

Bank Corporate Governance: A Paradigm for the Post-Crisis World

Jonathan Macey* and Maureen O'Hara**

March 2014

* Sam Harris Professor of Corporate Law, Corporate Finance and Securities Regulation, Yale University,
** Robert W. Purcell Professor of Finance, Johnson Graduate School of Management, Cornell University.
We thank Hamid Mehran for helpful comments.

Bank Corporate Governance: A Paradigm for the Post-Crisis World

1. Introduction

Legislation tends to follow crisis, and the myriad corporate scandals in the prior decade led to a heightened awareness of the role played by corporate governance. In the aftermath of Enron, Tyco, and other high profile failures, Sarbanes-Oxley focused on the internal controls of firms and the risks that poor governance imposed on the market. In the aftermath of the recent financial crisis, Dodd-Frank unleashed a plethora of changes for markets, with restrictions on what banks can do, who can regulate them, how they should be liquidated, mortgage and insurance reform, and consumer protection. Surprisingly, the duties required of bank directors *per se* were not a focus of specific attention in either Act. We believe the role that bank corporate governance issues played in the financial crisis is not inconsequential and that, as suggested by the recent JPMorgan Chase Whale fiasco, these bank corporate governance issues pose an on-going risk to the financial markets. Hence, bank corporate governance in the post-crisis era warrants careful review.

That governance problems can arise in banks is well understood (see Levine [2003]; Bebchuk and Spamann [2010]; de Haan and Vlahu [2013]; Adams and Mehran [2012]). What may not be appreciated, however, is the degree to which the unique features of banking complicate both the role of the board and its governance effectiveness. In an earlier paper (see Macey – O’Hara [2003]), we reviewed the different models of corporate governance, with a particular focus on the duties board members owe to different constituencies. We argued that these unique features of banks dictated a heightened duty of care for bank directors. We discussed the various legal cases defining the duty of care for directors, and how the courts have vacillated in their application of these duties owed by directors. Since then a lot has changed

with respect to banking structure and practice, but little has changed with respect to the duties and obligations of bank directors. This inertia with respect to bank directors is all the more puzzling given that Dodd Frank explicitly addressed the externalities imposed by individual banks on the financial system - yet imposed no additional requirements on bank directors to make them responsible for limiting such risks.

In this paper, we propose a new paradigm for bank corporate governance in the post-crisis world. We argue that bank directors should face heightened requirements due to the increased risk that individual banks pose for the financial system. Our thesis is that the increased complexity, greater opacity, and monitoring complexity of banks requires greater expertise on the part of bank directors. We propose new “banking expert” and “banking literacy” requirements for bank directors akin to the financial expert requirements imposed on audit committee members by Sarbanes-Oxley. As we discuss, these requirements would mandate a higher level of competence from bank directors, consistent with the greater knowledge required to understand and oversee today’s more complex financial institutions than is required for other firms with less opaque operations and assets.

It has been argued that large, complex financial institutions are now simply too large to govern - that “too big to fail” is “too big to exist”. This may be true, but before we throw in the towel on the corporate form of bank organization in favor of some regulator-based form of control, we think it makes sense to try to craft a more relevant corporate governance standard for banks. Similarly, it has been argued that mendacity is to blame for the myriad scandals in banking – that bank management and presumably bank directors are somehow not sufficiently motivated to “do the right thing”. We think a better explanation is that operating and monitoring

a complex financial institution is extremely difficult, and the solution to better bank management lies in better bank corporate governance. Our proposals here are a first step in that direction.

This paper is organized as follows. In the next section, we draw on earlier work as well as lessons learned from the JP Morgan London whale debacle to talk about how governance problems arise in banks and why these differ from those arising in other firms. We develop how the growing complexity of banks creates a new set of governance problems, and how recent structural changes such as dual boards have contributed to governance failures in banking. In Section 3 we then consider how these corporate governance problems have traditionally been dealt with in banks, and we discuss recent approaches taken in the U.S. and other countries to make bank corporate governance more effective. In Section 4, we set out our alternative approach for bank corporate governance. We argue that bank directors should meet professional standards, as opposed to the amateur standards that apply to other corporate directors. We propose even greater standards for members of bank risk committees, reflecting that failures in bank risk management impose significant costs on the financial system and economy more generally.

2. Bank Corporate Governance: Why is it so difficult?

Generally speaking, the problem of corporate governance stems from agency problems that emerge when the residual claims on a firm's income take the form of shares of stock that are mostly owned by people who are not involved in the management or operations of the company (see Berle and Means [1936], Jensen and Meckling [1932]). In order to ameliorate agency costs, over time corporate law has generated the general rule that fiduciary duties should be owed exclusively to shareholders (see Macey [1999]). The justifications for making shareholders the

exclusive beneficiaries of the fiduciary duties owed by managers and directors are based on the fact that creditors, as fixed claimants, can safeguard their investments through a combination of pricing and the imposition of contractual protections such as conversion rights or put options (see Macey and Miller [1993]).

In our earlier paper on corporate governance problems in banks, we argued that banks are different from other firms and that the economic policies that justify making shareholders the exclusive beneficiaries of fiduciary duties do not apply with the same force to banks that they do to other types of corporations, such as manufacturing companies or technology companies. We believe these difficulties have only increased in the past decade, with the result that banks in the post-crisis era face even greater corporate governance difficulties. Specifically, we believe there are a variety of unique features of banks relative to other firms that make them unusually risky, more fragile, and more difficult to monitor and control.¹

2.1 Asset Structure and Liquidity Creation by Banks

First, banks' unusual capital structures give them a unique role in generating liquidity for the economy. It is well known that banks' balance sheets are highly leveraged (see Bebchuk-Spamann [2010]; Flannery [1994]), with fixed claim creditors supplying 90 percent or more of the funding banks require to operate. Moreover, these fixed claim liabilities generally are available to creditors/depositors on demand, while on the asset side of the balance sheet, the bank's loans and other assets have longer maturities.

The development of increasingly robust secondary markets and banks' ability to securitize assets has enabled banks to move assets off of their balance sheet, but this process has not led to a reduction in the size of banks' balance sheets: banks tend to grow rather than shrink even as they securitize more of their assets. Because more transparent and liquid assets are the

¹ Macey and O'Hara (2003) at 97.

ones that tend to be sold either outright or as part of a pool of securitized financial assets, what is left on the bank's balance sheet tends to be the more opaque and idiosyncratic assets. Arguably these evolutionary developments in capital markets have led to a secular deterioration, rather than to an improvement in the transparency and liquidity of bank assets.

The phenomenon of holding simultaneously transparent, liquid liabilities on the one hand, and illiquid, opaque assets on the other, enables banks to serve the vital economic role of creating liquidity (see Diamond and Dybig [1986]). However, to create liquidity, banks must lend the funds that they receive from deposits and other short-term liabilities, and consequently banks keep only a small fraction of funds as reserves to satisfy depositors' demands for liquidity. This asset transformation process results in a situation in which no bank has sufficient funds on hand to satisfy the demands of depositors if a significant number demand payment simultaneously.

The mismatch in the liquidity characteristics and term-structure of banks' assets leads to bank runs and other systemic problems in the financial system. With greater than a third of U.S. bank liabilities uninsured, rational uninsured depositors (and claimants) will try to be among the first to withdraw before other, more nimble creditors deplete the banks' assets. Thus, bank depositors, unlike creditors in other companies, are in a situation closely akin to the classic prisoner's dilemma. This prisoner's dilemma can lead to failures in solvent banks because the need for liquidity in the event of a run or panic can lead to fire-sale liquidations of assets, thereby spreading problems to heretofore solvent banks. For bank directors, the need to manage such liquidity risks is fundamental to a bank's survival.

2.2 Deposit Insurance, Moral Hazard and the Conflict Between Fixed Claimants and Equity Claimants

The existence of federally sponsored deposit insurance means that banks can continue to

attract liquidity to fund their operations even after they are insolvent. Thus, unlike other sorts of companies, it is virtually impossible for federally insured banks to become insolvent in the “equitable” sense of being unable to pay their debts as they come due in the ordinary course of business.² Federal insurance eliminates the market forces that starve nonfinancial firms of cash. The federal government has attempted to replace these market forces with regulatory requirements such as capital requirements and requirements for the “prompt resolution” of financially distressed banks. Nevertheless, it seems clear that the well-established tenet of corporate finance that there is a conflict between fixed claimants and shareholders is, as we previously observed “raised to a new dimension in the banking context.”³ In banking, neither creditors nor capital markets have incentives either to negotiate for protections against risky, “bet-the-bank” investment strategies, or to demand compensation for such risk in the form of higher interest payments.

