

## The Comprehensive Capital Analysis and Review and the New Contingency of Bank Dividends

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### ABSTRACT

*Historically, bank regulators have restricted bank dividends as part of a larger effort to preserve banks' capital and make them more able to withstand losses. In today's dynamic banking markets, the formulaic and rigid ways by which regulators have traditionally policed dividends have become anachronistic. Against this background, the Federal Reserve Board has attempted to update and reinvigorate dividend regulation through two regulatory reforms: (1) the Comprehensive Capital Analysis and Review (CCAR) program and (2) the Dodd-Frank Act Stress Test program.*

*This Article will explore the important practical and theoretical implications that result from these regulatory reforms. As a practical matter, the ability of banks to make distributions—the most basic method by which equity investors obtain returns on their capital investment—has been made contingent and contestable to an unprecedented degree. For example, over the past two years the Federal Reserve Board has required Bank of America, Citigroup, and Goldman Sachs to adjust their dividend plans. In a privatized system of banking, restrictions on the ability of stock investors to obtain returns potentially complicate bank funding.*

*As for regulatory theory, these reforms are noteworthy because they unite, for the first time, what had previously been two separate sub-systems of the bank regulatory framework: the formal-mandatory dimension of bank regulation, exemplified by the formulaic, automatic application of traditional dividend restrictions, and the informal-discretionary dimension of bank regulation, exemplified by the context-specific regulation of “unsafe and unsound practices” and stress testing. These reforms provide further evidence of a broader trend in financial regulation towards greater emphasis on hypothetical and conjectural future stress scenarios. Finally, this Article links the CCAR program to the existing “risk regulation” literature that has developed in the environmental, health, and safety regulatory arenas. Although the risk regulation model has*

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*not yet taken hold in financial regulatory scholarship, the CCAR program provides a clear example of its relevance to the regulatory tasks of bank supervisors. By viewing the program through the risk regulatory lens, the Article frames future research questions concerning the utility of applying the risk regulatory model to risk-taking financial institutions.*

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## I. INTRODUCTION

Since the Civil War era, banking law in the United States has restricted the ability of banks to pay dividends and make other distributions of corporate property. The premise of dividend regulation is that by limiting transfers of assets from banks and their holding companies to their stockholders, bank regulators increase the pool of capital that is available to absorb unexpected losses, thereby making banks more resilient. More resilient banks, in turn, result in

reduced demands on federal deposit insurance and other government safety nets as well as a more stable financial system. Dividend regulation figured prominently in all banking legislation from the late nineteenth century through the New Deal era. In the decades that followed the New Deal, Congress introduced new bank regulatory systems—such as the policing of “unsafe and unsound practices” and the “prompt corrective action” regime—that also provided for dividend restrictions, though as part of much broader regulatory reforms.

In recent decades, however, traditional dividend restrictions have become anachronisms because the ways in which they were used have proven too rigid and formulaic for a banking industry that has undergone rapid change as a result of deregulation, increased competition, and technological developments.<sup>1</sup> In explaining the irrelevance of traditional dividend regulation, other commentators focus less on its shortcoming as a regulatory *technology*, and more on regulatory capture, which critiques the ways in which regulators *implement* those regulatory technologies. Specifically, these commentators argue that supervisors treat banks with a light touch in order to curry favor with them for future employment, or on account of a vaguer, but potentially more pernicious, form of “cultural” or “social” capture that impedes their ability to perform their statutory mandates in the public interest.<sup>2</sup>

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<sup>1</sup> See MARTIN WOLF, *THE SHIFTS AND THE SHOCKS: WHAT WE’VE LEARNED—AND HAVE STILL TO LEARN—FROM THE FINANCIAL CRISIS* 117–48 (2014) (arguing that the financial system has become more unstable on account of liberalization, globalization, innovation, leverage, and perverse incentives); Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation and Increased Risks*, 2002 U. ILL. L. REV. 215 (providing magisterial history of the wrenching changes in the financial services sector from 1975 to 2000).

<sup>2</sup> See ANAT ADMATI & MARTIN HELLWIG, *THE BANKERS’ NEW CLOTHES: WHAT’S WRONG WITH BANKING AND WHAT TO DO ABOUT IT* 203–07 (2013) (discussing regulatory capture problem in the banking industry more generally); IAN AYRES & JOHN BRAITHWAITE, *RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE* 80, 90 (1992) (attributing regulatory capture in part to a desire for a “smoothly running work life” and a distaste for confrontation); James Kwak, *Cultural Capital and the Financial Crisis*, in *PREVENTING REGULATORY CAPTURE: SPECIAL INTEREST INFLUENCE AND HOW TO LIMIT IT* 71 (Daniel Carpenter & David A. Moss, eds. 2014) (discussing “cultural capture”); Willem H. Buiter, *Central Banks and Financial Crises*, in *MAINTAINING STABILITY IN A CHANGING FINANCIAL SYSTEM* 495, 601 (2009), available at [https://www.kansascityfed.org/~media/files/publicat/sympos/2008/buiter031209.pdf?la=en](https://www.kansascityfed.org/~/media/files/publicat/sympos/2008/buiter031209.pdf?la=en) (using the term “cognitive regulatory capture” to describe phenomenon by which regulators “internali[ze], as if by osmosis, the objectives, interests and perception of reality of the vested interest they are meant to regulate and supervise in the public interest”); Robert F. Weber, *Structural Regulation as Antidote to Complexity Capture*, 49 AM. J. BUS. L. 643, 649–56 (2012) (theorizing “complexity capture” as a “soft, hegemonic [form of regulatory] capture” in the

Whatever its cause, the regulatory track record is incontrovertible: in the lead up to the recent financial crisis, bank supervisors did not restrict the steady outflow of funds from banks to their stockholders. As weak signals of impending catastrophe piled up,<sup>3</sup> regulators blithely looked the other way as their supervised institutions became ever more thinly capitalized. Incredibly, bank dividends *increased* steadily every quarter from 2005 through 2007, and remained high throughout 2008—including late 2008, during which “the most unbelievable week in America ever”<sup>4</sup> brought the financial system to its knees.<sup>5</sup>

The failure of banking law and regulation to stanch the hemorrhaging of bank capital is a historical fact. Dividend regulation did not prevent or soften the impact of this most recent financial crisis. But the regulation of dividends, if it can be implemented in an effective manner, remains a useful tool, at least in theory, on account of its simplicity. By restricting the ability of banks and their holding companies to transfer capital to stockholders, dividend restrictions ensure that there is greater loss-absorbing capital within the enterprise. Better capitalized banks are more stable and resilient banks, and dividend regulation can contribute to that result.<sup>6</sup>

This Article explains how the Board of Governors of the Federal Reserve System (the “Federal Reserve Board,” or “FRB”), the regulator for banks at the holding company level, has recently attempted to

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context of authentically complex regulated markets that affects “even virtuous, public-regarding regulators who are resistant to traditional capture efforts by industry”); Arthur E. Wilmarth, Jr., *Turning a Blind Eye: Why Washington Keeps Giving in to Wall Street*, 81 U. CIN. L.REV. 1283 (2013) (discussing regulatory capture problem in the banking industry more generally); Steven M. Davidoff, *The Government’s Elite and Regulatory Capture*, N.Y. TIMES (June 11, 2010), <http://dealbook.nytimes.com/2010/06/11/the-governments-elite-and-regulatory-capture> (describing “social capture”).

<sup>3</sup> See, e.g., ALAN S. BLINDER, AFTER THE MUSIC STOPPED: THE FINANCIAL CRISIS, THE RESPONSE, AND THE WORK AHEAD 34, 36 figs.2.2 & 2.3 (2013) (registering decline in housing prices and housing starts in first quarter of 2006); *id.* at 90 (chronicling liquidity crisis at BNP Paribas subprime mortgage money market funds on account of evaporation of liquidity in that market).

<sup>4</sup> ANDREW ROSS SORKIN, TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM—AND THEMSELVES 2 (2010) (quoting JPMorgan Chase & Co. CEO Jamie Dimon during a morning meeting with his management team after consulting with government officials about the impending bankruptcy filing of Lehman Brothers and bailout of American International Group Inc., or “AIG”).

<sup>5</sup> See Beverly Hirtle, *Bank Holding Company Dividends and Repurchases During the Financial Crisis*, N.Y. FED. RESERVE BANK STAFF REPORT NO. 666, at 22 fig.1 (2014), [http://www.newyorkfed.org/research/staff\\_reports/sr666.pdf](http://www.newyorkfed.org/research/staff_reports/sr666.pdf) (showing dividends paid by large bank holding companies from 2005–2009).

<sup>6</sup> See Robert F. Weber, *Post-Crisis Reforms and High Reliability Theory*, 50 GA. L. REV. (forthcoming 2015) (explaining how capital adequacy regulation is designed to improve the resilience of supervised banks).

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reinvigorate dividend restrictions through two new regulatory initiatives.<sup>7</sup> And banks have taken notice. JPMorgan Chase & Co., the largest bank holding company in the United States by assets, has described this new, reinvigorated dividend regulation regime as the “primary measure [that it] use[s] to assess [its] capital adequacy.”<sup>8</sup> In the summer of 2014, the Chief Financial Officer of The Goldman Sachs Group Inc. told reporters it was “obvious” that these new programs required the bank to change its business practices—in that case, to scale back its profitable repurchase (or “repo”) lending program—in order to preserve its ability to pay dividends.<sup>9</sup> Under the two new programs, the FRB has over the past four years ordered ten of the largest banks in the world—a group that also includes Bank of America, Inc., the second largest U.S. bank by assets—to cease payments of dividends to their stockholders,<sup>10</sup> cutting off the principal means by which the stockholders expect to obtain a return on their capital investment.<sup>11</sup>

The important novelty of these new regulatory initiatives is underscored by the fact that each of these banks in the preceding examples was well capitalized and in compliance with applicable capital adequacy rules at the time of the regulatory interventions. The problem, according to regulators, was a circumstance that only five years earlier they would not be able to take into consideration: namely, that even though these banks were perfectly well capitalized at the time, they *might* run into trouble if *imaginary* and *hypothetical* adverse conditions in the *future* economy and *future* financial markets were to come to pass.

