrepreneurs routinely passed on their way to eventual riches”).
75 See further infra text accompanying notes 131-35.
II. LEARNING HOW TO REGULATE AND SUPERVISE AMERICAN UNIVERSAL BANKS

Government subsidization of American universal banks and consequential moral hazards reduce the incentives of market participants to monitor the health of financial institutions. This market failure strongly supports the proposition that prudential regulation is necessary to complement whatever partial discipline might be provided by the market. Regulation and supervision are necessary to compensate for market failures that can have an impact on the public when a financial institution fails. As American universal banks began to emerge at the beginning of the 21st Century, it was entirely appropriate to increase levels of regulation and develop much more sophisticated tools for supervision. Diverse financial institutions are exposed to an exponentially more complex universe of risk than their simpler

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76 As used in this article, “regulation” refers to the rules (legislation, regulations and “guidance”) establishing what banks can and cannot do, and “supervision” refers to the ongoing monitoring, supervision, and examination of specific financial institutions and specific actions (including enforcement) taken by regulators to address specific problems. Conceptually, regulation and supervision are distinct: both constitute complementary techniques for detecting and addressing business activities that threaten the safety, soundness and solvency of financial institutions. Each has its advantages and disadvantages. Regulation sets out rules upfront, such as capital and liquidity levels, leverage ratios, loan exposures, collateralization requirements, boundaries between permissible and impermissible products and services, accounting treatment and reporting. Supervision monitors the continuing activities of particular institutions to ascertain compliance, how institutions are being managed and whether they are being managed safely. There is a subtle difference between a “regulatory” approach and a “supervisory” one, in that the former tends to focus on compliance with advance rules and regulations whereas the latter focuses more on the actual risk generated by the specific portfolio of a bank and its current circumstances. In practice, however, these are differences of timing and degree: “regulation” and “supervision” tend to merge in their practical application because of the huge vagaries of specific circumstances and the need for discretionary evaluation. On the longstanding debate between rules-based and prudential-based financial regulation, see, e.g., Julia Black, Forms and Paradoxes of Principles Based Regulation, Working Papers 13/2008, (LSE Law, Soc. & Econ., available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1267722).

77 See supra text accompanying notes 2-6.

78 Moral hazard arises when one is protected against loss and therefore takes no precautions to prevent the loss from occurring. Hence depositors who are guaranteed deposit insurance have no incentive to monitor the health of their banks, while creditors who will be covered against loss because the debtor institution is prevented from bankruptcy as a result of a government bailout (i.e., institutions deemed TBTF) have little incentive to evaluate the creditworthiness of the debtor institution. For a discussion of moral hazard in banking, see HEIDI MANDANIS SCHONER & MICHAEL W. TAYLOR, GLOBAL BANK REGULATION: PRINCIPLES AND POLICIES 60-70 (2009).

79 As it has been put by an authority on universal banking, these banks “look more stable because they are more diversified, but in this diversification lies the problem.” Jordi Canalis, Universal banking needs careful monitoring, FIN. TIMES Oct. 19, 2009, available at http://www.ft.com/cms/s/0/95891156-9bd1-11dd-ac76-000077b07658.html. For an optimistic view that regulators would be up to the task, see Frederic S. Mishkin, Financial Consolidation: Dangers and Opportunities 23 J. BANKING & FIN. 675 (1999).
countertops: super-scale begets super-risks.\textsuperscript{80} Just as executives building new universal banks have much work to do in developing a management infrastructure to match, so too do regulators. Without a mutually balancing and a proportionally matched business-regulatory partnership, large universal banks pose great hazard to a system that cannot otherwise identify and understand their real dangers.

A. HURDLES FOR UNIVERSAL BANK REGULATION AND SUPERVISION

There is an enormous amount of work to do; yet in the United States we start out with a series of major challenges to this foundational enterprise.

1. Fragmented Regulatory Framework

The first obstacle stems from the meandering evolution of both the industry and the regulatory framework. Unlike many European counterparts, American universal banks have had to evolve within an extremely complicated industry framework, regulated on a piecemeal basis across various segments of the financial services industry.\textsuperscript{81} Separately spawned rules govern each sector. Laws and regulations, applied by multiple regulators at different levels of federal and state government, structure the way in which the overall business must be conducted. For example, a US financial conglomerate that engages in banking, securities and insurance must engage within frameworks set by federal banking laws and regulators, securities laws and regulators at both federal and state level, as well as by state insurance laws and regulators at state levels. To make matters worse, whole chunks of financial services activity—by so-called “shadow banks”—is largely beyond the purview of banking regulators.\textsuperscript{82}

\textsuperscript{80} For one graphical depiction of the matrix of risks that have to be addressed, see, e.g., Eric Lamarre & Martin Pergler, \textit{Risk: Seeing around the corners}, MCKINSEY Q. (Oct. 2008, available at \url{http://www.nealliance.com/images/resources/risk_seeingaroundthecorners_mckinseyquarterly_11-05-09.pdf}).

\textsuperscript{81} For a recent depiction of this regulatory maze, see Mark Jickling & Edward V. Murphy, \textit{WHO REGULATES WHOM? AN OVERVIEW OF U.S. FINANCIAL SUPERVISION}, CRS Rep. for Congress (Dec. 14, 2009, available at \url{http://assets.open CRS.com/rpts/R40249_20091214.pdf}).

\textsuperscript{82} For a recent analysis of this industry, see Raj Date & Michael Konczal, \textit{Out of the Shadows: Creating a 21st Century Glass-Steagall}, in \textit{MAKE MARKETS BE MARKETS} at 61-69 (ROOSEVELT INSTITUTE PROJECT ON GLOBAL FINANCE (2009, available at \url{http://makemarketsbemarkets.org/}). See also Jennifer S. Taub, \textit{What We Don’t Talk About When We Talk About Banking} (unpublished draft on file with author and cited with permission (discussing the repo, money market mutual fund and hedge funds industries).
This fragmented industrial framework and its accompanying regulatory mosaic is important because it highlights the under-developed nature of American universal banking and our present capacity to regulate such an industry. There is as yet no US equivalent to the European Financial Groups Directive, already implemented in Member States, to guide the supervision of financial conglomerates engaging in banking, investing and insurance. As the case of AIG demonstrates, coordinated supervision of large, diversified financial institutions ("conglomerates") is fairly new to US regulators and much less coordinated than is the case in Europe. Indeed, without legislative reform it is not fully possible for financial conglomerates to be comprehensively supervised in the United States.