Bebchuk and Spamann [2010] argue that these agency conflicts manifest particularly in problems with bank executive compensation. They make the intriguing point that governance reforms aimed at aligning compensation with shareholder interests – such as say-on-pay votes, use of restricted stock, and increased director independence – fail in banks because shareholders also benefit from bank management taking on excessive risk. This raises the disturbing specter that bank directors are in fact doing their job – but that their job does not include adequately recognizing the systemic risks that banks pose for the financial system.

2.3 Monitoring and Loyalty Problems: The London Whale

² In bankruptcy law and practice, there are two types of insolvency. Insolvency in the balance sheet sense means that the value of a company’s liabilities is greater than the value of its assets. Insolvency in the equity sense means that the firm is unable to pay its debts as they come due in the ordinary course of business. James J. Jurinski, *How to File for Bankruptcy*, 33 *Barrons* (2003).

³ Macey and Ohara 2003 at 98.

The moral hazard caused by deposit insurance coupled with imperfections in the regulatory system leads not only to excessive risk-taking by banks, but also to an industry-wide reduction in levels of monitoring within the firm, resulting in a higher incidence of large losses and bank failures due to fraud.⁴ The high incidence of fraud is attributable both to the lack of monitoring by creditors and to the highly liquid form of banks' assets, which makes it easy to divert bank assets to private use relative to less liquid assets such as factories and equipment.

Shareholders' incentives to monitor to prevent fraud and self-dealing exist in banks as they do in other sorts of companies. As in these other sorts of companies, however, "such monitoring is notoriously ineffective in many cases because individual shareholders rarely have sufficient incentives to engage in monitoring because of collective-action problems."⁵

Perhaps no event illustrates the endemic monitoring and other corporate governance problems in the context of the banking industry more clearly than the London whale trading loss debacle, in which Mary Jo White, the new chair of the U.S. Securities and Exchange Commission (SEC) deployed her marquee policy to require admissions of wrongdoing in certain "egregious" cases.⁶ The SEC charged JPMorgan Chase with misstating financial

⁴ See Remarks of R. L. Clarke, The Exchequer Club, in Comptroller of the Currency News Release no. NR 1988, p. 6 noting that fraud and self-dealing were "apparent" in as many as one-third of the bank failures that occurred during the 1980s. See also Jackson and Symons (1999, p. 152), citing a study by the U.S. General Accounting Office of banks failures in 1990 and 1991 that reported that in slightly more than 60 percent of these failures (175 out of 286), insider lending was a "contributing factor."

⁵ Macey and O'Hara, 2003 at 98.

⁶ Kevin LaCroix, The D&O Diary, <http://www.dandodiary.com/2013/09/articles/securities-litigation/a-closer-look-at-jp-morgans-920-million-london-whale-regulatory-settlements/> September 20, 2013, accessed most recently on November 21, 2013. The SEC's new policy was announced internally an email sent to SEC staff this week, co-Enforcement directors Andrew Ceresney and George Canellos announced that "cases in which the defendant engaged in 'egregious intentional misconduct' may justify requiring an admission, as would the obstruction of an SEC investigation or 'misconduct that harmed large numbers of investors.'" The traditional "neither-admit-nor-deny" settlements remain a "major, major tool" used by the SEC in the majority of cases, according to the SEC. Bruce Carton, SEC to Require Admissions of Wrongdoing in Settlements of Egregious Cases, Compliance

results and lacking effective internal controls to detect and prevent its traders from fraudulently overvaluing investments to conceal hundreds of millions of dollars in trading losses.⁷

The SEC's lawsuit against JPMorgan charged the company with violating provisions of the Sarbanes-Oxley Act of 2002 (SOX) relating to corporate governance and disclosure. In particular, SOX requires public companies to maintain disclosure controls and procedures that ensure that important information flows to the appropriate persons so that timely decisions can be made regarding disclosure in public filings.⁸ Also at issue were JP Morgan's alleged violations of SEC regulations requiring corporate managers to evaluate on a quarterly basis the effectiveness of the company's disclosure controls and procedures and to disclose management's conclusion regarding their effectiveness in its quarterly filings.⁹ The SEC also alleged that even after having announced a trading loss of approximately \$2 billion on May 10, 2012, the full extent of the trading losses that had occurred during the first quarter of 2012 was not detected and reported.¹⁰ This failure was due, in part, to ineffectiveness of internal control functions within the bank's Chief Investment Office, which was known as the Valuation Control Group ("CIO-VCG").¹¹

Week, June 19, 2013, <http://www.complianceweek.com/pages/article.aspx?articleid=299339&pagetypeid=2&publishDate=False×tamp=635072389785525327>, accessed November 22, 2013.

⁷ SEC, Order Instituting Cease-And-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order; <http://www.sec.gov/litigation/admin/2013/34-70458.pdf> (Order)

⁸ Id. Such requirements on internal accounting controls are intended to "provide reasonable assurances that transactions are recorded as necessary to permit preparation of reliable financial statements."

⁹ Id.

¹⁰ Id.

¹¹ Id.

Within banks, valuation control units are a critical part of a company's internal controls because they monitor and control for accuracy of the valuations of the financial assets acquired and held by traders and other market professionals within the firm. From a corporate governance perspective it is obvious that a valuation control group must be independent of the trading desks it monitors in order to be effective. The consequences of a corporate governance failure in this respect are severe because such failures risk both the inaccurate valuation of the bank's assets as well as the material misstatement of the bank's financial condition in its public filings. In the case of JPMorgan, the SEC found that JPMorgan's CIO-VCG was "unequipped to cope with the size and complexity of the credit derivatives" that were the principal assets in the banks' Synthetic Credit Portfolio ("SCP").¹² As of March 31, 2012, the SCP contained 132 trading positions with a net notional amount of approximately \$157 billion.¹³

The SEC also found that the CIO-VCG "did not function as an effective internal control" during the relevant time period because the CIO-VCG was "understaffed, insufficiently supervised, and did not adequately document its actual price-testing policies."¹⁴ Perhaps more disturbingly, it appeared to the SEC that the price-testing methodology used by CIO-VCG "was subjective and insufficiently independent from the SCP traders, which enabled the traders to

¹²The SCP was invested in two primary index groups: CDX, a group of North American and Emerging Markets indices, and iTraxx, a group of European and Asian indices. Some indices referenced companies considered to be investment grade and others referenced companies considered to be high-yield (which generally means that their credit risk is viewed as higher). Investors in CDX and iTraxx indices, including CIO, can be "long" risk, which is equivalent to being a seller of CDS protection, or "short" risk, which is equivalent to being a buyer of CDS protection. See Annex A to SEC, Order Instituting Cease-And-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order; <http://www.sec.gov/litigation/admin/2013/34-70458.pdf> (Annex).

¹³ Id.

¹⁴ SEC Order at 2.

improperly influence the VCG process.”¹⁵ In addition, during the first quarter of 2012, CIO-VCG failed to escalate to CIO and JPMorgan management significant information that management required in order to make informed decisions about disclosure of the firm’s financial results for the first quarter of 2012. As a result, JPMorgan did not timely detect or effectively challenge questionable valuations by the SCP traders as the portfolio’s losses accumulated in the first quarter of 2012, leading the bank to publicly misstate its financial results for that period.¹⁶

The internal problems were egregious. For example, when losses were incurred on the traditionally profitable SCP portfolio in the first quarter of 2012, the senior SCP trader instructed SCP traders to stop reporting losses to CIO management unless there was a market-moving event that could easily explain the losses. At least one SCP trader changed his daily marking methodology for the SCP and began assigning values at the point in the bid-offer spread that resulted in highest valuations of the SCP positions, a valuation technique inconsistent with Generally Accepted Accounting Principles (GAAP).¹⁷ Things got much worse when this trader

¹⁵ Id.

¹⁶ Another significant corporate governance failure was inadequate communication between JPMorgan’s Senior Management and the Audit Committee of JPMorgan’s Board of Directors (the “Audit Committee”). JP Morgan senior management initiated reviews of the CIO-VCG’s work after learning of significant disputes between the bank and its counterparties about the value of the assets held in the SCP. From these reviews, the Bank’s management learned that there were problems with the CIO-VCG’s price testing and “an undue amount of subjectivity” in its control function. Contrary to the requirements of SOX, however, JP Morgan’s management did not inform the Audit Committee of the Bank’s board of directors that it was aware of significant deficiencies or material weaknesses in the firm’s internal control over financial reporting. As the SEC observed in its Order, this information must be passed along to the Board by management so that “the Audit Committee to fulfill its oversight role and help to assure the integrity and accuracy of information.