Taken together, these two new FRB regulatory programs

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<sup>7</sup> The new dividend restrictions that are the focus of this Article apply only to the largest bank holding companies, known under the FRB’s new Regulation YY as “covered companies.” See *infra* note 190–92 and accompanying text (explaining that a “covered company” is a bank holding company with over fifty billion dollars in total assets or a company designated by the Financial Stability Oversight Council as systemically important). Unless otherwise noted, references to “banks” and “bank holding companies” should be read to refer to the term of art “covered companies” as set forth in Regulation YY.

<sup>8</sup> JPMorgan Chase & Co., Annual Report (Form 10-K) 117 (Feb. 28, 2013), available at <http://investor.shareholder.com/jpmorganchase/secfiling.cfm?filingID=19617-13-221> [hereinafter JPMorgan 10-K].

<sup>9</sup> See Michael J. Moore, *Goldman Sachs’s Stress-Test Stumble Leads to Repo Cut*, BLOOMBERG (July 15, 2014, 3:46 PM), <http://www.bloomberg.com/news/articles/2014-07-15/goldman-sachs-s-stress-test-stumble-leads-to-repo-cut>.

<sup>10</sup> See *infra* note 273 and accompanying text (summarizing the effects on dividend policy for those bank holding companies whose capital plans the FRB has rejected).

<sup>11</sup> See *infra* note 18 (explaining the critical role of dividends for stockholder returns).

reinvigorate the traditional regulatory tool of dividend regulation by combining it with the relatively new regulatory tool of stress testing. The first of its initiatives, the Dodd-Frank Act Stress Tests (DFAST) program, requires banks to demonstrate their ability to withstand economic and financial stress as reflected in hypothetical stress scenarios involving adverse financial economic developments.<sup>12</sup> The second initiative, the Comprehensive Capital Analysis and Review (CCAR) program, requires a bank to submit a “capital plan” detailing how it expects to ensure it will possess adequate capital over the coming year, including any proposed plans to make dividends or other distributions of bank property. If a bank is unable to demonstrate its financial stability under the hypothetical stress conditions and after giving effect to its planned capital actions, the FRB will reject the capital plan and restrict its ability to pay dividends or make other distributions. In evaluating the bank’s financial stability, the FRB determines whether the bank *would satisfy* all regulatory capital standards if the bank were to effectuate its proposed distributions or dividends under the *hypothetical* and *future* stressed market conditions.

These developments shift the focus from traditional capital regulation, under which regulators historically gauge compliance by determining whether a bank *presently satisfies* applicable regulatory capital standards under *actual* and *current* market conditions. The regulatory lens is projected into the future on two accounts: on the one hand, the FRB imagines adverse future economic and financial conditions, and on the other hand, the FRB imagines the effects of the bank’s future expectations to transfer capital (through dividends and the like) outside of the company group.

This shift in focus has significance not only because the FRB has exhumed and polished the traditional regulatory tool of dividend regulation for a new use. It also unites, for the first time, what had previously been two separate sub-systems of the bank regulatory framework: the *formal-mandatory dimension* of bank regulation, exemplified by the formulaic, automatic application of traditional dividend restrictions and capital requirements, and the *informal-discretionary dimension* of bank regulation, exemplified by the context-specific policing of “unsafe and unsound practices” and stress tests. Viewing dividend regulation through these formal-mandatory and informal-discretionary lenses reveals a troubling state of affairs. On the one hand, the formal-mandatory tools have become largely

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<sup>12</sup> On the practice and theory of stress testing as a regulatory tool, see Robert F. Weber, *A Theory for Deliberation-Oriented Stress Testing Regulation*, 98 MINN. L. REV. 2236, 2237–44 (2014).

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obsolete because they rely too heavily on rigid accounting metrics to police dynamic, flexible institutions, and they fail to consider how dividends might affect a bank's financial condition in light of future contingencies. On the other hand, regulators exhibit hesitancy, even unwillingness, to use informal-discretionary tools.

But dividend regulation is where the FRB has created a possible solution to the problem. The CCAR and DFAST programs reinvigorate dividend regulation, a traditional formal-mandatory regulatory tool, by taking into account hypothetical and conjectural future stress scenarios, a clearly informal-discretionary tool.<sup>13</sup> These programs are both rigid and forward-looking. They allow regulators to consider the effects of future hypothetical scenarios on a bank, but also tether those scenarios to a system of rigid numerical trigger points that require intervention by regulators.

Consequently, the ability of banks to make dividends and distributions to their stockholders—the most basic method by which equity investors obtain returns on their capital investment—has been made contingent and contestable to an unprecedented degree. In a jurisdiction relying on a privatized system of finance and banking, private investors are responsible for providing equity and debt capital to banks and other financial intermediaries. Restrictions on their ability to obtain return on their investment therefore strikes at the heart of this privatized system.<sup>14</sup>

Aside from its practical implications for banks and its innovations in regulatory techniques, the CCAR program has further implications for regulatory theory and practice. It provides an opportunity to bridge some intramural divides separating sub-fields of administrative law that historically have not interacted, in the process creating new opportunities for learning and improved practice. In particular, this Article describes how the CCAR program, and the informal-discretionary dimension more broadly, adopts features of so-called “risk regulation” regimes in the environmental, health, and safety regulatory fields.

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<sup>13</sup> See Bd. of Governors of the Fed. Reserve Sys., *Comprehensive Capital Analysis and Review 2014: Assessment Framework and Results 1* (2014), available at [http://www.federalreserve.gov/newsevents/press/bcreg/ccar\\_20140326.pdf](http://www.federalreserve.gov/newsevents/press/bcreg/ccar_20140326.pdf) [hereinafter 2014 CCAR RESULTS] (“CCAR is also designed to help both the [bank holding company] and the Federal Reserve evaluate whether a [bank holding company's] capital accretion and distribution decisions are prudent, given inherent uncertainty about the future.”).

<sup>14</sup> See Simon Johnson, *Morgan Stanley Speaks: Against Relying on Capital Requirements*, BASELINESCENARIO (Nov. 24, 2009), <http://baselinescenario.com/2009/11/24/morgan-stanley-speaks-against-relying-on-capital-requirements/>.

Risk regulation is a slippery moniker with a range of related, but rarely identical, connotations. Nevertheless, any attempt to define risk regulation starts with the burst of environmental, health, and safety regulation that emerged in the 1960s and 1970s. The common thread that ties these risk regulatory regimes together is that each requires regulators to exercise their discretion in settings where scientific uncertainty is unavoidable. The typical risk regulation regime consists of (1) a *statutory risk trigger* that permits an agency to act on the basis of anticipated, but uncertain, harm and (2) a *statutory standard* specifying the level or stringency with which the agency should regulate the harm and the factors it may consider in doing so.

The relevance of the risk regulation literature to the informal-discretionary dimension of bank supervision should be apparent. In both settings, the regulatory task requires the regulator to determine whether a statutory trigger test has been met by referring to an assessment of the risk that a future, uncertain outcome will transpire. Moreover, both settings also necessitate a trade-off, guided by the statutory standard, between protection against risks and the costs of providing that protection.

Notwithstanding the evident parallels between risk regulation and financial regulation and supervision, the idea that risk regulation is really about protecting health, safety, and the environment—and, by implication, not about protecting financial institutions and systems—has proven sticky. In a sense, this stickiness is counterintuitive. After all, financial regulatory systems are set up, among other things, for the express purpose of regulating systemic risk and supervising the institutions designed to create, take, and profit from risk. For purposes of this Article, the important point is to register how this particular corner of financial regulation resonates in perhaps unexpected ways with well-established traditions in other administrative law settings. Future research will undoubtedly advance our understanding of how the informal-discretionary mode of banking supervision (including the CCAR program and initiatives like it) fits into risk regulatory theory more broadly.

This Article begins in Part II by explaining why dividends matter: why they matter to stockholders, who look to them to obtain a return on their investment, and why they matter to bank supervisors, who look at them as a potential threat to the solvency of the bank and the stability of the financial system. Part III provides a brief history of regulatory restrictions on bank dividends, starting from the Civil War era legislation until the present day. Part IV explains how the so-called “prompt corrective action” regime revolutionized bank supervision



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and had served, since 1991 until these recent reforms, as the primary statutory authorization for the use of governmental power to restrict bank dividends. Part V offers some theoretical observations about the bank supervisory system, distinguishing its formal-mandatory dimension from its informal-discretionary dimension, both as a historical matter and as a matter of regulatory technology. This Part highlights in particular the open-ended, indeterminate, and hypothetical aspects of the informal-discretionary dimension, and explains why it historically contrasted sharply with the formal-mandatory system, which consisted of rigid regulatory responses calibrated to precise accounting metrics. It also explains how the literature on “risk regulation”—a research program that has developed in the environmental, safety, and health contexts, but has yet to take hold in the financial regulatory context—provides a useful frame within which to view financial regulatory programs that draw on the informal-discretionary dimension. Finally, Part VI undertakes the first comprehensive study of how the CCAR and DFAST programs constitute a novel system of dividend regulation, noting how they (1) combine, for arguably the first time, aspects of both the formal-mandatory and informal-discretionary dimensions of bank regulation, and (2) provide an example for how bank supervision has, in some respects, already incorporated attributes of risk regulatory theory and practice. Part VII concludes.