2. Cultural Hostility to Regulation

The second difficulty in developing a business-regulatory framework is both cultural and ideological. The American love-hate relationship with "bigness," which creates the very environment that has nurtured and celebrated the emergence of large scale universal banking, has blended with a broad national distaste for regulation—ultimately with bad results. So we have simultaneously encouraged or at least acquiesced in the growth of very large-scale financial institutions and simultaneously failed to develop—indeed, even removed—brakes that might promote public safeguards against failures. Brakes were removed in the US before the system could even be figured out, let alone grow to maturity. We have followed a pattern typical of so
many countries in eras of financial liberalization and we have met with the same disastrous results.\textsuperscript{89}

During the past two to three decades, probably beginning with the Depository Institutions Deregulation and Monetary Control Act,\textsuperscript{90} the structure and activities of the financial industry have been successively liberalized and regulatory controls have been reduced. Large and expanding banks in the United States were given broad assistance by regulators to hasten their mergers, introduce new products and avoid state-based regulation. This is not to say that all regulatory barriers were eliminated. However, the effect of nationalizing consumer protection,\textsuperscript{91} introducing fast-track merger and new activity approval processes or even eliminating them altogether,\textsuperscript{92} redefining markets concentration limits to reduce the bite of antitrust enforcement,\textsuperscript{93} and substituting bank-style regulation for that traditionally provided by other sometimes more restrictive regulators,\textsuperscript{94} was to make it much easier for universal banks to form quickly and

\textsuperscript{89} See, e.g., CARMEN M. REINHART & KENNETH S. ROGOFF, THIS TIME IS DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY 155-56 (2009) (discussing the prevalence of crises in countries where rapid financial liberalization was not also accompanied by strengthened regulation).


\textsuperscript{92} See, e.g., 12 C.F.R. § 5.13(a)(2) (2001) (expedited review for qualified national banks for creation of new operating subsidiaries or engagement in new activities): § 5.30(e)(5) (expedited review of branch applications); § 5.33(i) (expedited review of mergers): § 5.34(e)(vi) (no notice required for certain activities in operating subsidiaries of qualified national banks).

\textsuperscript{93} The Federal Reserve Board has raised Herfindahl-Hirschman Index (HHI) tolerances to higher levels than those applied by the Antitrust Division. See the discussion and material in LISSA L. BROOME & JERRY W. MARKHAM, REGULATION OF BANK FINANCIAL SERVICE ACTIVITIES 639-44 (3 ed. 2008); and Chad F. Brown, Bank Mergers in Concentrated Markets: The Role of Mitigating Factors, 2 N.C. BANKING INST. 345 (1998) (reviewing significantly increased HHI tolerances for merging banks; and adopting a broad range of mitigating factors permitting merger approvals); and compare United States Dept. Of Justice & Federal Trade Comm’n, HORIZONTAL MERGER GUIDELINES at 16-17 (rev. ed. Apr. 8, 1997, available at http://www.justice.gov/atr/public/guidelines/hmg.pdf) (indicating lower HHI tolerances for triggering concern).

\textsuperscript{94} State insurance commissioners have complained that bank regulators do not impose sufficiently strict compliance and reserve requirements on banks that underwrite and sell insurance products. See, e.g., Watters v. Wachovia Bank, N.A., 550 U.S. ___ (2007) (a case in which the state regulator asserted stricter powers of supervision than those applied by the Office of the Comptroller of the Currency over national bank subsidiaries).
expands into new markets and lines of business. Great reliance was vested in the discipline of
the markets, leaving regulators short staffed and unable to take the necessary preemptive actions
they needed, even when they had the legal power to do so and, in the case of universal banks,
before they had even developed a system of regulation itself.

The movement toward deregulation was propelled by the view that markets apply more
efficient, targeted discipline to business activities than regulation, with all its dysfunction, ever
can. Yet the emphasis on market discipline in markets that were (and remain) not only opaque
but also dominated by increasingly larger participants was a case of whistling in the dark and
catered to, perhaps even reflected and fostered, an ideological predisposition against regulation
as a legitimate activity in the realm of financial services. This had the effect of placing
regulators on the defensive, particularly in large companies where regulators often were (and
often still are) perceived not to understand the fast-paced business but instead to be fighting the
last war or even creating risks rather than regulating them.

3. Deficiencies in Market Discipline and Supervision

This brings us to a third challenge: markets could to some extent substitute for regulatory
supervision (and vice versa), yet serious deficiencies in the functioning of markets also abound.
As size and complexity increase these deficiencies become more pronounced, so that neither the

95 For differing perspectives on the numerous points along the path of deregulation, commencing with the
Depository Institutions Deregulation and Monetary Control Act, see, e.g., MATTHEW SHERMAN, A SHORT
HISTORY OF FINANCIAL DeregULATION IN THE UNITED STATES (Cntr Econ. & Pol. Res. July 2009,
available at http://www.openthegovernment.org/otg/dereg-timeline-2009-07.pdf); CALOMIRIS, supra note 37,
passim (placing the deregulation movement within the broader historical perspective of over a century of bank
regulation and deregulation in the US).
96 Indeed, outright hostility to regulation is a cultural icon in American history and an effective platform for
Presidents from Carter to Bush. See PHILIP J. COOPER, THE WAR AGAINST REGULATION: FROM JIMMY
CARTER TO GEORGE W. BUSH (2009). For scholarly attempts to move the debate concerning the role of
regulation beyond the plane of ideological rhetoric, see the essays in GOVERNMENT AND MARKETS:
TOWARD A NEW THEORY OF REGULATION (Edward J. Balleisen & David. A. Moss, eds. 2010); and NEW
PERSPECTIVES ON REGULATION (David Moss & John Cisternino eds. 2009); and see CASS R. SUNSTEIN
government regulation for the financial crisis). Mr. Allison, was Chairman of BB&T, which was a recipient of
government bailout (TARP) funds. See also Andrew Martin, Give BB&T Liberty, but Not a Bailout N.Y. TIMES
uncommon within the industry.
markets nor supervision is fully able to provide the kind of corrective safeguards necessary to safeguard against failures the activities of very large, complex financial institutions.