¹⁷ Under applicable accounting rules, the positions in the SCP had to be marked “within the bid-ask spread” at the point that is “most representative of fair value in the circumstances,” with a particular emphasis on the price where the traders could reasonably expect to transact. GAAP also allows for the use of mid-market pricing “as a practical expedient for fair value measurements within a bid-ask spread.”

even began valuing assets at prices that were completely “outside every dealer’s bid and offer received that day”... and thereby “intentionally understated mark-to-market losses in the SCP.”¹⁸

In JP Morgan’s \$200 million settlement of the SEC’s enforcement action against it, the bank acknowledged significant corporate governance failures. For example, the Bank admitted that significant facts learned in the course of the various internal reviews were not shared in meetings and calls among the participants in such reviews. As a result, these facts were not escalated to JPMorgan Senior Management or communicated to the Audit Committee of the board in a timely fashion.¹⁹ However, it is not clear that the Bank’s Audit Committee would have been able to handle the monitoring and internal control problems in the bank even if they had been better informed. Also apparently missing in action was the bank’s risk committee which also was not kept informed of what was clearly a gaping hole in the bank’s risk management process.

The Board of Governors of the Federal Reserve (Fed) joined the SEC in suing and settling with JPMorgan Chase & Co., (JPMC), the registered bank holding company that owns and controls the bank.²⁰ The Fed’s Order did raise these deficiencies in risk management and oversight, as well as raising concerns with the governance, finance and internal audit functions of the company.²¹

¹⁸ Id.

¹⁹ Id Annex A at 31.

²⁰ In addition to the SEC’s enforcement action, the Office of the Comptroller of the Currency, which regulates the national bank subsidiaries of the holding company, and the UK Financial Conduct Authority filed lawsuits against JPMorgan Chase, N.A., the bank subsidiary JP Morgan.

²¹ Board of Governors of the Federal Reserve System Order of Assessment of a Civil Money Penalty Issued Upon Consent Pursuant to the Federal Deposit Insurance Act, as Amended, September 19, 2013, <http://www.federalreserve.gov/newsevents/press/enforcement/enf20130919a.pdf>. (Fed Order)

In earlier decades, the mismatch between the maturity and liquidity characteristics of banks' assets and liabilities, their unusually high leverage, and the moral hazard caused by such institutional features as the Fed discount window, deposit insurance, and the expectation of bailouts, largely defined the unique corporate governance problems experienced by banks. These characteristics remain, but the JPMorgan whale debacle underscores some important new dimensions of bank corporate governance problems: the opacity of bank activities, combined with the complexity of risk management activities involving the valuation and control of complex asset positions, create significant monitoring difficulties for directors.

2.4 Dual boards and the Oversight of Banks

Yet another governance challenge arises from the unique structure of banks largely being controlled by holding companies. Since Goldman Sachs²² and Morgan Stanley²³ became bank holding companies and financial holding companies during the financial crisis, every major bank in the U.S. is now organized as some form of bank holding company ("BHC"). A BHC is defined as "[a] company that owns and/or controls one or more U.S. banks or one that owns, or has controlling interest in, one or more banks. A bank holding company may also own another bank holding company, which in turn owns or controls a bank; the company at the top of the ownership chain is called the top holder."²⁴

²² Goldman Sachs Group, Inc., a Delaware corporation, is a bank holding company and a financial holding company regulated by the Board of Governors of the Federal Reserve System (Federal Reserve Board). Its U.S. depository institution subsidiary, Goldman Sachs Bank USA (GS Bank USA), is a New York State-chartered bank.

²³ Morgan Stanley has operated as a bank holding company and financial holding company under the BHC Act since September 2008. Morgan Stanley is financial holding company holding company regulated by the Board of Governors of the Federal Reserve System (the "Federal Reserve") under the Bank Holding Company Act of 1956, as amended (the "BHC Act")<http://www.morganstanley.com/about/press/articles/6933.html>;

²⁴ Under § 2020.1.3.1 of the Bank Holding Company Act of 1956, administered by the Federal Deposit Insurance Corporation (FDIC), a bank holding company is defined as "any company which has control over any bank or over any company that is or becomes a bank holding company by virtue of this Act.

(2) Any company has control over a bank or over any company if--

Bank holding companies are, by definition, involved in the business of banking. In fact, bank holding companies are limited by law to activities that are “so closely related to banking as to be a proper incident thereto.”²⁵ Because the BHC controls the bank, the monitoring and control of risk must take place at multiple levels. From a regulatory perspective, the Federal Reserve “is responsible for regulating and supervising bank holding companies, even if the bank owned by the holding company is under the primary supervision of a different federal agency (OCC or FDIC).”²⁶ When assessing a BHC, however, the Fed will “work cooperatively” with the functional regulator of the subsidiary bank “to address information gaps or indications of weakness or risk identified in a supervised BHC subsidiary that are material to the Federal Reserve’s understanding or assessment” of the BHC.²⁷ This structure of supervision acknowledges that Bank holding companies wield control over the banks they hold.

From a governance perspective, the holding company’s board inevitably exerts control over the banks within the holding company structure, particularly where, as is often the case, the directors of the bank holding company also sit as officers and directors of the bank. As such, it is each holding company director’s duty to control risk down to the level of the banks the BHC

a. the company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 per centum or more of any class of voting securities of the bank or company;

b. the company controls in any manner the election of a majority of the directors or trustees of the bank or company; or

c. the Board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company.”

²⁵ Bank Holding Company Act, *passim*.

²⁶ National Information Center, *All Institution Types Defined*, <http://www.ffiec.gov/nicpubweb/Content/HELP/Institution%20Type%20Description.htm> (accessed January 24, 2012).

²⁷ The Board of Governor’s Division of Banking Supervision and Regulation, *Bank Holding Company Supervision Manual*, § 1050.1.4.1.1 (2011).

holds.²⁸ This means the directors of holding companies, like the directors of the banks themselves, must be involved in the governance, risk-management, and monitoring and oversight of the banks and bank affiliates within the holding company structure. The formal corporate separateness of BHCs and the banks they control does not absolve holding company directors from involvement with the activities of their subsidiary banks even if there are directors who are on the board of a BHC but not on the board of the bank.²⁹

Howell Jackson has observed that holding companies and the banks they own and control are not truly separate as a practical matter:

Within bank holding companies, there is a natural tendency of management to centralize decision making power and resources in the parent bank or BHC. It is doubtful that management would leave the bank and non-bank subsidiaries free to make the important business decisions as to activities, reinvestment of profits and new markets. It is more likely that there would be significant centralization of decision making at the parent company level, with management deciding what products and markets will be focused upon and how profits will be reallocated.³⁰

Jackson also argues that this inter-relatedness of banks and BHCs has increased over time:

“Until twenty years ago [i.e. until twenty years prior to the publication of this article by Professor Jackson in 1994], financial holding companies . . . had relatively few affirmative obligations with respect to their regulated subsidiaries Over the past two decades however, financial holding companies have become increasingly embroiled in the regulatory supervision of subsidiary financial institutions.”³¹

²⁸ For further discussion, see Gang Bai, *Asset Opacity and CEO Compensation of Bank Holding Companies*, 2011 Financial Management Association Annual Meeting, Session 099: Managerial Compensation and Financial Institutions (Jan. 12, 2011).

²⁹ See, e.g., Andrew Ellul and Vijay Yerramilli, *Stronger Risk Controls, Lower Risk: Evidence from U.S. Bank Holding Companies*, AXA Working Paper Series No. 1 Discussion Paper No. 646, ISSN 0956-8549-646 (February 2011) (for a discussion of Bank Holding Companies’ directors crucial role in risk management of the entire organization).

³⁰ Howell E. Jackson, *The Expanding Obligations of Financial Holding Companies*, 107 HARV. L. REV. 509, 510 (Jan. 1994); see also, HOWELL E. SYMONS AND EDWARD SYMONS, REGULATION OF FINANCIAL INSTITUTIONS 304 (West Group, 1999).

³¹ *Id.* (emphasis added).