## II. WHY DIVIDENDS MATTER IN A PRIVATIZED SYSTEM OF FINANCE

In a privatized system of finance, for-profit companies are responsible for performing the key financial functions that together are “the oil that lubricates the wheels of commerce.”<sup>15</sup> These private financial companies provide the payment systems infrastructure for large and small transactions, transmit monetary policy, manage risk through derivatives and insurance, provide information to markets, facilitate international trade, and transform savings (e.g., deposits) into investment capital (e.g., business loans). To fund these activities, companies raise capital from investors. By relying on private investment capital to fund these for-profit finance companies, such a financial system subjects the companies to the pressures and demands of capital markets.<sup>16</sup> The investors that fund financial enterprises look,

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<sup>15</sup> BENJAMIN J. COHEN, IN WHOSE INTEREST?: INTERNATIONAL BANKING AND AMERICAN FOREIGN POLICY 299 (1986).

<sup>16</sup> A privatized system of finance is not a preordained state of affairs, even in a largely capitalist system of economic exchange. On the other end of the spectrum are state-administered banking regimes like that of China, where the state dictates lending

as do all equity investors, for a return on their investment. Because the business of banking is conducted overwhelmingly through the corporate form,<sup>17</sup> the relevant investors are stock investors, who obtain

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policy through the use of macroprudential regulatory tools; as lending overheats, the state authorities order Chinese banks to increase loss provisions and capital buffers, and when companies struggle to obtain finance, state authorities order banks to lend more. See, e.g., *China Tightening: End of the Binge*, FIN. TIMES, <http://smartnews.cc/financial-times/BcFtCoAgDADQE-3LFrhuo-bwR1LgwOv33oj4LqK9N3pgeyeIuWjRQYIFzO8OdtYCIp0he07ALKreS1UrOGI-Pw#.VgebmOIOTww> (last visited Sept. 27, 2015) (reporting how China's bank supervisor implemented Basel risk weighting system in a manner so as to encourage debt capital flows to small and medium businesses); Claire Jones, *The Third Arm: Macroprudential Policy*, FIN. TIMES (Sept. 22, 2011, 7:58 PM), <http://www.ft.com/intl/cms/s/0/80e498de-de03-11e0-a391-00144feabdc0.html#axzz3mvERwsDb> (contrasting historic tendency of Asian governments to rely on macroprudential tools such as loan-to-value ratios to affect credit flows in economy with tendency of non-Asian large economies to rely solely on monetary and fiscal policy). Even the United States had a formal state-administered home mortgage credit system in the form of the government-sponsored entities Fannie Mae and Freddie Mac before they were legally, though not economically, privatized. See Roger Congleton, *The Political Economy of the Financial Crisis of 2008*, in LESSONS FROM THE FINANCIAL CRISIS: CAUSES, CONSEQUENCES, AND OUR ECONOMIC FUTURE 23, 23 (Robert W. Kolb, ed. 2010) [hereinafter LESSONS FROM THE CRISIS] (noting that Congress formed Fannie Mae in 1938 and arranged for its privatization in 1968); David Reiss, *Privatizing Profit and Socializing Loss*, in LESSONS FROM THE CRISIS, *supra*, 437, 437 (writing in 2010 that “[t]he federal government has given [Fannie Mae and Freddie Mac] the mission of providing liquidity and stability to the United States residential mortgage market and achieving certain affordable housing goals”).

<sup>17</sup> Congress has also provided authority to government agencies to charter mutual, non-corporate private credit institutions such as credit unions and mutual thrift banks (also known as mutual savings and loans institutions). See Mehrsa Baradaran, *How the Poor Got Cut out of Banking*, 62 EMORY L.J. 483, 500–19 (2013). Total assets at U.S. credit unions as of June 2014 were over one trillion dollars. See BD. OF GOVERNORS OF THE FED. RESERVE SYS., FINANCIAL ACCOUNTS OF THE UNITED STATES: FLOW OF FUNDS, BALANCE SHEETS, AND INTEGRATED MACROECONOMIC ACCOUNTS: FIRST QUARTER 2014 78 (2014), available at <http://www.federalreserve.gov/releases/z1/20140605/z1.pdf> [hereinafter Q1 2014 FUNDS FLOW / BALANCE SHEETS]. While that amount is significant, it pales in comparison to the nearly thirteen trillion dollars of assets held by non-credit union depository institutions. See *id.* at 76. The thrift industry, while larger than the credit union industry in terms of total assets, has experienced large-scale demutualization, which refers to the process of conversion from a mutual ownership structure to a stock ownership structure. See JAMES A. WILCOX, CREDIT UNION CONVERSIONS TO BANKS: FACTS, INCENTIVES, ISSUES AND REFORMS 2 (2006) (“Between 1975 and 2004, there were 1,830 mutual-to-stock thrift conversions, and the number of mutual thrifts shrunk from 3,791 to 625.”). So most of today’s thrifts are, like national banks, stock companies. Furthermore, it is expected that most remaining thrifts (whether mutual or stock companies) will convert to national banks in the coming years to avoid the surviving restrictions on thrift activities in the post-Dodd-Frank Act regulatory environment. See DAVIS POLK & WARDWELL, SUMMARY OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT 89 (2010), available at <http://froundtable.org/wp-content/uploads/2014/05/DavisPolk-Summary-of-Dodd-Frank-Wall-Street-Reform-Act.pdf> (“Although [the Dodd-Frank Act] maintains the federal thrift charter, it eliminates the most important advantages of the thrift charter and imposes new penalties for failure to comply with the qualified thrift lender (“QTL”)

returns on their capital investment in the form of stock dividends.<sup>18</sup>

The banking sector is distinctive because banks receive regulatory licenses to offer government-insured deposited savings and also enjoy access to special government safety nets unavailable to other financial market participants. The banking license therefore makes the government the primary risk-bearer in the event a bank defaults on its debts. In exchange for the privileges of the license, banks must comply with an extensive regulatory apparatus designed in principle to protect the government's contingent liability—i.e., its promise to provide lender-of-last-resort facilities and its deposit guarantee. One way of conceptualizing this regulatory apparatus is as a stand-in<sup>19</sup> for the contractual protections that private lenders and guarantors would extract from the bank in a system without government safety nets, to forestall attempts by managers and stockholders to obtain higher returns by taking on levels of risk that are excessive from the vantage point of creditors.<sup>20</sup> It might be objected that creditors could do this

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test. As a result, it is likely that most holders of a thrift charter will have a powerful incentive to convert it into a bank charter.”). The FRB has reflected this expectation in its quarterly funds flow report, in which it has collapsed thrifts with commercial banks in an umbrella category labeled “U.S.-chartered depository institutions.” See Q1 2014 FUNDS FLOW / BALANCE SHEETS, *supra*, at iii.

<sup>18</sup> Investors might object that stockholders also obtain returns in the form of capital gains. See William W. Bratton, *The New Dividend Puzzle*, 93 GEO. L.J. 845, 846 (2005) (reporting that “[d]uring the two decades preceding [2003], corporate boards steadily moved away from the dividends—the traditional vehicle for distributing profits to shareholders—diverting about half of the cash they distribute to shareholders to open-market repurchases of their firms’ own common stock” and ascribing that trend in large part to preferential tax treatment of capital gains relative to dividends). While that is true in practice, in theory the capital gain only reflects heightened expectations of future dividends. See RICHARD A. BREALEY ET AL., *PRINCIPLES OF CORPORATE FINANCE* 80 (10th ed. 2011) (“[S]hare value is equal to the discounted stream of dividends per share.”); ASWATH DAMODARAN, *INVESTMENT VALUATION* 323 (3d ed. 2012) (“In the strictest sense, the only cash flow you receive when you buy shares in a publicly traded [corporation] is a dividend.”); WILLIAM A. KLEIN & JOHN C. COFFEE, JR., *BUSINESS ORGANIZATIONS AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES* 288–89 (10th ed. 2007) (“The only thing that makes shares valuable is the expectation of payments of [dividends] at some time in the future.”).

<sup>19</sup> But see Jonathan R. Macey & Elizabeth H. Garrett, *Market Discipline by Depositors: A Summary of the Theoretical and Empirical Arguments*, 5 YALE J. ON REG. 215, 222–23 (1988) (“Our point is not that such regulatory devices do not exist; rather our arguments are (1) that these measures impose fewer constraints on excessive risk-taking than would be optimal from a societal perspective; and (2) that they do not punish excessive risk-taking by individual banks in the same way as a market-driven system would, because these measures are uniformly applied to all banks.”).

<sup>20</sup> See HELEN A. GARTEN, *WHY BANK REGULATION FAILED: DESIGNING A BANK REGULATORY STRATEGY FOR THE 1990S* xv (1991); *id.* at 41 (“[B]ank regulators faced the classic creditor’s dilemma of how to prevent unanticipated future alterations in the risk posture of insured banks . . . . [In response, t]hey imposed a series of restrictive covenants on the banking industry designed to limit the ability of bank managers to

on their own, but the opacity of bank balance sheets is such that the costs of obtaining private information about banks' relative credit risk is prohibitive. The regulatory apparatus, then, is justified on the grounds of obviating the need to monitor the creditworthiness of banks—of making bank debt (most obviously, insured deposits), in the words of Professor Gary Gorton, “information-insensitive.”<sup>21</sup>

This point took on added salience during the period from the 1980s to the present because the charter values of banks—that is, the ability to benefit from regulatory restrictions on competition and entry—has declined as a result of competition from non-regulated financial institutions.<sup>22</sup> Historically, banking law and regulation imposed various anti-competitive restrictions in the banking sector that endowed banks with market power, making their charters valuable.<sup>23</sup> The charter value of a bank, then, refers to the capitalized benefits of these restrictions that banks enjoy.<sup>24</sup> In the 1980s, technology and deregulation conspired to erode the charter value of

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take actions that increased the risk of loss to the insurance fund.”). The regulatory intervention is also motivated by a concern to promote a stable financial system by counteracting externalities resulting from excessive financial risk taking—that is, risk taking by financial institutions that creates negative effects on third parties, such as users of finance, unable to protect themselves through bargaining.