The attractiveness of relying on market discipline as a principle means of securing safe and efficient behavior on the part of financial corporations is clear: the large-scale, high volume and rapid reactions of market participants provides at least in theory the possibility of reward and punishment that incent sound business behavior. The standard argument for deregulating was made in classic work by Sam Peltzman, where he hypothesized that regulation and ownership risk are correlatives and that regulation, with all its dysfunctions, susceptibility to capture and that the (potentially unfair) transfer of wealth and power, is hardly an obvious or appealing alternative to market discipline. This is of course to touch on the huge and long-standing debate about the efficient market hypothesis; here it is sufficient to observe that the news is replete with reports indicating the prevalence of market imperfections, from the moral hazard generated by the TBTF subsidy itself, to accounting gimmickry, the unreliability of the models and ratings of credit reporting agencies, and to agency problems created by unaccountable management. Despite the focus of many legislative and regulatory efforts, market transparency remains a long-term goal rather than a reality. Even if markets could in theory provide the discipline necessary to channel the business behavior of large universal banks more or less safely, there remain too many imperfections in the financial markets, and too great consequences of failure, for us to rely on market discipline alone.

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100 For recent reviews of the issues and ideas involved, and their intellectual history, see, e.g., Balleisen & Moss, supra note 96, ch. 1, 13-51 (Joseph E. Stiglitz, Government Failure vs. Market Failure: Principles of Regulation), ch. 3, 92-142 (Mary O. Furner, From “state Interference” to the “Return of the Market”: The Rhetoric of Economic Regulation from the Guilded Age to the New), ch. 7, 213-55 (Jessica Leight, Public Choice: A Critical Reassessment).
101 See infra at note 116 (discussing market transparency (Pillar 3) under the Basel II regime).
102 See infra text accompanying notes 133-137 (discussing why financial failures generate greater externalities).
103 This view would extend beyond the regulation of depository institutions themselves and to their holding companies. See Robert R. Bliss & Mark J. Flannery, Market Discipline in the Governance of U.S. Bank Holding Companies: Monitoring versus Influencing, in PRUDENTIAL SUPERVISION: WHAT WORKS AND WHAT DOESN’T (Frederic S. Mishkin ed. 2001), 107 at 141 (“in the absence of specific evidence that BHC [bank holding company] stock- and bondholders can effectively influence managerial actions under normal operating conditions, supervisors would be unwise to rely on investors—including subordinated debenture holders—to constrain BHC risk taking”).
This then leaves a critical role for regulation and supervision, defects and all. The task of developing an effective framework of regulation, supervision and examination of complex financial institutions is immense. While efforts by regulators in many countries to develop such a framework have been underway for more than two decades, an enormous amount of work still has to be done globally, let alone in the US. Many apparent solutions proved themselves to be seriously inadequate during the global financial crisis and serious regulatory failure has been acknowledged at the highest levels.  

This has triggered a whole new round of exceptionally complicated proposals for regulatory change and restructuring.

B. COMPLEX RISKS AND THEIR SUPERVISION

A vast mass of legislation, rules, guidelines and manuals relating to bank supervision belies the fact that the regulation and supervision of large, complex financial institutions remains a science in its infancy. The rules and models upon which regulation and supervision rest are highly suspect, largely untested in their effectiveness (except where they have failed when they mattered most), and only dimly understood within the institutions and among the field examination forces themselves.

1. Evolving Dimensions of Risk

There is good reason for this state of affairs. The risks generated by modern universal banking and finance have become extraordinarily complex. In traditional banking (taking deposits and lending money), the most important risk to be monitored was credit risk. Bank regulators were able to draw their own supervisors from the pool of expertise developed within the loan administration (credit underwriting) departments of banks, a business long and mostly well understood. Now, however, credit risk is only one aspect of a multi-faceted cluster of risk management and regulatory concerns. Whole new categories of risk have become centrally

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105 Professor Tarullo’s anxieties about Basel II have proven quite prophetic: “Insofar as capital requirements are central to contemporary banking regulation and the IRB approaches are essentially untested, the regulators adopting them are taking at least a leap of faith and, critics fear, possibly a leap off the cliff.” DANIEL K. TARULLO, BANKING ON BASEL: THE FUTURE OF INTERNATIONAL FINANCIAL REGULATION 6 (2008). Professor Tarullo is currently a governor of the Federal Reserve Board. On Basel II and the IRB approach, see infra text accompanying notes 110-21.
important to both the management of the institutions themselves and their supervision by regulators.\textsuperscript{106} Proliferation of new products, particularly structured securities and complex derivatives, and profusion of interconnectivity among financial institutions as a result of complex product innovation within a globalizing environment, is now an inherent part of the business of universal banks.\textsuperscript{107} Points of vulnerability and potential failure have escalated, and regulators and corporate risk officers have collectively, rapidly and often reactively had to address rapidly burgeoning dimensions of risk management and supervision.

The most important newly developing areas of risk management and regulation are market risk and operational risk. The former—market risk—“is the risk of losses in on and off-balance-sheet positions arising from movements in market prices, including interest rates, exchange rates and equity values.”\textsuperscript{108} Market risk attracted earlier attention than operational risk because of its centrality to the securities and investment banking industry.

The latter—operational risk—is important for present purposes because it acquires acute significance within the context of the management and regulation of complex universal banks. “Operational risk” is defined as the “risk of loss resulting from inadequate or failed internal processes, people and systems or from external events” and it includes legal risks, such as liabilities for damages or damage to reputation arising from failures in the conduct of business.\textsuperscript{109} This dimension of overall risk is escalating in importance as a focal point for management and regulators in complex financial activity. Yet the scale, complexity and sophistication of operational risk are new for universal banks and regulators alike. Only in the past decade has the subject even attracted serious managerial attention, so it is not surprising that operational risk has also only recently been subjected to detailed articulation by regulators.