Jackson posits that this increased inter-relatedness reflects a regulatory push to “transfer front-line supervisory responsibility from governmental agencies to financial holding companies.” This is because, “[n]ot only are financial holding companies apt to be more proficient than government officials in evaluating institutional behavior, but holding companies also can monitor risks at a lower cost than government agencies, because holding companies already have substantial information about their regulated subsidiaries as a result of ordinary managerial activities.”³²

The Fed evaluates bank holding companies’ directors and senior executives based upon their ability to identify, measure, and control risk, which includes those posed by the underlying banks. Thus, the Fed essentially treats bank holding companies and their bank affiliates as so inextricably linked that, when evaluating BHCs, it analyzes the *consolidated* organization’s financial strength and risks. Additionally, the Fed can examine a bank holding company’s subsidiaries directly to “inform itself of the systems for monitoring and controlling risks to such depository institutions.”³³

Since both the holding company and the bank have boards of directors, a natural question is what role should each board play? Thomas C. Baxter, Jr., General Counsel and Executive Vice-President of the Federal Reserve Bank of New York addresses this point:

We want the governing body of the holding company to perform two critical functions. First, we want it to understand the risks to the ‘enterprise,’ meaning the risks in all of the company’s constituent parts. Second, we want the holding company to *take reasonable steps to manage* those risks and keep them within acceptable limits.”³⁴“As I see it,

³² *Id.* at 513.

³³ CARNELL at 458.

³⁴ Thomas C. Baxter, Jr., *Governing the Financial or Bank Holding Company: How Legal Infrastructure Can Facilitate Consolidated Risk Management 1*, presented at the Puerto Rico Bankers Association conference “Financial Transparency and Corporate Governance of Financial Institutions after the Sarbanes-Oxley Act of 2002” in San Juan, Puerto Rico, 9(3) Current Issues in Economics and Finance 1 (Oct. 25, 2002).

the public interest in the bank subsidiary is protected by a panoply of prudential laws and regulations. The ownership interest of the holding company in the bank is protected by the holding company's ability to control the bank's board of directors.”

From both a regulatory perspective and a corporate governance perspective, bank safety and soundness is paramount. The well-known “source of strength” doctrine requires that bank holding companies provide financial assistance to support its banking subsidiaries. In particular, § 225.142 of the Bank Holding Company Act provides that “ [i]n supervising the activities of bank holding companies, the Board has adopted and continues to follow the principle that bank holding companies should serve as a source of strength for their subsidiary banks.” This notion pervades the BHC's corporate governance and directly impacts the relationship between the BHC and its subsidiaries.

It is our contention that the Fed's BHC regulations, the principles of corporate governance developed here, as well as basic concerns about systemic risk and bank safety all indicate that bank holding company officers and directors have fiduciary obligations that guide -- and when necessary, trump -- corporate form. Fiduciary duties flow not only to shareholders of the holding company but also to the corporate organization itself. Thus the responsibility for bank safety and soundness must be shouldered by both holding company directors and officers and the directors and officers of their subsidiaries, particularly their bank subsidiaries.

Less clear, however, is how the shared responsibility between the holding company board and the bank board should work in practice in the post-crisis environment. On the one hand, it clearly makes no sense to say that bank holding company officers and directors can ignore issues of safety and soundness that affect their subsidiary banks on the grounds that they are fiduciaries of a different corporate entity, namely the holding company. On the other hand, the notion that the duties and obligations of holding company officers and directors and

bank officers and directors are identical and wholly duplicative also appears problematic. To see why, consider the perspective of the OCC (the Office of the Comptroller of the Currency), the main regulator of nationally chartered banks, on its expectation for the subsidiary bank's directors. The OCC argues "For its part, the primary duty of the subsidiary bank's directors is to protect the bank"³⁵. This may be the view of the OCC, but this view is inconsistent with the duties of the directors of bank holding companies, which require that directors of holding companies – like directors of other firms – maximize value for shareholders.

Thus, there is a significant obstacle to making safety and soundness the primary duty of bank holding company directors or of bank holding companies. And these holding companies determine who sits on the board of directors of the banks they own or control. Bank holding companies are, from a state-law point of view, garden variety corporations, with garden variety fiduciary duties that are owed exclusively to shareholders. Unlike banks themselves, holding companies are not only subject to the same corporate governance rules as other companies, but, unlike banks, which receive charters either from the Comptroller of the Currency (national banks) or state bank regulators (state banks), holding companies are chartered by the same state chartering authorities as any other non-banks. For example, Citigroup, which owns a national bank, is charged in the state of Delaware,³⁶ as are Morgan Stanley³⁷ and Goldman Sachs.³⁸

³⁵ See Office of Comptroller of the Currency, *The Directors Book*, October 2010 (reprinted October 2013), pg. 26.

³⁶ See Certificate of Incorporation of Citigroup, available at:

http://www.google.com/url?sa=t&rct=j&q=&esrc=s&frm=1&source=web&cd=1&ved=0CCkQFjAA&url=http%3A%2F%2Fwww.citigroup.com%2Fcity%2Finvestor%2Fdata%2Fcitygroup_rci.pdf&ei=gHjyUvCZN8_KsQSeiDQDA&usg=AFQjCNGY8g7ajcVsqMbRCIhq17JsTGo1w&sig2=ksmOh7KNWoPoz17Jf0QKdA&bvm=bv.60799247,d.cWc.

³⁷ See Certificate of Incorporation of Morgan Stanley, available at:

<http://www.morganstanley.com/about/company/governance/certcomp.html>

³⁸ See Certificate of Incorporation of Goldman Sachs, available at:

<http://www.google.com/url?sa=t&rct=j&q=&esrc=s&frm=1&source=web&cd=1&cad=rja&ved=0CDkQFjAA&url=http%3A%2F%2Fwww.goldmansachs.com%2Finvestor-relations%2Fcorporate-governance%2Fcorporate->

The problem is simple to describe. Because they are considered simply to be directors of garden variety corporations, holding company directors (and bank directors too, for that matter), ostensibly have no obligation to mitigate risk, but rather are tasked with *maximizing* the value of the company on whose board they sit. This rule makes perfect sense in the context of non-financial corporations, whose failure poses no systemic risk and whose shareholders can eliminate the firm-specific risk of the company's business antics easily and cheaply through diversification.

On the other hand, of course, the federal government, if not the state governments, want banks and bank holding companies to refrain from engaging in excessive risk-taking. Thus, bank holding company directors are pulled in two opposite directions by the legal rules that govern their behavior. On the one hand, as established in this section, it is the clear policy of federal banking regulators, particularly the Fed, that holding companies – and particularly large holding companies whose operations pose systemic risks – should focus primarily on issues of safety and soundness. On the other hand, the state laws that impose fiduciary duties on the directors of all corporations, both banks and non-banks, require all such directors to maximize the value of the firm, even if doing so causes the company to assume considerable risk. And, because of the low-cost of leverage for federally insured banks and for systemically important financial institutions of all kinds, these fiduciary duties will channel directors towards tolerating, if not actively encouraging, risky capital structures and risky investment practices.

One way to reconcile the apparently deep inconsistency between bank and bank holding company directors' fiduciary obligation to maximize returns and their statutory and

[governancedocuments%2Frestatecertificate.pdf&ei=B3vyUu2cKonMsQTwnIHVDg&usg=AFQjCNEct6m0O5Q7ueDIz0bbwzGH-iEcMg&sig2=K-iIoR5fwWEsp1yniZh8Jg&bvm=bv.60799247,d.cWc](#)

regulatory obligations to promote safety is to prioritize these conflicting dictates. The regulatory and statutory obligations come first. Managers and directors can only maximize profits to the extent that doing so does not conflict with relevant legal rules and regulations. As the influential American Law Institute Principles of Corporate Governance make clear, a corporation "[i]s obliged, to the same extent as a natural person, to act within the boundaries set by law."³⁹ Or as Milton Friedman admonished, corporations are obligated "to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom."⁴⁰

In our view, the fact that banks and their officers and directors can only maximize profit within the limits of applicable law and regulations is an extremely important feature of the corporate governance landscape. Establishing and maintaining this hierarchy, however, does not resolve entirely the tension between profit maximization and the regulatory and social goals of achieving safer and sounder financial institutions. This is because, as we have seen over the past several decades, there is plenty of room for financial institutions to engage in excessive risk-taking even after they have complied with the law.

For example, banks must of course comply with the relevant rules regarding the maintenance of certain capital levels. But even after complying with such rules, there is ample room to maneuver. Banks, for example, can, and do invest in the riskiest assets within a particular risk-weighting class. They also look for loopholes in regulations such as the Volcker rule in order to squeeze the highest returns they can for their shareholders: and, of course this quest for the highest returns involves risk, which, in turn, is not something that regulators are interested in maximizing.