<sup>21</sup> See GARY B. GORTON, *SLAPPED BY THE INVISIBLE HAND: THE PANIC OF 2007* 19–23 (2010); cf. Charles W. Calomiris & Gary Gorton, *The Origins of Banking Panics: Models, Facts, and Bank Regulation*, in *FINANCIAL MARKETS AND FINANCIAL CRISES* 109, 129–60 (R. Glenn Hubbard ed., 1991) (arguing that one purpose of banks is that they create debt (e.g., deposits) to serve as a medium of exchange, but that the opaqueness of the asset side of bank balance sheets (i.e., their loan portfolios) gives rise to an information asymmetry between debt holders and banks that requires intervention, either through clearing houses or regulation).

<sup>22</sup> See A. Sinan Cebenoyan et al., *Ownership Structure, Charter Value, and Risk-Taking Behavior for Thrifts*, 28 *FIN. MGMT.* 43, 43–44 (1999). Others emphasize that the largest banks still enjoy significant bank charter value due to the implicit perceptions of government support. See *Global Financial Stability Report: Moving from Liquidity- to Growth-Driven Markets*, INT'L MONETARY FUND 104 (Apr. 2014), <http://www.imf.org/external/pubs/FT/GFSR/2014/01/index.htm> (“In terms of the funding cost advantage in 2013, these subsidies are at least 15 or so basis points in the United States, 25–60 basis points in Japan, 20–60 basis points in the United Kingdom, and 60–90 basis points in the euro area.”). But the evidence of this position is equivocal, especially in the United States. See GOV'T ACCOUNTABILITY OFFICE, *LARGE BANK HOLDING COMPANIES: EXPECTATIONS OF GOVERNMENT SUPPORT* 40 (2014), available at <http://www.gao.gov/assets/670/665162.pdf> (“Our analysis and the results of studies we reviewed provide evidence that the largest bank holding companies had lower funding costs than smaller bank holding companies during the 2007–2009 financial crisis but that differences may have declined or reversed in more recent years.”).

<sup>23</sup> See Michael C. Keeley, *Deposit Insurance, Risk, and Market Power in Banking*, 80 *AM. ECON. REV.* 1183, 1198 (1990).

<sup>24</sup> *Id.* at 1185.

banking firms.<sup>25</sup> No longer could bank managers and investors sit back and comfortably enjoy earnings subsidized by the government-imposed barriers to entry.<sup>26</sup> As a result, the potential loss of the charter no longer stood as a bulwark against the moral hazard that would otherwise exist due to the government's guarantee of bank debt (i.e., deposit insurance).<sup>27</sup> In this new market environment, banks no longer enjoyed meaningful charter values. Consequently, the moral hazard effect took root and banks took on additional leverage and embraced riskier lending programs.<sup>28</sup> The decline in charter value of banks reinforced the normative justification for the bank supervisory system: that is, to serve as a counterweight to this moral hazard effect, which would otherwise result in risk-taking and leverage in excess of socially optimal levels, both from the perspective of the deposit insurer (the Federal Deposit Insurance Corporation) and the lender of last resort (the FRB).

Dividend restrictions have historically formed a part of this supervisory system. The risk of insolvency for a bank is, as with any firm, inversely related to its equity capitalization—that is, as the amount of equity decreases, less equity is available to absorb future losses and the risk of default on debt claims increases.<sup>29</sup> By paying dividends, a bank reduces its equity.<sup>30</sup> Therefore, it is unsurprising that bank regulators and policymakers have sought to restrict a bank's ability to declare and pay dividends.<sup>31</sup> Dividend regulation protects

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<sup>25</sup> See *id.* (measuring charter value by looking to declining market-to-book value ratios).

<sup>26</sup> See *id.* at 1185–86.

<sup>27</sup> See Robert C. Merton, *An Analytic Derivation of the Cost of Deposit Insurance Loan Guarantees*, 1 J. BANKING & FIN. 3, 7 (1977). Merton described this moral hazard effect of deposit insurance as a put option on the bank's assets. If the value of the assets exceeds the value of the loans on the maturity date of the bank's debt, then the stockholders will exercise the option and pay back the debt. If, on the other hand, the value of the assets does not exceed the value of the debt, then the stockholders will let the option lapse and the deposit insurer will make good on the debt claims. Cf. Keeley, *supra* note 23, at 1186.

<sup>28</sup> See Keeley, *supra* note 23, at 1184.

<sup>29</sup> See BREALEY ET AL., *supra* note 18, at 447–58 (discussing costs of financial distress).

<sup>30</sup> See ROBERT J. RHEE, *ESSENTIAL CONCEPTS OF BUSINESS FOR LAWYERS* 60 (2012) (“A corporation may distribute to shareholders dividends, which are cash payments from equity.”).

<sup>31</sup> In this Article, “bank supervision” and “bank regulation” are used interchangeably. For an explanation of the difference between “regulation” and “supervision” in the financial regulatory context, see Frederic S. Mishkin, *Prudential Supervision: Why Is It Important and What Are the Issues?* 16–17 (Nat'l Bureau of Econ. Res., Working Paper No. 7926, 2000), available at <http://www.nber.org/papers/w7926>.

against insolvency, thereby also limiting recourse to government safety nets by ensuring the bank maintains a buffer to absorb unexpected losses. But it does more than that. By requiring banks to maintain some equity capitalization at all times, it also ensures that stockholders—and, indirectly, the directors they elect to the board—have something to lose in the event of financial distress. Consequently, it promotes a corporate governance system in which stockholders are incentivized to guard against the possibility of failure. If the dividend restrictions are meaningful, then the privatized system should police itself relatively well: stockholders are in effect deputized to play an important role in promoting financial stability and institution-level safety and soundness. But notwithstanding the potential utility of dividend restrictions as a regulatory tool, they had largely faded into irrelevance prior to the recent reforms. Dividend restrictions became obsolete because they relied too heavily on rigid accounting metrics to police dynamic, flexible institutions, and they failed to consider how dividends might affect a bank's financial condition in light of future contingencies.

### III. THE EARLY HISTORY OF BANK DIVIDEND RESTRICTIONS

Before explaining why traditional dividend restrictions became obsolete and what is meant by the new contingency of bank dividends, it is necessary to understand the history of dividend regulation. The early history of these restrictions grows out of three landmark pieces of banking legislation that together created modern U.S. banking law: the National Bank Act of 1864, the Federal Reserve Act of 1913, and the Banking Act of 1933. Whether these restrictions applied to a given distribution of corporate bank funds depended entirely on a snapshot determination of either a precise accounting metric or compliance with a payments system obligation. For example, a dividend would be illegal if it were paid out of “capital,” a legal accounting metric with specialized meaning in banking law. Similarly, a dividend would be illegal if it were paid when a bank failed to comply with laws concerning the amounts of reserves it was required to maintain. Gradually, Congress introduced the more indeterminate term “unsafe and unsound practices” as a trigger for regulatory intervention that would justify, among other things, restrictions of dividends.

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Regulation of corporate dividends is not unique to banking law. Since the late nineteenth century, legislatures and regulators have limited the ability of *all* corporations, including banks, to declare dividends. These restrictions, referred to as “legal capital” rules, most typically specify that a corporation may only declare dividends out of current earnings or earned surplus.<sup>32</sup> The legislative impetus behind these restrictions was to afford a modicum of extra-contractual protection for creditors.<sup>33</sup> In effect, the board could only declare a dividend after the corporation had paid its creditors, or, alternatively, when the corporation had accumulated earnings from previous accounting periods that would be available for execution by creditors. State legislatures included these dividend restrictions as part of general corporation laws that facilitated the formation of limited liability enterprises.<sup>34</sup>

Unsurprisingly, Congress included dividend restrictions in its first general incorporation statute for federally chartered banks.<sup>35</sup> The

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<sup>32</sup> See, e.g., CAL. CORP. CODE § 500 (West 2015) (authorizing boards of directors to declare dividends only from retained earnings); DEL. CODE ANN. tit. 8, § 170 (2015) (permitting corporations to declare dividends out of “surplus” or, where there is no surplus, out of net profits for the current and preceding year); N.Y. BUS. CORP. L. § 510(b) (McKinney 2015) (same).

<sup>33</sup> See *Wood v. Dummer*, 30 F. Cas. 435, 436 (Cir. Ct. D. Me. 1824) (“[T]he capital stock of banks is to be deemed a pledge or trust fund for the payment of the debts contracted by the bank.”); DONALD KEHL, CORPORATE DIVIDENDS: LEGAL AND ACCOUNTING PROBLEMS PERTAINING TO CORPORATE DISTRIBUTIONS 15 (1941) (“[T]he principal objective of dividend law has therefore been the preservation of a minimum of assets as a safeguard in assuring the payment of creditors’ claims.”). In this respect, the legal capital rules share a similar purpose with fraudulent transfer laws, which permit certain creditors to avoid transactions that, among other things, transfer property of a debtor when it is, or nearly is, insolvent. See UNIF. FRAUDULENT TRANSFER ACT §§ 4 & 5 (1984). Both legal devices restrict transfers of corporate property as the solvency of the corporation becomes impaired.

<sup>34</sup> With general incorporation statutes, state legislatures created the power for any individual or group of individuals to form business corporations by complying with the same set of generally applicable criteria. See Herbert Hovenkamp, *The Classical Corporation in American Legal Thought*, 76 GEO. L.J. 1593, 1634 (1988) (“General business corporation acts, which permitted firms to incorporate without seeking a special charter from the legislature, first became popular during the Jacksonian period.”); see also Susan Pace Hamill, *From Special Privilege to General Utility: A Continuation of Willard Hurst’s Study of Corporations*, 45 AM. U. L. REV. 81, 101–05 (1999) (chronicling history of state general incorporation statutes, from the era of initial experimentation in New York (1811), Pennsylvania (1836) and Connecticut (1837) to the Reconstruction era, by which time forty-four of the forty-seven states had enacted such statutes).