\textsuperscript{106} For a review of the range of risks for which modern risk management is developing, see, e.g., Kevin Buehler, Andrew Freeman & Ron Hulme, \textit{The New Arsenal of Risk Management}, HARV. BUS. REV. 93 (Sept. 2008).
\textsuperscript{109} BASEL COMMITTEE, REVISED FRAMEWORK, id., at 144. See also BASEL COMMITTEE, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS: A REVISED FRAMEWORK COMPREHENSIVE VERSION (REVISED FRAMEWORK) at 157 (2006).

2. The Basel Process and the Enshrinement of Quant Models

To address credit, market and credit risk, risk managers turned with increasing sophistication to quantification models designed to measure risk. The regulators, in their turn, have aligned their own regulatory and supervisory techniques with those models. This is illustrated quite concretely by the evolution of the risk management framework developed by under the Basel Committee on Banking Supervision (Basel Committee), which has driven the process for internationally active banks (including all American universal banks).

Driving the evolution of quantified risk management and the corresponding approach to modern bank regulation are two central principles. The first is estimation of expected losses on very large-scale portfolios. Banks know that some loans, for example, will go bad; they just don’t specifically know which ones. They can, however, estimate fairly reliably over large numbers the losses that might be expected on a aggregate basis, taking into account past experience and current conditions. Quantification (quant) models are the techniques for estimated these expected losses. The second principle is ensuring that banks have reserves or “provisions” for absorbing the expected default losses when they actually occur, and capital buffers for absorbing unexpected losses and avoiding bankruptcy that might otherwise follow from those losses. The combined application of these principles forms the core to the framework for large-scale financial organization regulation under the Basel approach.

After previously focusing almost entirely on credit risk, in 1996 the Basel Committee introduced the additional concept of market risk and, in doing so, prompted an accelerating trend toward increased reliance on quantitative models as the means of supervision. The Committee amended its 1988 Capital Accord by issuing a Market Risk Amendment. This Amendment permitted regulators of banks to rely upon proprietary in-house value-at-risk (VaR) models in order to determine the amount of capital charge to be assessed against assets. The principle of

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110 On the BASEL COMMITTEE generally, see http://www.bis.org/bcbs/index.htm.
111 Available at http://www.bis.org/publ/bcbs23.pdf?noframes=1.
112 On VaR, see generally, PHILIPPE JORION, VALUE AT RISK: THE NEW BENCHMARK FOR MANAGING FINANCIAL RISK (2 ed. 2001). Professor Jorion defines VaR as “the quantile of the projected distribution of gains and losses over a target horizon” and providing a description of its application as follows: “If c is the selected confidence level, VAR corresponds to the 1 - c lower tail level. For instance, with a 95 percent confidence level, VAR should be such that if exceeds 5 percent of the total number of observations in the distribution.” Id. at 22.
drawing from the own internal risk management systems of financial institutions for signals upon which regulatory assessments could themselves be drawn was widely hailed as a significant innovation. Yet it was also, in effect, a fundamental delegation of regulatory judgment from the regulators to the developers and operators of the internal systems, leaving regulatory certification as the primary vehicle for ensuring that financial institutions are operating safely. An inevitable result has been to transfer the focus of risk management and supervision onto IT systems and quantitative models.

This approach has been refined throughout the past decade. Discreet risks are now measured by means of complex formulae and models, which systems—not the actual business decisions themselves—are in turn assessed by regulators for reliability and adequacy in order to determine the regulatory capital complex banks must hold. Capital charges are then assessed in light of expected losses estimated by the models, and these are factored into the evaluation of the capital adequacy for specific institutions. Risk factors are assigned to specific classes of assets to either discount or inflate their expected impact on the capital buffer.113

In an effort to produce more sophisticated capital measurement for banks and encourage greater awareness and sophistication in risk management by banks themselves, the Basel Committee developed and in 2004 published a Revised Framework on International Convergence of Capital Measurement and Capital Standards, generally known as “Basel II.”114 Pillar 1 of this Framework is designed to instruct banks how to assess credit, market and operational risk. Pillar 2 instructs bank supervisors how they should evaluate the systems and controls developed by bankers under Pillar 1.115 Pillar 3 (still in various stages of development and implementation) is designed to add the component of external market discipline by promoting greater transparency of risk through better company disclosure of its capital structure,  

113 For a very concise exposition, see SCHOONER & TAYLOR, supra note 78, at 131-43.


115 Pillars 1 and 2 have now been jointly implemented by United States banking regulators. See 12 C.F.R. Pts 3 (OCC), 208 & 225 (Fed), 325 (FDIC), 559, 560, 563 & 567 (OTS) (Pillar 1 final rule: 72 FED. REG. 69287 (Dec. 7, 2007); Pillar 2 supervisory guidance: 73 FED. REG. 44620 (July 15, 2008)).
The interrelationship between determinations under Pillar 1 and Pillar 2 is considerably complex and its entire methodology is subject to strong criticism. For the purposes of this article, an important basic limitation of the overall approach is the focus on quant models.

Under Pillar 1, large and internationally active banks (so-called “core banks” in the US), with balance sheet assets of $250 billion or greater, or on-balance sheet foreign exposure of $10 billion or more, are required to apply an “advanced measurement approach” (AMA) for calculating operational risk. Detailed quantitative and qualitative guidelines are articulated in the Framework and, to an even greater extent, in the US rules implementing the Framework. The rules identify seven categories of operational risk: internal fraud; external fraud; employment practices and workplace safety; clients products and business practices (e.g. liability for fiduciary violations); damage to physical assets; business disruption and system failures; and execution, delivery and process management (e.g., loss as a result of a failed wire transfer). Losses must be calculated and captured by data, event capture and loss assessment systems and quantification systems that can generate estimates of forward-looking operational risk exposure. The bank’s processes must “reflect the scope and complexity of its business lines, as well as its corporate organizational structure.”