³⁹ A.L.I. Principles of Corporation Governance, Section 2.01(b)

⁴⁰ <http://www.professorbainbridge.com/professorbainbridgecom/2011/03/a-corporations-obligation-to-obey-the-law.html>

But the fiduciary duty to maximize profits is not the only obstacle to reaching the goal of incentivizing managers and directors of financial institutions to focus on keeping banks safe with the same intensity as directors of other companies focus on maximizing share prices. In addition to fiduciary duties, it also is the case that holding company directors, like the directors of all other corporations, are elected by the shareholders. Fixed and contingent claimants, such as depositors, non-depositor-creditors and the U.S. government lack voting power. In an election between a risk-taker and a non-risk taker, the shareholders will vote for the risk-taker. Thus, to the extent that directors survive in their jobs in the Darwinian environment that characterizes the democratic process, among the strongest characteristics for survival in the job of bank or bank holding company directors is a strong proclivity for risk-taking.

3. Bank Corporate Governance: Solutions Past and Present

How to resolve the unique moral hazard and corporate governance problems of banks is a matter of long-standing debate. Certainly these problems explain, at least in part, why banks are -- and long have been -- the subject of much more intensive regulation than virtually all other forms of business.⁴¹ The fact that safeguards for creditors of banks existed long before deposit insurance made the government a contingent claimant on banks' cash flows supports our argument that banks are unique in their susceptibility to insolvency. Moreover, the fact that the power of these safeguards has diminished in certain significant ways is highly relevant to our analysis of how to restructure bank corporate governance in the post-crisis era. In this section

41 With the possible exception of companies that manufacture and use nuclear material, banking is the most regulated industry in the U.S. The U.S. Nuclear Regulatory Commission (NRC) is responsible for regulating - commercial and institutional uses of nuclear materials, including nuclear power plants. Founded in 1975, the NRC sets limits on radiation exposure from the radioactive materials it licenses and requires those with licenses to keep exposures well below these limits. Emily Fisher, editor, *Nuclear Regulation in the U.S.: A Short History* (2012)(Nova Science)

we consider the varied ways bank governance issues have been addressed in the past, and some new approaches being proposed and implemented in locales both within and outside of the U.S.

3.1. Heightened Regulation

Banks are subject to myriad special regulations. The periodic reporting and on-site inspections required by federal and state regulators are only the beginning. Many regulations actually require bank regulators to make subjective determinations of the quality of bank management. This is a responsibility virtually unheard of in a free-market, private enterprise system. In such systems, shareholders generally have plenary authority to decide who manages the companies in which they have invested.

For U.S. commercial banks, regulators use the Uniform Financial Institutions Rating system, generally referred to as CAMELS, to evaluate banks' financial soundness.⁴² The CAMELS system evaluates banks' capital adequacy, asset quality, management, earnings, liquidity and sensitivity to market risk. These assessments require regulators to evaluate the quality of bank management. For example, a bank's capital adequacy will depend, in part on management's ability to identify measure, monitor and control risks.⁴³ Asset quality requires that regulators evaluate assets in light of management's ability to identify measure monitor and control credit risk.⁴⁴ The Management criterion reflects a bank's primary regulator's judgment of the ability of the bank's board of directors and senior officers to identify, measure, monitor and control the risks of the bank's activities and to assure the bank's safe and efficient operation

⁴² Carnell, Macey, Miller at 434.

⁴³ Id. at 435.

⁴⁴ Id.

in compliance with applicable laws.”⁴⁵ Other criteria evaluate the quality of the control systems implemented by management as well as banks’ funds management practices.⁴⁶

Banks whose management is deemed inadequate may be categorized as unsafe and unsound, and are subject to enforcement action including closure. In addition to the CAMELS system, the Federal Deposit Insurance Corporation Improvement Act (FDICIA) requires regulators to promulgate safety and soundness standards for banks’ internal controls, information systems, and internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, and compensation, fees, and benefits, and asset quality, earnings, and stock valuation.⁴⁷

Bank regulators also have the power to remove officers and directors, to ban them from ever working for a bank, and to impose civil monetary penalties against a banking institution and its affiliates. So-called prompt corrective-action powers allow regulators to regulate every significant operational aspect of a bank.⁴⁸ This oversight means that corporate governance is no longer the ambit of the bank’s owners, but rather is an odd (at least relative to other firms) shared-custody arrangement with the regulators.

There are clearly problems with this hybrid approach. As observed previously, replacing private-sector creditors with public-sector regulators as the first line of defense against bank fraud and self-dealing raises two problems. First, private-sector creditors have stronger incentives than public-sector regulators to monitor closely for fraud and self-dealing because the creditors’ own money is on the line, while the regulators’ money is not. Unlike regulators, private sector creditors will monitor until the losses avoided from such monitoring equal the

⁴⁵ Id.

⁴⁶ Id.

⁴⁷ 12 U.S.C. § 1831p-1

⁴⁸ As a practical matter the FDIC’s power to revoke a bank’s deposit insurance conveys similar power.

marginal cost of such activity. Second, because of the lack of private sector market discipline, there are insufficient incentives for bankers to develop mechanisms for providing depositors and creditors with credible assurances that they will refrain from fraudulent activities.⁴⁹

These difficulties may explain why even embedding regulators in the bank has not proved effective. Rather than reporting to an office in a government building, embedded regulators work inside the private sector institutions to which they have been assigned. At JPMorgan Chase approximately 40 examiners from the Federal Reserve Bank of New York and 70 examiners from the Office of the Comptroller of the Currency were embedded in the bank at the time of the whale trading episode. Yet, the London Whale trading losses were not monitored by embedded regulators because the regulators did not embed any examiners in the unit's offices in either London or New York. Instead, the unit was examined periodically.

The relative lack of oversight of JPMorgan's chief investment office by the legion of regulators embedded in the bank apparently was due to a lack of understanding of what this office did. Generally speaking, banks' investment offices, known as Treasury units, restrict their activities to hedging and making low-risk, short-term investments with cash on hand. In contrast, the Treasury unit at JPMorgan had a portfolio of almost \$400 billion. Far from limiting itself to hedging, the unit had become a profit center that made large bets and claimed to have recorded \$5 billion in profit over the three years through 2011.⁵⁰ This episode strongly suggests limits on the efficacy of embedded regulators in curtailing risk in the bank.

On January 16, 2014, the Comptroller of the Currency proposed minimum standards for the design and implementation of a risk governance framework for large insured national banks,

⁴⁹ Macey and O'Hara at 98-99.

⁵⁰ These standards would also apply to insured Federal savings associations, and insured Federal branches of foreign banks with average total consolidated assets of \$50 billion or more. See Jessica Silver-Greenberg and Ben Protess, "Bank Regulators Under Scrutiny in JPMorgan Loss," May 25, 2012, The New York Times, http://www.nytimes.com/2012/05/26/business/regulators-role-at-jpmorgan-scrutinized.html?_r=3&hp&.

and minimum standards for the board of directors in overseeing the framework’s design and implementation.⁵¹ The OCC also proposed a new statute authorizing the OCC to prescribe operational and managerial standards for national banks and Federal savings associations.⁵² This proposal represents a new, and remarkably detailed, regulatory mandate regarding bank governance activities and responsibilities.

In its request for public comments on its proposed minimum standards, the OCC observed that “[S]ince large banks are often one of several legal entities under a complex parent company, each bank’s board must ensure that the bank does not function simply as a booking entity for its parent and that parent company decisions do not jeopardize the safety and soundness of the bank. This often requires separate and focused governance and risk management practices.”⁵³

The OCC proposal articulates several other expectations. These include that large institutions have a “well-defined personnel management program that ensures appropriate staffing levels, provides for orderly succession, and provides for compensation tools to appropriately motivate and retain talent that does not encourage imprudent risk taking”⁵⁴; and that institutions define and communicate “an acceptable risk appetite across the organization, including measures that address the amount of capital, earnings, or liquidity that may be at risk on a firm-wide basis, the amount of risk that may be taken in each line of business, and the amount of risk that may be taken in each key risk category monitored by the institution.”⁵⁵

⁵¹ Office of the Comptroller of the Currency, “OCC Guidelines Establishing Heightened Standards for Certain Large Insured National Banks, Insured Federal Savings Associations, and Insured Federal Branches; Integration of 12 CFR Parts 30 and 170.” The Guidelines would be issued and enforceable under section 39 of the Federal Deposit Insurance Act (the “FDI Act”), which authorizes the OCC to prescribe safety and soundness standards. 12 U.S.C. § 1831p-1.

⁵² Id.

⁵³ Id. At 5.

⁵⁴ Id.

⁵⁵ Id.