<sup>35</sup> See National Bank Act of 1864, ch. 106, 13 Stat. 99 [hereinafter NBA] (codified as amended in scattered sections of 12 U.S.C.).

National Bank Act of 1864 (NBA) created a new category of financial institution, national banks, which would issue bank notes backed by U.S. bonds deposited with the U.S. Treasury.<sup>36</sup> In enacting the NBA, Congress hoped to create a new and reliable national currency, in the process promoting the market for federal bonds and facilitating the financing of the Civil War.<sup>37</sup> A new federal administrative agency, the Office of the Comptroller of the Currency (OCC), would administer this new privatized and federalized banking system.<sup>38</sup> The NBA applied

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<sup>36</sup> See *id.* § 16 (establishing as a condition of a national bank charter that applicant deposit the greater of one-third of the applicant's paid-in capital and \$30,000 in the form of U.S. government bonds).

<sup>37</sup> See *Veazie Bank v. Fenno*, 75 U.S. 533, 548 (1869) (“These powers [to provide for a national currency], until recently, were only partially and occasionally exercised. Lately, however, they have been called into full activity, and Congress has undertaken to supply a currency for the entire country.”); OFFICE OF THE COMPTROLLER OF THE CURRENCY, NATIONAL BANKS AND THE DUAL BANKING SYSTEM 7 (2003) (“Backed by government securities, these circulating notes were designed to be the new national currency that would hold a stable value and could be used, reliably, across the nation.”). The creation of a reliable national currency was, however, the lesser of the two goals; the immediate impetus behind the legislation was war finance. National banks would be required to purchase federal bonds as a precondition to the grant of a charter, contributing to demand for U.S. government securities. See THOMAS P. KANE, *THE ROMANCE AND TRAGEDY OF BANKING* 5 (1922) (“[The NBA] was originally a war measure, and it grew out of the urgent necessities of the Government to replenish the public treasury by creating a market for its bonds through the inducement offered banks to obtain circulation based upon the security of such bonds.”); Bray Hammond, *The North's Empty Purse, 1861-1862*, 67 AM. HISTORICAL REV. 1, 11 (1961) (listing as a critical component of federal efforts to finance the Civil War “the authorization of a system of national banks, whose purchases of bonds to guarantee their issues of circulating notes would create a new supply of funds for the government”); cf. RANAJAY RAY CHAUDHURI, *THE CHANGING FACE OF AMERICAN BANKING: DEREGULATION, REREGULATION, AND THE GLOBAL FINANCIAL SYSTEM* 2 (2014) (“The aims [of the NBA] were to create a national currency, damage the interests of the banking sector in the Confederate South (where a majority of the state banks were located), and, along with income taxes and excise duties, help finance the American Civil War for the Union.”). Although the national bank system traces its roots to war finance, it was only part of a broader array of in extremis maneuverings by the Treasury Department—such as new taxes and the printing of legal tender fiat currency—and ultimately proved “of far less help to the war than the war was of help to it.” Hammond, *supra*, at 10; see also RICHARD H. TIMBERLAKE, *THE ORIGINS OF CENTRAL BANKING IN THE UNITED STATES* 85–86 (1978). Nevertheless, the enduring legacy of the legislation was the creation a new nationwide financial infrastructure buttressed by uniform currency issued by regulated banks. See A. Piatt Andrew, *The Crux of the Currency Question*, 2 YALE L.J. 595, 609 (1913) (quoting Alphonso Taft, who served as the U.S. Attorney General in Ulysses Grant's administration, as having stated: “if the Civil War resulted in nothing else than providing the country with a uniform currency it would not have been fought in vain”).

<sup>38</sup> Technically, Congress had created the OCC a year earlier, in 1863, when it enacted the National Currency Act. See 1 ALFRED M. POLLARD ET AL., *BANKING LAW IN THE UNITED STATES* § 2.05 (2d ed. 1999). The NBA was seen as a corrective measure, and it supplanted the 1863 Act. See BRAY HAMMOND, *BANKS AND POLITICS IN AMERICA FROM THE REVOLUTION TO THE CIVIL WAR* 731 (1957).



basic legal capital rules to the national banks, prohibiting them from effectuating distributions of corporate property, including dividends, out of their “capital,” a term that included the initial and any subsequent equity contributions by stockholders.<sup>39</sup> As a result of this restriction, a bank could only pay dividends out of its retained earnings—that is, current earnings or past earnings kept within the firm and not distributed or re-invested in the bank.<sup>40</sup>

In recognition of the special vulnerabilities of banks, Congress restricted dividends in additional ways that went beyond the traditional legal capital rules. For example, the NBA required each national bank to contribute ten percent of its previous year’s earnings to a “surplus” fund until such fund amounted to twenty percent of its total capital stock before declaring any dividends at all.<sup>41</sup> For *state* banks that converted into the new national bank form, limited liability was conditioned on the maintenance of the twenty percent surplus; failure to maintain it would trigger a prohibition on declaring dividends until the bank replenished the surplus.<sup>42</sup> Stockholders receiving dividends in violation of these restrictions would be liable to the bank or its receiver unless they had a good faith belief that it was properly paid.<sup>43</sup>

The NBA also imposed reserve requirements on national banks, mandating that banks maintain minimum amounts of reliable assets “on hand” (or on deposit with money-center banks in cities such as New York<sup>44</sup>)—referred to in banking law as “lawful money”<sup>45</sup>—to honor

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<sup>39</sup> NBA, *supra* note 35, § 38 (prohibition on withdrawal of capital); *id.* §§ 7–16 (discussing initial capitalization requirements for banks and requirements relating to increasing or decreasing, and depositing bonds in respect of, bank “capital”).

<sup>40</sup> See W. STEVE ALBRECHT ET AL., FINANCIAL ACCOUNTING: CONCEPTS AND APPLICATIONS 28 (11th ed. 2011).

<sup>41</sup> NBA, *supra* note 35, § 33.

<sup>42</sup> *Id.* § 12.

<sup>43</sup> See *Finn v. Brown*, 142 U.S. 56, 70 (1891) (“In regard to the dividend . . . it was clearly fraudulent and unlawful . . . . The money belonged to the bank, and ought to have been restored to the bank [by the director defendant.]”); *McDonald v. Williams*, 174 U.S. 397, 398–99, 408 (1899) (holding receiver of a national bank could not obtain recovery of illegal dividend paid entirely out of the bank’s capital because “the stockholder receiving such dividend acted in good faith, believing the same to be paid out of profits”).

<sup>44</sup> See NBA, *supra* note 35, § 32 (permitting a bank to “keep one half of its lawful money reserve in cash deposits in the city of New York”).

<sup>45</sup> As used in the NBA, “lawful money” referred to legal tender United States notes, known as “greenbacks,” which had been issued in 1862 and 1863. Edward C. Simmons, *The Concept of Lawful Money*, 46 J. POL. ECON. 108, 111 (1938). Congress periodically adjusted the “lawful money” classification in the decades following the NBA to include specie, U.S. notes, Federal Reserve notes, clearinghouse certificates, and silver and gold certificates. See Ira Cross, *Lawful Money: A Note*, 46 J. POL. ECON. 409, 410–11 (1938). Congress possesses this power under the Constitution, and since 1913 has

the bank notes it issued in the ordinary course.<sup>46</sup> Congress anticipated how dividends might pose a threat to reserves; it expressly prohibited any bank whose reserves had fallen below statutory thresholds from paying dividends to its stockholders.<sup>47</sup>

These dividend restrictions formed part of the regulatory infrastructure for this newly established, post-NBA nationwide financial system.<sup>48</sup> Together with minimum initial capitalization levels,<sup>49</sup> restrictions on the assets banks could hold and liabilities they could issue,<sup>50</sup> deposit of government bonds as security for national banks notes,<sup>51</sup> and provisions limiting bank activities to the “business of banking,”<sup>52</sup> these federal interventions into what would otherwise be among the core—arguably *the* core—prerogatives of bank management<sup>53</sup> promoted adequate capitalization levels at national

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delegated it to the FRB. *See* *Milam v. United States*, 524 U.S. 629, 630 (9th Cir. 1974) (discussing *Juilliard v. Greenman*, 110 U.S. 421 (1884)). Interestingly, national bank notes themselves were *not* lawful money—even following the enactment of the NBA. *See, e.g.*, *Hamilton v. State*, 60 Ind. 193, 194 (1877) (reversing conviction of defendant for larceny of “lawful money of the United States” because defendant might have stolen national bank notes, which “are in no sense money of the United States”).

<sup>46</sup> *See* NBA, *supra* note 35, § 31 (imposing fifteen percent reserve requirement on national banks that increased to twenty-five percent for banks located in statutorily designated money center cities); J. LAWRENCE BROZ, *THE INTERNATIONAL ORIGINS OF THE FEDERAL RESERVE SYSTEM* 27–28 (1997). A bank regulatory regime that requires banks to maintain minimum amounts of reliable assets as a percentage of total deposit liabilities is referred to as a fractional reserve banking system. *See* N. GREGORY MANKIW, *PRINCIPLES OF MACROECONOMICS* 332–33 (2012) (introducing principles of fractional reserve banking).

<sup>47</sup> *See* NBA, *supra* note 35, § 41 (prohibiting banks from “mak[ing] any dividend of its profits until the required proportion between the aggregate amount of its outstanding notes of circulation and deposits and its lawful money of the United States shall be restored”).

<sup>48</sup> *See* POLLARD ET AL., *supra* note 38, § 2.05 (“The National Bank Act of 1864 provided the foundation for the modern system of federal bank regulation.”).