Pillar 2 of the Framework focuses on the quality of the internal assessment by a company of its credit, markets, operational and also other risks, such as liquidity risk, and how these risks interrelate to each other, and it is just as complicated. Under the US implementing regulations,

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116 See BASEL COMMITTEE, REVISED FRAMEWORK, supra note 108, Pt. 4 at 226 et seq. For recent revisions, see BASEL COMMITTEE, ENHANCEMENTS TO THE BASEL II FRAMEWORK at 28-30 (July 2009).
118 See, e.g., TARULLO, supra note 105 passim. Governor Tarullo mounts three objections against the Basel Framework: the compliance costs and supervisory limitations within domestic systems outweigh any benefit that might be gained from an international framework; a domestic process can generate more effective rules; and a simpler framework might be more effective in permitting domestic regimes to develop optimal rules.
119 For credit risk, financial institutions are permitted to use an internal ratings-based (IRB) approach which also relies on the company’s own risk assessments. See 72 FED. REG. at 69289; and for a critical assessment, see further SCHOONER & TAYLOR, supra note 78, at 152-59.
120 See 72 FED. REG. at 69314-69318.
the Pillar requires larger banks to use an Internal Capital Adequacy Assessment Process (ICAAP). The regulators assess the capability of an institution to manage its credit, market and operational risks (developed under the Pillar 1 structure) by evaluating the quality of the institution’s ICAAP. In other words, although regulator can impose additional capital charges to account for risks not captured solely under the Pillar 1 framework, the institution’s own methods of controlling its risks are the primary driver of how the institution is supervised.

3. Collapse of Quant

The Basel framework, with all its focus on the detailed assumptions and formulae of quant models, suggests the mathematical quality of precision and predictability. As we have seen through the financial crisis, however, these models do not necessarily capture risks sufficiently, guarantee correct initial assumptions, or provide a sufficiently broad basis on which to measure actual operational risks. The models focus on aggregate performance and do not measure well how the various parts of a complex enterprise function together or interact over time, nor do they adequately target individual, yet potentially very damaging, vulnerabilities. While aggregate predictors might produce consistent results in theory, they do not differentiate between factors that are highly relevant but inherently non-quantifiable. Good managers perform better than bad managers. The difference can show up quickly in a crisis, and this difference, within the context of financial services, can be devastating. We do not have to blame Black Swans or once-in-a-century events; many of the reasons for the financial crisis can be attributed to such commonplace maladies as greed, criminality, sheer stupidity, and all the organizational dysfunctions already described, while the moral hazard inherent in modern systems of banking and finance merely serves to exaggerate these defects in corporate performance.

Reliance on aggregate models, whether effective or not, might be reasonable in a mature, relatively predictable industry that is unlikely to have its mistakes amplified through systemic interconnection. In the volatile and rapidly innovating world of financial services such reliance

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121 73 FED. REG. at 44623, 44624 et. seq.
122 Alan Greenspan uses the term “hundred year flood” in a different way, not as an excuse for not seeing the crisis coming but to emphasize that financial institutions should expect wide scale help from the government in very rare, extreme events. See Greenspan, supra note 104, at 17-19.
123 See supra text accompanying notes 57-75.
has proven downright dangerous. Quant models have even had the effect of generating substantially greater risk by adding momentum to activities that should in fact be reigned in near the top of bubbles. The combination of exceptionally complex, interconnected and partially subsidized business with quant models designed both to manage and regulate such business has proven disastrous. One of the high priests of bank regulation, Alan Greenspan, has identified one of the major problems in the recent financial crisis to be “the virtual indecipherable complexity of a broad spectrum of financial products and markets that developed with the advent of sophisticated mathematical techniques to evaluate risk.” Indeed, Mr. Greenspan levels his mea culpa at the very theoretical basis upon which these models were built as the origin of massive regulatory failure:

How could [our highly sophisticated global system of financial risk management] have failed on so broad a scale? The paradigm that spawned Nobel Prize winners in economics was so thoroughly embraced by academia, central banks, and regulators that by 2006 it became the core of global regulatory standards (Basel II).

Notwithstanding all their sophistication and complexity, the modeling and monitoring systems developed under the Basel frameworks have proven seriously inadequate as a basis for comprehensive risk management and its regulation.

C. DEVELOPING BETTER REGULATION

Financial institutions and regulators around the world have expended enormous effort in developing techniques for monitoring and projecting operational risk. The complexities of this endeavor are also well recognized and understood. Yet for all the detailed categorizations, reliance upon formulae and recognition of variation and the need for comprehensive assessment,

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124 See, e.g., Michael Knight, Searching for new paradigms at BIS ABA BANKING J. July 2008, at 7 (noting that central bankers “seem to have concluded that banks that relied on VaR tended to operate in ways which exaggerated the banking system’s natural ‘procyclicalit’y”).
125 Greenspan, supra note 104, at 12.
126 Id., at 11.
127 “Harry Markowitz, Robert Merton, Myron Scholes, and Fisher Black, had he lived” (footnote in original, id. note 22). Theoretical analyses are beginning to demonstrate the shortcomings of these quant models. See, e.g., Guy Kaplanski & Haim Levy, Basel’s value-at-risk capital requirement regulation: An efficiency analysis, 31 J. BANKING & FIN. 1887 (2007) (critical economic analysis of the effectiveness of the VaR model).
it is not clear that the modern business of complex universal banking is really understood to the degree that provides confidence that regulators truly understand the business or that they have the resources to monitor it. Certifying models, policies and procedures, rather than the assessing the actual and current operational safety of complex financial institutions, is insufficient on its own for regulatory supervision. We are learning that many additional prudential principles (and even some old ones) must also be factored into the safe operation of large universal banks. Principles, such as strict liquidity standards and leverage ratios, countercyclical measures, capital buffers for counterparty exposure, are being added to an already incredibly complex supervisory framework. The development of policy and regulatory guidance on these measures in Europe or the United States is underway, though the process is far from complete.  

One of the least discussed areas of supervision is the capability of the regulators and supervisory forces. We talk a lot about agency structure but not much about resources. Yet practical capability is one of its most critical dimensions of regulation. There is also simply no substitute for supervision by highly trained and experienced regulators who have experience and wisdom to be able to judge the quality of the key decisions and decision makers within the organizations themselves. What is needed is the careful development and, where necessary, the introduction innovative ways to import of top-level talent—indeed every level talent—from the fast-paced lanes of investment banking, derivatives, structured finance, exotic insurance, etc., that have accreted around the traditional banking structure. New kinds of supervision and supervisory teams that are able to bring wisdom to bear in the evaluation of corporate operations must be created to match the growing sophistication of the companies they monitor.