Additionally, the OCC “expects institutions to have reliable oversight programs, including the development and maintenance of strong audit and risk management functions. This expectation involves institutions comparing the performance of their audit and risk management functions to the OCC’s standards and leading industry practices and taking appropriate action to address material gaps.”⁵⁶ The OCC proposal also “focuses on the board of directors’ willingness to provide a credible challenge to bank management’s decision-making and thus requests independent directors to acquire a thorough understanding of an institution’s risk profile and to use this information to ask probing questions of management and to ensure that senior management prudently addresses risks.”⁵⁷

A bank can use its parent company’s risk governance profile to satisfy the Comptroller’s new Guidelines if the parent’s risk profile is substantially the same as its own risk profile.⁵⁸ If not, the bank must come up with its own risk governance framework. Banks may, in consultation with OCC examiners, use components of its parent’s risk governance framework, but should ensure that the Bank’s risk profile is easily distinguished and separate from that of its parent for risk management and supervisory reporting purposes, and that the Bank’s safety and soundness is not jeopardized by decisions made by the parent’s board of directors and management.⁵⁹

The OCC’s Guidelines also set out minimum standards for the design and implementation of a bank’s Framework for risk management. Every bank would have to establish and adhere to a formal, written Framework that covers: (a) credit risk; (b) interest rate risk; (c) liquidity risk; (d) price risk; (e) operational risk; (f) compliance risk; (g) strategic risk; and (h) reputation risk. Each bank’s

⁵⁶ Id. at 5-6.

⁵⁷ Id. at 6.

⁵⁸ A parent company’s and Bank’s risk profiles would be considered substantially the same if, as of the most recent quarter-end Federal Financial Institutions Examination Council Consolidated Reports of Condition and Income (Call Report), the following conditions are met: (i) the Bank’s average total consolidated assets represent 95% or more of the parent company’s average total consolidated assets; (ii) the Bank’s total assets under management represent 95% or more of the parent company’s total assets under management; and (iii) the Bank’s total off-balance sheet exposures represent 95% or more of the parent company’s total off-balance sheet exposures. Id. at 11.

⁵⁹ Id. at 11.

Framework must also account for the risks to the Bank’s earnings, capital, liquidity, and reputation that arise from all of its activities.

The Comptroller identifies three “lines of defense” for bank risk, namely front-line units, independent risk management, and internal audit. The three units should remain independent of each other. The bank’s board of directors and its CEO retain substantial responsibility for risk-management. But, as a law firm with substantial experience in representing banks before the OCC has observed, “[i]f adopted as proposed, the Guidelines’ detailed requirements regarding roles, responsibilities, and reporting structures would represent a significantly enhanced level of regulatory intervention into bank management and internal processes.”⁶⁰

The OCC’s proposed Guidelines impose specific risk management-related responsibilities on the CEO and new standards for the bank’s board of directors.⁶¹ These board standards stipulate that:

A. Each member of the bank’s board of directors has a duty to oversee the bank’s compliance with safe and sound banking practices. Consistent with this duty, the board of directors should ensure that the bank establishes and implements an effective risk governance framework that meets the minimum standards described in these Guidelines. The board of

⁶⁰ ,Sullivan & Cromwell, LLP, “Heightened Risk Governance Standards for Banks and Bank Boards of Directors: Proposed OCC “Guidelines” Would Establish Heightened Standards for Large National Banks’ Risk Governance Frameworks and Boards of Directors, and Accelerate Trends of Regulatory Involvement and Reliance on Enforcement,” January 21, 2014, at 2, https://www.sullcrom.com/files/Publication/5a0f2ae7-09cf-4f18-a9be-5910c9775b0b/Presentation/PublicationAttachment/559b34e5-b3b6-43a1-ac66-619e6d61d4e6/SC_Publication_Heightened_Risk_Governance_Standards_for_Banks_and_Bank_Boards_of_Directors.pdf.

⁶¹ Under the Guidelines, the CEO is responsible for developing a strategic plan of at least three years, that includes a comprehensive assessment of risks to the Bank during the time period covered by the plan, along with an explanation of how the Bank will update the Framework to account for changes in the Bank’s risk profile. The strategic plan must be approved by the bank’s board of directors and reviewed, updated, and approved to reflect changes in the Bank’s risk profile or operating environment. The CEO is also required to oversee the day-to-day activities of the Chief Risk Executive and the Chief Accounting Executive.

directors or the board's risk committee should approve any changes to the risk governance framework.

B. The bank's board of directors actively oversee the bank's risk-taking activities and hold management accountable for adhering to the risk governance framework. In providing active oversight, the board of directors should question, challenge, and when necessary, oppose recommendations and decisions made by management that could cause the bank's risk profile to exceed its risk appetite or jeopardize the safety and soundness of the bank.

C. When carrying out his or her duties under each member of the board of directors should exercise sound, independent judgment.

D. at least two members of the board of directors should not be members of (either) the bank's management or the parent company's management.⁶²

E. the board of directors should establish and adhere to a formal, ongoing training program for independent directors. This program should include training on: (i) Complex products, services, lines of business, and risks that have a significant impact on the bank; (ii) Laws, regulations, and supervisory requirements applicable to the bank; and (iii) Other topics identified by the board of directors.

F. The bank's board of directors should conduct an annual self-assessment that includes an evaluation of its effectiveness in meeting the standards for directors contained in section III of the OCC Guidelines.⁶³

⁶² The OCC requests comment regarding the composition of a Bank's Board, including whether the minimum number of two independent directors required under the Guidelines is the appropriate number, whether there are other standards the OCC should consider to ensure the Board's composition is adequate to provide effective oversight of the Bank, and whether there is value in requiring the Bank to maintain its own risk committee and other committees, as opposed to permitting the Bank's board to leverage the parent's Board committees.

⁶³ OCC Guidelines 75-78.

The OCC's proposed rule posits that "one of the primary fiduciary duties of a Bank's Board is to ensure that the institution operates in a safe and sound manner." As Sullivan & Cromwell's Memorandum points out,

this statement is troublesome in multiple respects. First, it provides that the Board has an obligation to "ensure" a result, which is a standard that is beyond existing law and often achievability. Second, there may be an implicit suggestion that this "fiduciary duty" is owed to someone, e.g., the OCC, other than the shareholder(s). Third, the statement suggests that there is a separate fiduciary duty beyond the two widely recognized duties of loyalty and care.⁶⁴

The OCC also asserts that boards of directors of national banks "must ensure . . . that parent company decisions and 'complex banking structures' do not jeopardize the safety and soundness of the bank."⁶⁵ This is a strange assertion in light of the fact that it is the Fed, and not the OCC that regulates the parent companies of banks. In light of this fact, [i]t is not clear how this could be accomplished."⁶⁶

The OCC's proposed Guidelines represent the most complete articulation to date of the expectations that regulators have for bank directors with regard to safeguarding the safety and soundness of banks. These Guidelines raise more questions than they answer. In particular, there is no indication of where profit maximization fits into the OCC's vision of bank corporate governance. Even more significantly, there is no indication of how the competing duties and responsibilities of bank and holding company directors are to be reconciled. In other words, as so often is the case, the regulations purport to compel behavior without taking into account the incentives of the regulated officers and directors. This is particularly relevant in light of the fact that officers and directors of banks likely are interested in such things as promotions,

⁶⁴ S&C Memo, *supra*, at p. 11

⁶⁵ OCC Guidelines at 75.

⁶⁶ S&C Memo, *supra*, at p. 11.

compensation, and continued tenure in their jobs - and it is the holding companies, not the OCC, that controls these matters.

3.2 Multiple Liability for Bank Shareholders

The system of double and sometimes triple liability for bank shareholders was an ingenious device for dealing with bank's moral hazard and balance-sheet instability. In the late nineteenth century, decades before deposit insurance was introduced, states imposed double, triple, and, in the cases of New Hampshire and Pennsylvania, even unlimited joint and several liability on bank shareholders. These state laws prevented the issuance of corporate charters to banks whose shareholders did not agree to pay up to the amount of their original investment into the estate of the bank if it ever should become insolvent. The National Bank Act of 1863 extended this liability regime to shareholders in national banks, requiring that "each shareholder shall be liable to the amount of the par value of the shares held by him, in addition to the amount invested in such shares."⁶⁷

The historical system of multiple liability for bank shareholders did more than protect depositors and other creditors from the consequences of bank failure *ex post*. It also had the effect of reducing moral hazard *ex ante* because shareholders, who controlled banks' boards of directors, realized that they would be personally liable for much, if not all, of the negative consequences of excessive risk-taking. And multiple liability worked to stem depositors' losses in the Great Depression, despite the very large number of bank failures.⁶⁸ In other words,

⁶⁷ National Banking Act of 1863, Ch. 58, 12 Stat. 665.