<sup>49</sup> *See* NBA, *supra* note 35, § 7 (setting forth minimum initial amounts of paid-in capital for national banks ranging from \$50,000 to \$200,000, depending on the size of the city in which the bank would be “organized”).

<sup>50</sup> *See id.* § 28 (setting forth limitations on national banks’ real estate holdings); 1 MILTON R. SCHROEDER, *THE LAW AND REGULATION OF FINANCIAL INSTITUTIONS* ¶ 1.02 (2012) (“The act imposed . . . restrictions on lending policies.”).

<sup>51</sup> *See supra* note 36 and accompanying text.

<sup>52</sup> *See* NBA, *supra* note 35, § 8 (restricting national banks only to the conduct of the “business of banking,” to be defined by the OCC, and providing an exhaustive list of legal bank powers).

<sup>53</sup> Subject to fiduciary duties and legal capital rules (and special legislative-regulatory rules for particular industries, such as the banking restrictions discussed above), the payment of dividends under U.S. corporate law has always been the exclusive province of the board of directors. *See, e.g.*, *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 722 (Del. 1971) (applying the business judgment rule to board of directors’ decision to declare dividends).

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banks and reduced perceptions of their credit risk. In the process, they also bolstered confidence in the new national banking system. Dividend restrictions, as we have seen, served as backstops for several of these measures.

Increased confidence in national banks was crucial to the postbellum financial system, and it differed sharply from the uncertainty and instability that marked the previous era of banking in the United States. With the NBA, Congress had created, in effect, a new national currency, issued by national banks and backed by the U.S. Treasury Department.<sup>54</sup> Over the next few decades, this new currency gradually replaced the thousands of different state bank notes that previously had comprised the money supply during the period between the demise of the Second Bank of the United States in 1836 and the enactment of the NBA, known as the “free banking” era.<sup>55</sup> These state bank notes were often of dubious quality, and merchants had no centralized information source to rely on in determining whether the notes were issued by financially solid banks or poorly capitalized, or even insolvent, banks.<sup>56</sup> Now that there was a standardized federal currency issued by reliable banks, businesses no

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<sup>54</sup> See *supra* notes 36 & 37 and accompanying text.

<sup>55</sup> See CHAUDHURI, *supra* note 37, at 7–19; GARY B. GORTON, *MISUNDERSTANDING FINANCIAL CRISES: WHY WE DON'T SEE THEM COMING* 11–17 (2012); SCHROEDER, *supra* note 50, ¶ 1.02. The national bank era was also, in a sense, a “free banking” era, inasmuch as there was no central governmental authority allocating credit and all applicants could form a bank by complying with the statute. See HAMMOND, *supra* note 38, at 727 (“The new act was a free-banking measure, derived from the original free-banking law enacted in New York in 1838 but modified by variations thereof in other states.”). In fact, on the surface all the NBA did was create another chartering entity (the OCC), if anything *increasing* the freedom of choice for would-be bank founders. In context, however, the coercive effect of Congressional intervention becomes apparent. Congress did not merely create a new chartering option; it also imposed a ten percent federal tax in 1866 on state-chartered bank notes. This tax pressured state banks to convert to the national bank form, which thereafter became the predominant form through which the business of banking was conducted. See *id.* at 733–34; *Veazie Bank v. Fenno*, 75 U.S. 533, 548–49 (1869) (acknowledging that the tax’s purpose might very well have been the destruction of the state banking system, but nevertheless upholding its constitutionality); *but cf.* HAMMOND, *supra* note 38, at 734 (noting that the tax did not completely eliminate the state bank form, since money increasingly took the form of bank deposits, which were untaxed).

<sup>56</sup> See GORTON, *supra* note 55, at 19; OFFICE OF THE COMPTROLLER OF THE CURRENCY: *A SHORT HISTORY* 1 (2011), available at <http://www.occ.gov/about/what-we-do/history/OCC%20history%20final.pdf> (“[T]he biggest problem with state banking before the Civil War was that it discouraged the development of an integrated national market and a shared national identity. At each destination, long-distance travelers had to convert their bank notes into local money, usually sustaining a loss with each exchange. The cost and inconvenience were significant deterrents to interstate travel and commerce.”).

longer needed to hold a hodgepodge of disparate, potentially worthless notes, nor accept the risk that their counterparties would discount their notes. Once national bank notes had become the norm, all that mattered was whether that business had enough of them to consummate a transaction.

With the confidence in this new standardized, federal national bank note currency firmly established, bank liabilities increasingly took the form of *deposits* of currency, and *checks*, which represented a draw on those deposit accounts, became the predominant form of money by the close of the century.<sup>57</sup> But this new deposit-check financial system revealed itself to be even less stable than the state bank note system that had prevailed during the free banking era.<sup>58</sup> Whereas the chief problem with the free banking era was the uncertain credit quality of state bank notes, the problem in the post-NBA national banking era was that merchants did not know how much specie and currency, however standardized, the banks actually held to support their deposits.<sup>59</sup> This uncertainty led to runs.<sup>60</sup>

The eventual solution was the creation of a central bank in 1914 to act as lender of last resort to shore up depositor confidence.<sup>61</sup> The

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<sup>57</sup> See Kris James Mitchener & Matthew Jaremski, *The Evolution of Bank Supervision: Evidence from U.S. States* 16 (Nat'l Bureau of Econ. Res., Working Paper No. 20603, 2014), available at <http://www.cepr.org/sites/default/files/MITCHENER%20-%20Bank%20Supervision.pdf> (“By the end of 1900, bank notes made up less than 10% of all liabilities.”).

<sup>58</sup> See GORTON, *supra* note 55, at 20–24 (observing that banking panics between the Civil War and establishment of the Federal Reserve System in 1914 “all involved demand deposits, as currency was now backed by the federal government and was no longer subject to runs”); ELMUS WICKER, *BANKING PANICS OF THE GILDED AGE* xii (2000) (“[T]he identifying characteristic of all major banking panics [during the period from the Civil War to 1907] was the general loss of depositor confidence manifest by a sudden and unanticipated switch from deposits to currency.”); Calomiris & Gorton, *supra* note 21, at 129–60; O.M.W. SPRAGUE, *HISTORY OF CRISES UNDER THE NATIONAL BANKING SYSTEM* (1910) (report commissioned by the National Monetary Commission, which Congress formed in Aldrich-Vreeland Act in 1908 in reaction to the Panic of 1907, individuating banking “crises” in 1873, 1893, and 1907, a “panic” in 1884, and “financial stringency” in 1890).

<sup>59</sup> *But cf. supra* notes 45 & 46 and accompanying text (noting that the fractional reserve system of the NBA required banks to maintain “lawful money” at a certain percentage of their total deposit and note liabilities—an amount that in any event was far short of their total deposit liabilities).

<sup>60</sup> See *supra* note 58 (citing Sprague report, a study of post-NBA banking crises).

<sup>61</sup> See BEN S. BERNANKE, *THE FEDERAL RESERVE AND THE FINANCIAL CRISIS* 8–9 (2014). In the period leading up to the creation of the Federal Reserve System, money center banks set up clearinghouses that served as private lenders of last resort, performing functions that were typically the province of central banks. See *id.*; GORTON, *supra* note 55, at 51 (“Before the Federal Reserve came about in the United States, banks tried to reduce the possibility of anyone finding secrets by creating stronger backing of

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Federal Reserve Act of 1913 created the Federal Reserve System (FRS),<sup>62</sup> a decentralized central bank system consisting of twelve “federal reserve banks.” It would serve as the first central bank for the United States since Andrew Jackson won his battle not to renew the charter of the Second Bank of the United States in 1836.<sup>63</sup> A Board of Governors would oversee the FRS. The Federal Reserve Act picks up where the NBA left off, making adjustments to existing reserve requirements and applying dividend restrictions to a wider array of banks.

Section 9 of the Federal Reserve Act applied the prohibition on dividends paid out of capital, previously applicable only to national banks,<sup>64</sup> to state banks that became members of the FRS.<sup>65</sup> The Act also imposed the first dividend reporting requirement on U.S. banks, requiring member banks to file reports with the Comptroller of the Currency detailing payments of dividends to stockholders.<sup>66</sup> Furthermore, it established new reserve requirements for all member banks, which included not only state member banks but also all national banks.<sup>67</sup> The Act required each member bank to maintain its reserves with the Federal Reserve Bank of which it was a member or with another federal reserve bank at which it maintained an account.<sup>68</sup> Banks could draw on these reserves to meet existing liabilities, but they could not pay any dividends “unless and until the total reserve required by law is fully restored.”<sup>69</sup> Again, the idea motivating the dividend restrictions was to ensure each bank maintained a minimum amount

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demand deposits. The principal way they did this was by organizing themselves into clearinghouses.”); GARY B. GORTON, *SLAPPED BY THE INVISIBLE HAND: THE PANIC OF 2007* 33–37 (2010) (discussing role of clearinghouses during the national bank era); WICKER, *supra* note 58, at 12–15 (describing how the New York Clearing House (NYCH) issued certificates backed by the NYCH, which had the power to pool all member reserves, and how the persistence of banking crises notwithstanding the NYCH was due to its institutional failure to take collective action rather than any structural weakness of the clearinghouse concept).

<sup>62</sup> Federal Reserve Act, Pub. L. No. 63-43, 38 Stat. 251 (1913) (codified as amended in scattered sections of 12 U.S.C.) (creating federal reserve banks owned by privately controlled “member banks” that became members of the FRS).

<sup>63</sup> See HAMMOND, *supra* note 38, at 439.

<sup>64</sup> See *supra* note 39 and accompanying text.

<sup>65</sup> Federal Reserve Act, *supra* note 62, § 9.

<sup>66</sup> *Id.*

<sup>67</sup> *Id.* §§ 2, 19. The Act required all national banks to become members of the FRS.

<sup>68</sup> *Id.* § 19. The Federal Reserve Act reserve requirements differed from the NBA reserve requirements, which had previously required national banks to maintain reserves in the form of “lawful money on hand.”