Supervisory manuals do not have much to say about operational risk supervision, and regulators do not yet enjoy a high reputation among operational managers. It is not uncommon to hear sincere complaints from bankers that their banking examiners are still learning at abstract levels through elementary discovery reviews, and that they do not yet really understand the businesses they are supposed to be supervising. Even if the government could match the allure of market forces that make it hard to recruit for the public sector, the pool of industry experience (as opposed to expertise) is itself still developing. Furthermore, we don’t yet have a satisfactory “science of regulation.” What writing and teaching there is still often comprises ideologically driven “free market,” “public choice,” and “public interest” critiques of alternative approaches. So we are not graduating professional regulators.

At this stage in the development of large, complex financial institutions we cannot therefore assume that they are subject to truly meaningful and adequate supervision at all, or whether they even can be, given their levels of complexity. In other words, ultra large financial institutions may well still be too complex to manage and too complex to regulate (or at least supervise).

III. FINANCIAL INSTITUTIONS REALLY ARE DIFFERENT

In his now-iconic speech of almost twenty years ago, E. Gerald Corrigan made the case that banks were different from other industries because they possess characteristics that even

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130 See, e.g., COMPTROLLER’S HANDBOOK: LARGE BANK SUPERVISION at 53-57 (Jan. 2010) (no more than a brief scorecard for examiners to apply when assessing operational risk—though this scorecard is to be applied within the context of the risk management framework already described supra at notes 106-18). The FEDERAL RESERVE provides some scattered guidance throughout its COMMERCIAL BANK EXAMINATION MANUAL (continuing updates 2009) and these references are to be understood within the context of the general Basel-based regulatory guidance as well.

131 There are, to be sure, many works on the subject (as is evident in the citations to this article), but we lack sophisticated educational centers that have regulation as their specific focus. Compare, e.g., the Centre for the Analysis of Risk and Regulation at the London School of Economics and Political Science. The chapters contained in the works cited supra notes 93 & 96, provide illustrations of the kind of theoretical work to be done. See, e.g., Tom Baker & David Moss, Government as Risk Manager, in Moss & Cisternino, supra note 96, at 87-109. See also BARTH, CAPRIO & LEVINE, supra note 99, passim.

distinguish them from other financial institutions. Banks were “special,” Mr. Corrigan argued, because they have three key traits:

[F]irst, they offer transaction accounts as defined; second, they are the backup source of liquidity for all other institutions; and third, they are the transmission belt for monetary policy.

These features implied the strong separation between banking and commerce, that the holding company model should structure the expansion of banks into other financial services such as investment banking, and that the full-scale safety net should be extended only to banks. Although some have suggested that deregulation and industry evolution has heavily diluted the “specialness” of banks, Mr. Corrigan continues to believe, rightly in the author’s view, that banks are different and need special regulation.

If one considers banks within the larger web of the financial services industry as a whole, it is also clear that the financial industry as a whole is itself also very different from other industries. Once one understands the dynamics of systemic failure, it becomes evident that failures in other industries do not present the kind of system-wide threats that are posed by large bank failures. Nowadays banks and other financial institutions are heavily interconnected, so a failure by any one institution, bank or otherwise, can wreak havoc to the system as a whole: the banking business (perhaps necessarily and inevitably) combines a potentially lethal cocktail of interconnectedness and moral hazard.

Numerous recent failures, such as Lehman

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136 For excellent discussions of the mechanisms of systemic risk, see, e.g., SCHOONER & TAYLOR, supra note 78, at 35-49; and THE FUNDAMENTAL PRINCIPLES OF FINANCIAL REGULATION 13-24 (Geneva Reports on the World Economy 11, June 2009).

Brothers\textsuperscript{138} and Northern Rock,\textsuperscript{139} demonstrate the consequences of such failures in the United States, United Kingdom, and worldwide. The collapses of these financial institutions were major events precipitating the financial crisis of 2008-09.

Corporate mistakes in the financial world can therefore have far reaching consequences to other institutions and ultimately to the taxpayer. Even if we can afford “learning mistakes” in other industries, we cannot afford them to be made by newly emerging universal banks. Yet by allowing such institutions to grow rapidly, within a climate of deregulation, and by conducting forced marriages between them as they started to fail, we have increased the likelihood of such mistakes.\textsuperscript{140} We have assumed much greater risk without building the framework for managing and regulating this risk! This is why the continued growth of large universal banks should be resisted, at least until it is clear that they can be safely and properly managed, regulated and, if necessary, dissolved.

IV. WHERE DO WE GO NOW?

This review of the way in which ultra-large financial institutions get supersized, the paths of complexity such institutions can generate, and the relative capabilities of regulators, suggests that, as a matter of public policy, regulators and legislators should strongly resist the growth of such institutions, at least until their management and the regulatory framework have matured.

Addressing the reality of large scale universal banks and the great risks they pose to the financial system, domestic and global, is a complicated and multi-pronged enterprise in itself, requiring better capital requirements, major revisions to the Basel system, a framework for systemic risk regulation, specific activity restrictions and greater resolution powers, structural

\textsuperscript{138} Many popular accounts of the failure of Lehman Brothers are now in publication. On the causes and regulatory consequences of the failure of Lehman, see, e.g. the report of Anton R. Valukas, Examiner, \textit{In re Lehman Brothers Holdings Inc}, supra note 70.

\textsuperscript{139} See \textit{THE SUPERVISION OF NORTHERN ROCK: A LESSONS LEARNED REVIEW} (Report by the Financial Services Authority Internal Audit Division March 2008), available at \url{http://www.fsa.gov.uk/pubs/other/nr_report.pdf}.

\textsuperscript{140} On these developments, too, a considerable literature has already accumulated. \textit{See, e.g.}, Johnson \& Kwak, \textit{supra} note 8, ch. 6; ANDREW ROSS SORKIN, \textit{TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM—AND THEMSELVES} (2009).
regulatory reform, possible absolute size caps—all the subject of innumerable reform proposals and current bills.