⁶⁸ During the period of the Great Depression (1929-1933), 9,000 banks failed or suspended operations, depositor losses amounted to only \$ 1.3 billion, a figure that pales in comparison to the \$ 85 billion in losses borne by holders of common and preferred stock over the same period. M. Friedman & A. Schwartz, *A Monetary History of the United States, 1867-1960*, at 440 (1963). During the Depression-era, the number of banks in the US fell from 24,633 to 15,015 - a decline of 39 percent. The 5,712 banks that failed during this period had total deposits of \$1.6 billion, total losses to depositors was \$565 million, which was 1 percent of average deposits during this period.

shareholders, not depositors, internalized the costs of bank failures before the Banking Act of 1933 initiated *de jure* deposit insurance for all deposit accounts under the statutory limit (currently \$250,000).⁶⁹ Deposit insurance made the pre-Depression multiple liability regimes unnecessary from the point of view of many depositors. On the supply side, the credit enhancement for depositors provided by multiple liability was replaced by the credit enhancement provided by deposit insurance. As a result, banks no longer faced the same demand for a mechanism to signal that they would keep moral hazard in check. By 1935 the federal and state multiple liability regimes had been eliminated.⁷⁰

To a very large extent, all of the modern banking regulations that we observe, including capital requirements, reserve requirements, enhanced supervision, embedded regulators, and prompt intervention are devices intended to deal with the fact that much of the costs of bank failure has shifted from bank shareholders to bank regulators.

3.3 Capital and Liquidity Requirements

In general, there are no legal requirements that companies maintain any particular level of capital as a protective cushion for creditors and other constituencies. Of course, this is not the case in banking. Capital requirements of various sorts, including simple limits on overall leverage and various forms of risk-based capital rules are a standard feature of bank regulation. The purpose of these capital requirements is to reduce the probability of failure and to reduce moral hazard by forcing bank shareholders to bear a larger share of the losses experienced by the claimants on the cash flows of distressed firms.

Charles Calamoris, "The Political Lessons of Depression-era Banking Reform", in *The Great Depression of the 1930s: Lessons for Today*, 166 (edited by Nicholas Crafts and Peter Fearon).

⁶⁹ Macey & O'Hara 100.

⁷⁰ *Id.*

Along with most observers, we are of the view that requiring appropriate levels of capital is critical to achieving a safe and sound banking system. Unfortunately, for several reasons we also believe that reasonably stringent bank capital requirements, while important, are only part of a properly functioning regulatory and governance system. Among our concerns about relying too heavily on bank capital requirements to avoid the financial meltdowns associated with banking crises is that “banks can respond to higher capital requirements in ways that make them less rather than more safe.”⁷¹ For example, banks avoid complying with the spirit of higher capital requirements by selling risky assets to “off balance sheet” entities, such as Structured Investment Vehicles (SIV’s) and Variable Interest Entities (VIE’s). Banks also can limit the effectiveness of higher capital requirements by investing in increasingly risky assets. Doing this will increase the expected returns on whatever new levels of capital are required. This strategy is effective because risk weightings are distributed among rather crude categories of assets and often do not adequately reflect the true risk of the assets in a particular risk weighting category, either because the chosen weights are wrong or because the categories are too broad.⁷²

Another problem with bank capital requirements is that capital levels do not adjust at nearly the same high speed at which assets can deteriorate. Many examples from the ongoing financial crisis that began in 2007-2008 illustrate this observation, as financial firms that were considered well-capitalized became insolvent in days, and sometimes even in mere hours. During the financial crisis a number of financial institutions saw their capital levels, as expressed as Tier 1

⁷¹ Douglas J. Elliott, A Primer on Bank Capital, Brookings Institution Research Paper, at 17. The Brookings Institution, January 28, 2010, <http://www.brookings.edu/research/papers/2010/01/29-capital-elliott>.

⁷² Thomas Hoenig, Basel III Capital: A Well-Intended Illusion, FDIC, Speeches and Testimony, April 9, 2013.

common equity, erode by over 500 basis points.⁷³ A Fed study has shown that even the higher proposed levels of capital used in the Basel III rules, which establish a minimum Tier 1 common equity plus the conservation buffer of 7 percent for most banks, and at 8 to 9.5 percent for systemically important financial institutions, would not have been sufficient for some banks.⁷⁴

Thus, bank capital requirements need to be set in coordination with other regulations and with a good system of supervision and examinations, ideally aided by transparent accounting that allows the capital markets and rating agencies to form their own judgments about the true riskiness of the activities of the banks. Simply put, “high capital levels alone are not enough.”⁷⁵

Turning from capital levels to bank liquidity, recently, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System, and the FDIC have issued a notice of proposed rulemaking that would impose a quantitative liquidity requirement consistent with the liquidity coverage ratio in line with that established by the Basel Committee on Banking Supervision. The liquidity coverage ratio proposal would apply to specified financial companies with \$250 billion or more in total consolidated assets or \$10 billion or more in on-balance-sheet foreign exposure, to systemically important nonbank financial institutions, and to banking subsidiaries of one of these companies that have assets of \$10 billion or more. The purpose of the proposed liquidity coverage ratio is to strengthen the liquidity risk management of the companies to which it applies by requiring them to keep certain levels of high-quality liquid assets in order to meet the proposed rule’s quantitative liquidity standard. The quantitative liquidity standard is the ratio of a company’s high-quality liquid assets to its

⁷³ Eric S. Rosengren, Bank Capital: Lessons from the U.S. Financial Crisis, February 25, 2013 Speech at the Bank for International Settlements Forum on Key Regulatory and Supervisory Issues in a Basel III World at the Bank of Korea, Seoul, Korea, Figure 1. <http://www.bostonfed.org/news/speeches/rosengren/2013/022513/>

⁷⁴ Id.

⁷⁵ Id.

projected net cash outflows over a 30-day period. A company would have to calculate and maintain an LCR equal to or greater than 1.0 on each business day.⁷⁶

As with capital ratios, we do not view the proposed liquidity requirements as a panacea for the broad societal externalities created by bank crises. While liquidity is important, liquidity does not measure solvency. It measures only the ability of a firm to meet their short-term, immediate requirements for cash. Still more is needed.

3.4 Enhanced Duty Of Care

Another important way that bank regulation and bank corporate governance standards differed from those of other types of corporations is that bank directors were historically held to higher standards than other directors.⁷⁷ Specifically, the fiduciary duty of care, which is the duty to make reasonable, fully informed decisions and to engage in the levels of monitoring and oversight of risk that are sufficient to the particular needs of the business, was enforced more strictly against bank directors than for those of other companies. Courts attributed their tougher enforcement of directors' duties to the fact that "banks are charged with serving the public interest, not just the interests of the shareholders."⁷⁸

It is highly significant in our view that courts historically held directors of banks not merely to the standard to which it held other corporate directors, but to a higher standard that encompassed the concept of professionalism. Courts would, for example, impose personal liability on bank directors who approved transactions that were deemed to be "so improvident,

⁷⁶ "Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring" (PDF) 1 See "Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring" (December 2010), available at <http://www.bis.org/publ/bcbs188.pdf> . 2 See "Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools" (January 2013), available at <http://www.bis.org/publ/bcbs238.pdf> . TNS 30VianaGem - 131130-4565074 30VianaGem

⁷⁷ Macey & O'Hara, *supra* at 111

⁷⁸ *Id.*

so risky, so unusual and unnecessary as to be contrary to fundamental conceptions of prudent banking practices.”⁷⁹ Requiring bank directors to conform to prudent banking practices brought the standards for bank directors close to the standards imposed on professionals such as doctors and engineers. These professionals must perform their functions to the standards generally held by those in their profession.

In contrast, in the corporate world in general, directors and officers are required to act, and to make decisions in the same manner as a reasonable person would believe appropriate under similar circumstances.⁸⁰ Put simply, directors of most U.S. corporations are held to the same negligence standard as people participating in any amateur activity such as recreational golf or pleasure driving. Conduct that meets the standards expected of amateur, non-professionals is all that is expected.

As noted above, this low standard for director conduct stands in sharp contrast to the conduct required of professionals. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA),⁸¹ formally eliminated from U.S. common law the notion of higher standards for directors:

A director or officer of an insured depository institution may be held personally liable for monetary damages * * * for gross negligence, including any similar conduct or conduct that demonstrates a greater disregard of a duty of care (than gross negligence) including intentional tortious conduct, as such terms are defined and determined under applicable State law.⁸²

⁷⁹

⁸⁰ Model Business Corporation Act, §8.30(c)

⁸¹ 12 U.S.C.A. §1821(k)

⁸² Id.