<sup>69</sup> *Id.*; cf. *supra* notes 45–47 and accompanying text.

of liquid funds that deposit creditors could withdraw, thereby promoting confidence in the banking system and limiting bank runs.

The next landmark banking law legislation in the United States was the Banking Act of 1933, which established the Federal Deposit Insurance Corporation (FDIC).<sup>70</sup> The Act created a new dividend restriction in the interests of another privileged creditor: the FDIC itself.<sup>71</sup> The FDIC, the first federal deposit insurer, was (and still is today) funded by assessments from insured depository institutions.<sup>72</sup> The Act proscribed the payment of any dividends while any assessment obligations remained outstanding.<sup>73</sup> It also required all insured banks to become members of the FRS, which in the process subjected all insured banks, including those state banks that were previously not members of the FRS, to the basic suite of federal bank dividend restrictions.<sup>74</sup> In 1959, Congress created a new dividend contingency in the form of a procedural requirement that national banks must seek *prior approval* of the Comptroller of the Currency before declaring dividends under certain circumstances. Specifically, the prior approval requirement applied where the bank proposed to declare dividends in a calendar year in an amount in excess of the aggregate retained net profits of the previous three years.<sup>75</sup>

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<sup>70</sup> Banking Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (codified as amended in scattered sections of 12, 15, 39 U.S.C.).

<sup>71</sup> The Act also included the Glass-Steagall Act, which restricted securities and insurance activities of commercial banks, as well as affiliations between commercial banks and companies conducting those activities. See PATRICIA L. MCCOY, BANKING LAW MANUAL §§ 7.01, 7.02[1], 7.03[1] & [3], and 7.04 (2d ed., 2015).

<sup>72</sup> See generally 12 C.F.R. pt. 327 (2014) (setting forth insurance assessment regime).

<sup>73</sup> Banking Act of 1933, *supra* note 70, § 8 (adding a new section 12A to the Federal Reserve Act). Section 8 imposed criminal liability on directors and officers that “participat[e] in the declaration or payment” of such dividends. *Id.*

<sup>74</sup> *Id.* (adding new Section 12B(*h*)); see *supra* notes 39 & 65 and accompanying text (detailing how the Federal Reserve Act applied the NBA’s basic no-dividends-from-capital restriction, previously applicable only to national banks, to all member banks of the FRS).

<sup>75</sup> See Act to Amend the National Banking Laws to Clarify or Eliminate Ambiguities, to Repeal Certain Laws Which Have Become Obsolete, and for Other Purposes, § 21(a), Pub. L. 86-230, 73 Stat. 465 (1959) (codified at 12 U.S.C. § 60(b) (2012)); OFFICE OF THE COMPTROLLER OF THE CURRENCY, COMPTROLLER’S LICENSING MANUAL: CAPITAL AND DIVIDENDS 16 (2007), available at <http://www.occ.gov/publications/publications-by-type/licensing-manuals/capital3.pdf> (“A bank that declares a dividend in excess of its current year net income may attribute dividends in excess of the current year’s net income to each of the prior two years, to the extent that there is sufficient undistributed net income in those years.”); MICHAEL P. MALLOY, THE CORPORATE LAW OF BANKS: REGULATION OF CORPORATE AND SECURITIES ACTIVITIES OF DEPOSITORY INSTITUTIONS 248–49 (1988) (referring to this restriction as a “net profits or modified earned surplus test”). By virtue of Section 9 of the Federal Reserve

B. *Introducing Indeterminacy into Banking Law Through the Term “Unsafe and Unsound Practices”: Applications to Dividend Restrictions*

The restrictions discussed so far leave little room for administrative discretion and rely on regulatory accounting methods to yield binary regulatory decisions: either the dividend is legal, in which case regulators have no role, or it is illegal, in which case regulators will proscribe it, order its restitution, or withdraw government licenses to the charter or deposit insurance. With the Banking Act of 1933, Congress introduced a more indeterminate term—“unsafe and unsound practices”—into the U.S. banking law lexicon. Subsequent legislative actions empowered bank supervisors to take certain actions, including ad hoc dividend restrictions, if they found banks (or their executives or directors) engaging in such practices.

Section 30 of the Banking Act vested the FRB with authority to issue show-cause orders on a bank’s directors and officers engaging in unsafe or unsound practices in the conduct of the bank’s business. Such an order would require them to demonstrate why they should not be removed.<sup>76</sup> In 1950, the Federal Deposit Insurance Act authorized the FDIC to withdraw deposit insurance where the insured bank has engaged or is engaged in unsafe or unsound practices.<sup>77</sup> In 1966, Congress amplified regulators’ powers by authorizing them to issue cease-and-desist orders to banks engaging in unsafe or unsound practices.<sup>78</sup> In each of these cases, Congress intentionally left the term ambiguous.<sup>79</sup> The Chairman of the Federal Home Loan Bank Board, John Horne, provided the following oft-cited gloss on the term during testimony before Congress in 1966, over three decades after its insertion into the U.S. banking laws:

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Act, this requirement applied to all state member banks as well. *See supra* note 65 and accompanying text. In 1994, Congress amended the statute to refer to “net income” rather than “net profits,” but the requirement of prior OCC approval in such circumstances persists today. *See* Riegle Community Development and Regulatory Improvement Act of 1994, § 602(h)(2), Pub. L. 103–325, 108 Stat. 2160 (1994) (codified at 12 U.S.C. § 56). A national bank seeking approval for such a dividend must submit its request to its district office. 12 C.F.R. § 5.64(b)(3) (2014).

<sup>76</sup> Banking Act of 1933, *supra* note 70, § 30 (also providing authority to issue show-cause orders to directors and officers of banks committing violations of law).

<sup>77</sup> Federal Deposit Insurance Act of 1950 § 8(a), Pub. L. 81-97, 64 Stat. 873 (1950) (codified at 12 U.S.C. § 1818).

<sup>78</sup> Financial Institutions Supervisory Act of 1966 §§ 101, 102, 202, Pub. L. No. 89-695, 80 Stat. 1028, 1028, 1036, 1046 (1966) (codified at 12 U.S.C. §§ 1464(d), 1730, 1818).

<sup>79</sup> *See* Joseph M. Korff, *Banking*, 8 B.C. L. REV. 599, 606 (1967).

The concept of “unsafe or unsound practices” is one of general application which touches upon the entire field of the operations of a financial institution. For this reason, it would be virtually impossible to attempt to catalog within a single all-inclusive or rigid definition the broad spectrum of activities which are embraced by the term . . . . Like many other generic terms widely used in the law, such as “fraud,” “negligence,” “probable cause,” or “good faith,” the term “unsafe or unsound practices” has a central meaning which can and must be applied to constantly changing factual circumstances. Generally speaking, an “unsafe or unsound practice” embraces any action or lack of action, which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk or loss or damage to an institution, its shareholders, or the agencies administering the insurance funds.<sup>80</sup>

Courts have largely ratified Horne’s gloss on the indeterminate statutory norm.<sup>81</sup> In this post-New Deal banking regulatory environment, the determination of safety or soundness required a highly discretionary judgment with reference to the specific facts of the case.<sup>82</sup> Excessive or otherwise improper dividend payments are among the types of conduct that bank regulators, and courts called on to perform judicial review, have found to be “unsafe and unsound practices.”<sup>83</sup>

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<sup>80</sup> *Financial Institutions Supervisory and Insurance Act of 1966: Hearings on S. 3158 and S. 3695 Before the H. Comm. on Banking and Currency, 89th Cong., 2d Sess. 49–50 (1966)* [hereinafter *Horne Testimony*] (memorandum submitted by John Horne, Chairman, Fed. Home Loan Bank Bd.). Horne’s discussion entered the realm of formal public law when the banking agencies included it in their examination manuals.

<sup>81</sup> See *Landry v. FDIC*, 204 F.3d 1125, 1138 (D.C. Cir. 2000); *Greene Cnty. Bank v. FDIC*, 92 F.3d 633, 636 (8th Cir. 1996); *Nw. Nat’l Bank v. United States*, 917 F.2d 1111 (8th Cir. 1990); *Gulf Fed. Sav. & Loan Ass’n v. Fed. Home Loan Bank Bd.*, 651 F.2d 259 (5th Cir. 1983); cf. *Franklin Sav. Ass’n v. Office of Thrift Supervision*, 934 F.2d 1127, 1145–46 (10th Cir. 1991) (stating that a bank is in an “unsafe and unsound condition” when it “is operated in such a manner as to cause unacceptable levels of risk to its depositors’ funds”).

<sup>82</sup> See Lawrence G. Baxter, *The Rule of Too Much Law? The New Safety/Soundness Rulemaking Responsibilities of the Federal Banking Agencies*, 47 CONSUMER FIN. L. Q. REP. 210, 211 (1993) (contrasting the wide discretion bank regulators exercise when making “safety and soundness” determinations with the more “prophylactic” mode of regulation that imposed direct controls on the conduct of the business of banking, including dividend restrictions).

<sup>83</sup> See *Seidman v. Office of Thrift Supervision*, 37 F.3d 911, 927 (3d Cir. 1993) (“Among the specific acts that may constitute an unsafe and unsound practice are paying excessive dividends, disregarding a borrower’s ability to repay, careless control of expenses, excessive advertising, and inadequate liquidity.”) (quotation marks



While Congress layered on new dividend restrictions with each periodic post-crisis burst of banking law reform, state legislatures did the opposite, attenuating the dividend restrictions embedded in the legal capital rules.<sup>84</sup> Legal capital restrictions in general corporation statutes—that is, those laws governing non-bank, general purpose business corporations—became anachronisms on account of changes in the corporate law permitting zero-par value stock issuances.<sup>85</sup> Where the “capital” base could be manipulated by legal fiat, it no longer remained a meaningful restriction to limit the payment of dividends from a corporation’s capital.