A. CONSOLIDATING UNIVERSAL BANK REGULATION

It is particularly important in the United States to establish a comprehensive system of regulation that would cover all the activities and dimensions of complex universal banking, and the creation of a unified regulatory structure that could focus on large-scale universal banking and develop a sophisticated science and practice of regulation and supervision. Unless and until such a comprehensive and unified regulatory system is established, America is unlikely to be ready to regulate and supervise large universal banks and highly unlikely to be able to develop the expertise to do so.

The most important structural reform, and one that has a good chance of enactment, would be the anointment of the Fed as the primary regulator for all large, complex financial institutions (i.e., those owning banks and thrifts with combined assets greater than $50 billion). By having one regulator focused on and accountable for this type of regulation there is a better chance that the right expertise, experience and resources will be developed. The Fed is particularly well placed because it has historically focused on bank and financial holding companies, the latter being the principal vehicle for the creation of American universal banks after the enactment of the Gramm-Leach-Bliley Act in 2009. Being the regulator of bank and financial holding companies, the Fed has traditionally focused on systemic risk issues more broadly than other regulators, and this orientation to supervision complements well the regulation and supervision of large universal banks. The Fed also has strong research resources and offers perhaps the most prestigious career paths for would-be financial regulators. Providing the Fed with a key role in the supervision of LCBOs (universal banks and their

141 Comprehensiveness is a centerpiece of bills passed in the House and pending in the Senate, but even these legislative vehicles would grant exemptions and still perpetuate the fragmentation, albeit to a lesser degree. See Financial Stability Improvement Act, H.R. 4173 (engrossed version Dec. 2009) Title I(B); Financial Stability Act of 2010, S. ___ (Dodd Bill) Title I(A).

142 See supra text accompanying notes 81-87 (reviewing the shortcomings of the fragmented US approach to the regulation of large financial conglomerates).

143 See supra text accompanying notes 47.

144 The Dodd Bill would also give the Fed a central role in systemic supervision, extending to non-bank financial companies that pose systemic risks. See the Dodd Bill, §§ 113-15.
affiliates) is an objective that is central to reforms pending in Congress but the certainty of their enactment is not clear.

Other ameliorative actions that are not dependent on congressional action might be helpful in the interim. It is not clear whether we have the political will, as was displayed by the European Commission in the case of ING\textsuperscript{145} and the British government in the case of Lloyds and Royal Bank of Scotland,\textsuperscript{146} to actually force the breakup of the current group of diversified behemoths headquartered in the United States is an open question,\textsuperscript{147} particularly after having headed so recently in precisely the opposite direction (with the hasty mergers of JP Morgan and Bear Stearns, Bank of America and Merrill Lynch and Wells Fargo and Wachovia and others). Regulators have apparently been nudging some institutions, including Citi\textsuperscript{148} and possibly also Bank of America,\textsuperscript{149} toward smaller scale.\textsuperscript{150} But one might assume that the prospects of meaningful involuntary downsizing remain remote at this stage.

Nevertheless, even if we cannot completely undo large-scale universal banking, we can ensure that sudden new growth through mergers and acquisitions be arrested or at least slowed down to better levels of safety. There are strategies for applying checkpoints, brakes and growth retardants that should and could be inserted more carefully at various points in the growth trajectories of complex financial institutions. And these strategies could largely be implemented and applied by the banking regulators without Congressional action. The key point at which to apply these retardants is the moment at which complex financial institutions jump-shift their risk profiles with new mergers and acquisitions.


\textsuperscript{146}See \textit{Lloyds and Royal Bank of Scotland are forced to sell businesses}, THE ECONOMIST, Nov. 3, 2009.


\textsuperscript{148}See, e.g., supra text accompanying notes 1-2.

\textsuperscript{149}See James Kwak, \textit{Are Regulators Trying to Make Bank of America Smaller?}, (Baseline Scenario, March 14, 2010, available at http://baselinescenario.com/2010/03/14/regulators-bank-of-america-smaller/?utm_source=feedburner&utm_medium=email&utm_campaign=Feed%3A+BaselineScenario+%28The+Baseline+Scenario%29) (discussing a report that executives at Bank of America are coming under increasing pressure from regulators to downsize their firm).

\textsuperscript{150}For some initial thoughts, see e.g., Gary H. Stern & Ron Feldman, \textit{Addressing TBTF by Shrinking Financial Institutions: An Initial Assessment} (Fed. Res. Bank of Minn. June 2009).
B. SPECIFIC NEW MERGER APPROVAL REQUIREMENTS

Current antitrust policy focuses on market concentration measures and, in the case of banks, whether the “convenience and needs of the public” might be served by the combination—an escape clause that has permitted combinations that might otherwise have raised antitrust concerns.\textsuperscript{151} Under bank antitrust law no formal assessment is required of how the proposed combination will actually operate in the post-merger environment, whether the management and systems are up to the task of leading the new combination, and whether the regulators and management can monitor the risks associated with new size, diversification and exposure. No detailed operational plan is required, neither is any regulatory enhancement plan. Great faith is placed on the ability of executives and the judgment of investors and shareholders, when it is very difficult for the latter to do anything more than accept assurances by the leaders and dealmakers of new combinations and the regulators who provide their approval. Furthermore, seldom is any focused attention give at the time of a combination to what might happen in the event of failure.

These omissions suggest that far greater detail ought to be required from an organization that is about to ramp up its growth. Three kinds of plans ought to be insisted upon realistic and detailed:

1. Integration and operation plans;
2. Resolution plans anticipating the possibility of failure; and
3. Regulatory plans detailing the methods and costs of adequate regulation.

1. Integration and Operation Plans

Integration plans ought to be much more concrete. Under the regulations based on the Basel II Advanced Capital Framework merging companies that, prior to their merger, were not under the advanced systems framework are permitted to continue using their old frameworks for 24 months (with a possible 12 month extension at the discretion of their

regulators) and must provide implementation plans for transition to the advanced framework within 90 days of consummating the merger.\(^{152}\)

There are two problems with this safeguard. First, the actual and proposed plans suffer from the limitations of “certification regulation” already described above. Second, the requirement comes too late: once a merger has been approved the horse is out of the barn. It is too late if the new combination is inherently unmanageable or incapable of direct regulation.