By affirming that bank directors need only meet the standard of gross negligence for personal liability, FIRREA removed a potentially effective mechanism for incentivizing bank directors to consider the risk posed by banks to the greater financial system. We will return to this issue in the next section, but we note for now that the notion that U.S. bank directors could (and should) face higher burdens than other directors has long antecedents.

3.5 Global Approaches – Duty of Trust and Strict Liability

Outside of the U.S., bank directors have faced strictly higher burdens, with some jurisdictions viewing bank failures as a criminal offense on the part of directors. Brazil, for example, holds banks' executives and directors personally liable for the debts of failed institutions even when no fault is proven.⁸³ The notion that “reckless management” is a crime is rather alien to the U.S. perspective that business failure is not a criminal offense, but rather a natural, albeit unfortunate, outcome, of business judgment in an uncertain world. In our view, criminalizing bank failure is not a viable approach to resolving the difficulties of bank corporate governance. It does, however, change the calculus for bank directors with respect to the acceptable level of risk for a financial institution.

A similar change in calculus can arise from the concept found in Germany, Switzerland, and Austria called *Untreue*. This “breach of trust” is defined as “a derogation of duty that causes real harm to the institution”, and it has been the basis for charges against bankers at West LB, Bayern LB, HSH Nordbank and Sal Oppenheim.⁸⁴ Indeed, the CEO of WestLB paid a fine of 150,000 euros to settle charges relating to breach of trust, and the CEO of Bayern LB is currently awaiting trial on similar charges. More intriguing are the cases involving board members of these failed financial institutions. The entire

⁸³ See “Prosecuting bankers: Blind Justice, The Economist, May 4, 2013.

⁸⁴ Op Cit

management board of the German bank HSH Nordbank is on trial for breach of trust due to risk management failures relating to a CDO and other off-balance sheet activities that resulted in the bank having to be bailed out to the tune of 30 billion Euros.⁸⁵ Similarly, seven former directors of LBBX, Germany's largest public sector lender, have been charged with breach of trust in connection with moving risky assets to special purpose vehicles allegedly to hide the riskiness of the bank. This case in Germany's commercial crime court is expected to get underway in the first quarter of 2014.⁸⁶

In the U.S., bank directors and managers can be criminally prosecuted for fraud and for violating the federal securities laws or provisions of the securities laws, and such was the fate that befell more than 800 bankers jailed in the aftermath of the S&L crisis. But pursuing such cases, particularly against bank directors, is notoriously difficult due to the challenge of linking wrong-doing to those actually running the bank.⁸⁷ The rarity of this outcome means that bank director behavior is unlikely to be affected.

What is clear from this review is that corporate governance problems are remarkably resilient. While some approaches have been more successful than others, in general even the most extreme outside constraints have failed to resolve bank governance problems. In our view, this suggests using a new approach, one that explicitly recognizes the inherent difficulty of managing and controlling risk in the post-crisis era.

4. Bank Governance in the Post-Crisis World: A Proposal

⁸⁵ This duty of trust does not just attach to financial firms. Board members of the German firm Mannesmann were also charged with Untreue in connection with that firm's takeover by Vodaphone last year. See "Breach of Trust? German corporate governance is literally on trial", *The Economist*, Feb.20, 2013.

⁸⁶ See "Former board of bailed-out German bank LBBW to go on trial", Thomson Reuters, Thursday October 31, 2013 at <http://uk.reuters.com/assets/print?aid=UKBREE99U0J120131031>.

⁸⁷ *Op Cit*, Prosecuting bankers: Blind Justice, *The Economist*, May 4, 2013

Several factors suggest that it may be time to impose a more rigorous standard on the directors of certain financial institutions, particularly those deemed to be systemically important by regulatory authorities. The fact that an institution is systemically important seems to us reason enough to expect directors of such institutions to be able to perform their functions at the level of other directors at comparable financial institutions. The vast complexity not only of the businesses of banking and finance but also of the laws and regulations that govern financial institutions, particularly in the wake of Dodd-Frank, provide additional support for the argument that bank directors should be held to somewhat higher standards than the amateur standard that governs directors generally. Our proposal here is particularly relevant for directors of bank holding companies, who currently face no special requirements as to qualifications.⁸⁸

The notion that some directors should be held to higher standards is not alien to corporate governance. The Sarbanes-Oxley Act explicitly set higher requirements for qualified audit committees by requiring all members to be independent and at least one member to be a “financial expert” as defined by SEC rules.⁸⁹ Indeed, one of the

⁸⁸ Interestingly, directors of subsidiary banks do face additional requirements. For example, the OCC notes” In addition to the citizenship and residency requirements contained in 12 USC 72, the qualifications of a candidate seeking to become a member of the board of directors of a national bank include (1) Basic knowledge of the banking industry, the financial regulatory system, and the laws and regulations that govern the operation of the institution; (2) Willingness to put the interests of the bank ahead of personal interests; (3) Willingness to avoid conflicts of interests; (4) Knowledge of the communities served by the bank; (5) Background, knowledge, and experience in business or another discipline to facilitate oversight of the bank; (6) Willingness and ability to commit the time necessary to prepare for and regularly attend board and committee meetings. See OCC, *The Directors Book*, 2010, pg. 4.

⁸⁹ An “audit committee financial expert” is defined as a person who has the following attributes: (i) an understanding of generally accepted accounting principles and financial statements; (ii) the ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves; (iii) experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant’s financial statements, or experience actively supervising one or more persons engaged in such activities; (iv) an understanding of internal controls and procedures for financial reporting; and (v) an understanding of audit committee functions.” See Lawrence J. Trautman, *Who Qualifies as an*

motivations behind Sarbanes-Oxley was to strengthen audit committees to “avoid future auditing breakdowns” which were contributing to a loss of confidence in the integrity of U.S. companies and markets.⁹⁰ Our argument here is that the failure of risk management at financial institutions, particularly systemically important ones, can lead to outcomes of even greater consequence.

How might such a system work? We suggest a two-part structure involving differential standards for both bank risk committee members and bank directors. With respect to risk committee members, we note that risk management of a complex financial institution is not something easily grasped by a typical corporate director but instead requires specialized expertise. Indeed, the shareholder advisory services ISS and Glass Lewis both recommended voting against the members of JPMorgan Chase’s Risk Committee citing their lack of risk management experience. We believe that risk management committees should be composed only of individuals who can demonstrate expertise in evaluating and monitoring the risk control systems of a bank. Allowing “amateur hour” in this oversight function at large complex financial institutions is simply irresponsible in post-crisis financial markets.

Such individuals, whom we will call “banking experts”, would have acquired, either through experience or education, the skills needed to monitor the risk management functions of the bank. For smaller financial institutions, this expertise may be more limited, reflecting that risk management at such institutions generally involves less complex methodologies (such as gap analysis, liquidity monitoring, and the like). For large, complex financial

Audit Committee Financial Expert Under SEC Regulations and NYSE Rules?, *DePaul Business & Commercial Law Journal*, 11, Winter 2013.

⁹⁰ See Senate Report No.107-205 as cited in Tsacoumis, Bess, and Sappington, *The Sarbanes-Oxley Act: Rewriting Audit Committee Governance*, BLI Issue 3, International Bar Association.

institutions, the needed skill set will be larger, requiring familiarity with risk modeling, valuation of complex derivatives, synthetic asset replication, hedging strategies, etc. The specific qualifications for being a banking expert could be defined in much the way that audit committee financial experts are determined.

Second, we also propose higher professional standards for bank directors. As we have argued in this paper, bank corporate governance issues pose an on-going threat to the financial system. While heightened oversight of banks is surely called for, such oversight will be successful only to the extent that the directors of financial institutions have both the incentives and the experience and skill required to be successful in carrying out their oversight responsibilities. At a minimum, we believe bank directors should be “banking literate” where such literacy is defined by an understanding of the basic functions of banking, the nature of risk in complex financial organizations, and the complex regulatory structure defining banking. Such literacy, which would be a pre-requisite for becoming a director, could have been acquired through experience or through education.

We suspect that some may object to these proposals on the grounds that if having more qualified directors was valuable, then bank shareholders would demand this on their own. Alternatively, others may argue that if higher requirements are desirable for banks, then perhaps they should be required of firms more generally. We think the response to both objections is actually the same: banks are different from other firms. As we have argued, bank shareholders do not have properly aligned incentives to limit bank risk, so externally-imposed requirements may be necessary. Other firms can adequately address corporate governance deficiencies internally, so requiring higher standards for all corporate directors is unnecessary.