Therefore, the proposed business of the combination, its accompanying risks, and exactly how these will be managed and by whom ought to be detailed at an operational level and in advance of merger approval. Otherwise neither shareholders nor regulators can really know what they are approving. Furthermore, these plans should be real ones: spreadsheet and Gantt chart plans detailing the schedules for technology systems and customer conversions, not the Powerpoint, picture book plans that are hastily developed for CEOs to use at merger announcements.

Once approved, integration and operation plans ought to have the same kind of binding application as memoranda of understanding (MOUs).\(^{153}\)

2. Resolution Plans

Resolution plans should outline how a proposed combination would be unwound if it were to prove unsuccessful. Such plans, often referred to as “living wills” or “funeral plans” have been proposed in the United States\(^ {154}\) and Europe.\(^ {155}\) They have been resisted by the industry as ineffective and possibly even counterproductive but the living will approach provides

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\(^{153}\) MOUs are binding agreements imposed on financial institutions by their regulators at the intermediate step before enforcement, in terms of which the institutions concerned undertake to implement measures designed to improve their safety and soundness.\(^{153}\)

\(^{154}\) See, e.g. E. Gerald Corrigan, Containing Too Big To Fail, at 8-9 (Charles F. Dolan Lecture Series, Fairfield Un., Nov. 10, 2009); Greenspan, supra note 101, at 27. The House and Senate bills both contain provisions requiring financial holding companies deemed systemically significant to file periodic resolution plans. See Financial Stability Improvement Act, H.R. 4173 (engrossed version Dec. 2009) § 1104(i); Financial Stability Act of 2010 (Dodd Bill) § 165(d)(1) (2010).

\(^{155}\) See John Gapper, Where there’s a will there’s a way FIN.TIMES, Sept. 23, 2009, available online at http://www.ft.com/cms/s/0/227734b6-a870-11de-9242-00144feabde0.html (suggesting that the term “living will” is a misnomer since it applies once the bank is already insolvent).
an *ex ante* means of identifying the kinds of situations and activities that, if they were to arise, would lead the organization into serious difficulties. By conducting this advance analysis, regulators (and the firm management) would have a better chance of commencing pre-emptive action to avoid a crisis.\footnote{See Ron Feldman, *Living Wills in the Context of Activity and Size Restriction* (unpublished paper on file with the author and cited with permission). Mr. Feldman is co-author of the works by STERN & FELDMAN, *supra* notes 7 and 150.}

Resolution plans are difficult to develop once a combination is a *fait accompli* because their very preparation can be construed as a signal that all is not well with the enterprise, and this in turn can quickly lead to the kind of information contagion that could turn fear into reality. Hence a very effective moment for the preparation of such a plans would be when a combination is proposed because (a) the development of a serious and concrete integration and operational plan addresses the primary and fundamental elements of the combination and its very *raison d’être*, and (b) the proposed combination overtly looks to the future and hypothetical projections and, unless the proposed combination is ill conceived in the first place, could not be construed a possible reflection of concerns about current operations or prospects.

3. Regulation Plans

Finally, the resources required for realistic and adequate regulation of a new, ultra-large and diversified combination should be properly assessed and exposed to shareholder and public view for evaluation *at the time the merger is planned*. One of the perennial factors undermining regulatory effectiveness is a moral hazard by which regulators are themselves tempted. As is aptly stated by a former legislative staffer and regulator: “regulators’ reputations suffer less from problems that develop on their watch than from the problems that become public on their watch.”\footnote{Richard Scott Carnell, *Regulators’ Incentives*, in MAKE MARKETS BE MARKETS, *supra* note 82, 35 at 37 (available online at http://makemarketsbemarkets.org/).} There is therefore always a risk that the regulatory needs for supervising a new combination will be underestimated because the incentives for ensuring adequate resources in advance are lacking.

The requirement proposed here would serve two purposes: first, regulators would be encouraged to focus in detail on the resources they will really need to cope with the new
institution (and whether such resources can even be procured and funded and by whom).
Second, dealmakers would be forced to factor in the (not insignificant) costs of regulating their new combination because the regulatory agency would require them to commit to the costs of regulation in advance. This would help avoid some of the externalization—whether opportunistic or inadvertent—that seems to have taken place with many of the recent hyper-combinations that have failed or threaten to become wards of the state. Even under the Basel II regime, the capability of regulators to handle the new institution and the associated costs for appropriate regulation do not have to be formally estimated. It is simply assumed that the combination will be “regulatable”\(^\text{158}\) and that costs of providing such regulation will be covered by assessments made against the newly combined institution.

The appropriate regulatory agency (i.e., the one that will become the primary regulator for the new combination) should be required itself to develop and publish a regulatory plan, coupled with a financial estimate of the new costs of regulation, as part of its approval of such combinations. This will hold the responsible regulators accountable to the congressional oversight committees and public for granting approval to the mergers that so greatly increase levels of risk.

The addition of this proposed three-fold requirement for regulatory approval (and public scrutiny) of a proposed merger or acquisition by and between financial companies is not designed to displace other safety measures and growth retardants, such as higher capital, liquidity requirements, and “bank taxes,” that are already under consideration. Such measures address different elements of the overall risk to the system: ensuring stronger buffers in anticipation of greater shocks resulting from the scale of operations; prefunding the costs of emergency bailouts; and so on. The measures proposed in this paper, on the other hand, would help dampen risky M&A effervescence and replace wishful thinking with realistic assessments, objectively determined, of what hyper-combinations really require in order to be both safe and successful. The proposals are sure to be resisted as generating “more red tape” and time delays.

\(^{158}\) A term I borrow from Andrew Hilton, director of the London-based Center for the Study of Financial Innovation, in his preface to GRUMPY OLD BANKERS: WISDOM FROM CRISES PAST 1 (CFSI 2009).
Perhaps, however, this is precisely what we need during a period of experimental evolution in an industry whose mistakes affect everyone and not just the companies themselves.