But, as we have seen, restrictions on the ability of *bank* stockholders to receive distributions of corporate property continued. The source-of-strength doctrine was first articulated by the FRB in the 1980s pursuant to its authority under the 1956 Bank Holding Company Act and eventually received a Congressional imprimatur in 2010. The doctrine requires bank holding companies, the direct and indirect equity owners of banks, to contribute additional funding to bank subsidiaries that run into financial difficulty.<sup>86</sup> So in the zone of

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omitted); *First Nat’l Bank of Bellaire v. Comptroller of the Currency*, 697 F.2d 674, 680 (5th Cir. 1983); Thomas K. Benshop, 1992 OFIA LEXIS 14, \*42 (1992) (prohibiting former bank director from further participation in conduct of business of any federally insured depository institution under Section 8(e) of the Federal Deposit Insurance Act due in part to a finding that bank had “engaged in unsafe and unsound practices in 1988 and 1989 by paying dividends which were excessive in light of the bank’s condition”); \*\*\* Bank, 1986 FDIC Enf. Dec. LEXIS 2, \*15 (1986) (administrative appeals board affirming FDIC order requiring bank to “cease and desist from unsafe and unsound banking practices,” including “[p]aying excessive cash dividends in relation to the [b]ank’s net income”).

<sup>84</sup> See *supra* notes 32 & 33 and accompanying text (discussing concept of “legal capital”).

<sup>85</sup> See ADOLPH A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 144–46 (2d ed. 1968). By permitting zero-par value (or de minimis par value) stock issuances, the requirement that dividends be paid out of surplus no longer represented a meaningful constraint on the board of directors. The issuance of zero-par stock ensures that any positive equity capitalization will be surplus, which is defined in most statutes as total paid-in capital minus aggregate par value, because the aggregate par value would be zero—or, in the case of stock issued with de minimis par value, negligible.

<sup>86</sup> The legality of the source-of-strength doctrine was contested prior to its adoption by Congress in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. See *Dodd-Frank Wall Street Reform and Consumer Protection Act* § 616, 12 U.S.C. § 1831o-1 (2011) (providing express statutory authority for the source-of-strength doctrine); Policy Statement of Bd. of Governors of the Fed. Reserve Sys., 52 Fed. Reg. 15707, 15708 (1987) (providing that the FRB would consider the “failure” to “stand ready to use available resources to provide adequate capital funds to its subsidiary” an unsafe and unsound banking practice, which would trigger, among other things, the FRB’s authority to issue cease-and-desist orders to holding company); *MC Corp Fin., Inc. v. Bd. of Governors of the Fed. Reserve Sys.*, 900 F.2d 852, 863 (5th

insolvency, bank stockholders might be required to make contributions to, rather than permitted to receive distributions from, banks.<sup>87</sup>

#### IV. "PROMPT CORRECTIVE ACTION": RIGID AND MANDATORY INTERVENTION POINTS BASED ON ACCOUNTING-BASED CAPITAL LEVELS

The next major banking law reform ushered in a new era of bank capital adequacy regulation that would provide for, among many other things, restrictions on dividends that were to apply before the in extremis scenarios, such as capital impairment and reserve shortages, described earlier. When it was enacted in 1991, the Federal Deposit Insurance Corporation Improvement Act (FDICIA) represented the most significant banking law reform since at least the Bank Holding Company Act of 1956, and perhaps since the Banking Act of 1933 that established the FDIC.<sup>88</sup> Unsurprisingly for such an important reform, FDICIA, like the major banking law reforms before it, also provided for regulatory dividend restrictions. The "prompt corrective action" (PCA) regime inserted a new Section 38 into the Federal Deposit Insurance Act,<sup>89</sup> which represented Congress's attempt to force bank regulators' hands in the aftermath of the savings and loan debacle.<sup>90</sup> Following that crisis, bank and thrift supervisors were excoriated for having engaged in regulatory forbearance, refusing to take decisive action until bank capital fell too low to be remediated through effective supervision and enforcement.<sup>91</sup> The problem was not an

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Cir. 1990), *overruled on other grounds*, 502 U.S. 32 (1991) (holding that "the [FRB]'s determination that [a] holding company's failure to transfer its assets to a troubled subsidiary was an 'unsafe or unsound practice' under § 1818(b)(1) is an unreasonable and impermissible interpretation of that term").

<sup>87</sup> Cf. 12 U.S.C. §§ 55 & 324 (2012) (requiring bank regulators to levy assessments on stockholders of national banks and state member banks of the FRS where their "capital stock"—that is, their legal capital—is impaired).

<sup>88</sup> See KENNETH SPONG, *BANKING REGULATION: ITS PURPOSES, IMPLEMENTATION, AND EFFECTS* 85 (5th ed. 2000) ("[P]rompt corrective actions standards have become the primary regulatory influence over bank capital levels.").

<sup>89</sup> The Federal Deposit Insurance Act of 1950, § 38, Pub. L. No. 81-797, 64 Stat. 873 (1950) (codified at 12 U.S.C. § 1831o). The FDIA established a comprehensive system of regulation of federal deposit insurance, providing for, among other things, an extensive supervisory architecture for insured banks and thrifts.

<sup>90</sup> See SPONG, *supra* note 88, at 85 ("This system of supervision, commonly known as prompt corrective action, represents an attempt to provide a timely and nondiscretionary triggering mechanism for supervisory actions.").

<sup>91</sup> See CONGRESSIONAL BUDGET OFFICE, *THE ECONOMIC EFFECTS OF THE SAVINGS & LOAN CRISIS: A CBO REPORT 9* (1992), available at [https://www.cbo.gov/sites/default/files/102nd-congress-1991-1992/reports/1992\\_01\\_theeffectsofthesavings.pdf](https://www.cbo.gov/sites/default/files/102nd-congress-1991-1992/reports/1992_01_theeffectsofthesavings.pdf) ("Many analysts believe that this regulatory forbearance was an especially key cause of the escalating public liabilities in the S&L crisis."); LAWRENCE J. WHITE,

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authority deficit for supervisors—we have already seen how Congress empowered them to withdraw deposit insurance and to issue cease-and-desist orders. The problem instead was that supervisors failed to exercise their discretion in deploying those sanctions.<sup>92</sup>

Under the PCA regime, Congress specified statutorily a five-part classificatory system for capital adequacy—“well capitalized,” “adequately capitalized,” “undercapitalized,” “significantly undercapitalized,” and “critically undercapitalized”—and instructed the bank supervisors to set the numerical criteria for those categories.<sup>93</sup> As a bank’s capital declines, its federal supervisor is empowered, and eventually required, to intervene to address the source of the declining capital levels.<sup>94</sup> The regime functions as a capital “tripwire system” in which institutions are subject to increasingly stringent supervision and business restrictions as their health declines.<sup>95</sup>

For example, PCA requires an “undercapitalized” bank to submit a “capital restoration plan” to its supervisor for approval.<sup>96</sup> If the bank’s capital dips to “significantly undercapitalized” levels, the supervisor is required to take at least one of a series of actions, including requiring that the bank raise additional capital, agree to an acquisition by a better-capitalized institution, make certain asset divestitures, or cease payments of dividends.<sup>97</sup> Once a bank becomes “critically undercapitalized,” PCA requires the supervisor to place it in

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THE S&L DEBACLE: PUBLIC POLICY LESSONS FOR BANK AND THRIFT REGULATION (1991).

<sup>92</sup> Richard J. Herring, *Banking Disasters: Causes and Preventative Measures: Lessons Derived from the U.S. Experience*, in PREVENTING BANK CRISES: LESSONS FROM RECENT GLOBAL BANK FAILURES 209, 221–23 (Gerard Caprio, Jr. et al. eds., 1998) (noting that supervisors for savings and loan associations reduced capital requirements and allowed for more liberal accounting rules to delay regulatory intervention for financial, ideological and psychological reasons).

<sup>93</sup> 12 U.S.C. § 1831o(b)(1). The statute directs the supervisors to define the metes and bounds of the classifications, subject to statutory limits specified by the Congress. See § 1831o(c).

<sup>94</sup> § 1831o(a)(2). Under the PCA regime, bank supervisors are empowered or required, depending on the capitalization level of the supervised bank, to mandate the submission of a “capital restoration plan,” “closely monitor” the bank, restrict asset growth, require approval for certain transactions and business development plans (e.g., new branching initiatives), restrict certain inter-affiliate transactions, restrict interest rates paid on deposits, require divestiture of assets, prohibit deposits from certain correspondent banks, restrict capital distributions, restrict payments on subordinated debt, restrict payments to senior executives, and place the bank in conservatorship or receivership. See 12 U.S.C. § 1831o(e)–(i).

<sup>95</sup> Baxter, *supra* note 82, at 212.

<sup>96</sup> § 1831o(e)(2)(A).

<sup>97</sup> § 1831o(f)(2). In deciding which actions to take, the supervisor must apply certain presumptions in favor of certain of the actions listed in subsection (f)(2)(H). § 1831o(f)(3).

conservatorship or receivership.<sup>98</sup>

PCA expanded greatly the range of conditions over which bank regulators could exert control over matters that were traditionally the managerial prerogatives of bank management, including dividend policy. By contrast, in the pre-PCA environment, intervention could occur only where bank boards of directors declared a dividend while the bank was experiencing in extremis financial circumstances: e.g., when the bank depleted its capital surplus, lacked profits out of which it could pay dividends, accumulated arrearages on its FDIC assessments, or failed to maintain adequate reserves with its federal reserve bank.<sup>99</sup> With PCA, regulatory intervention is supposed to occur as soon as a bank is only “adequately capitalized.” Because a bank pays dividends out of its capital, the PCA regime, which intervenes based on capitalization levels, *indirectly* regulates outflows of dividends from banks to their stockholders. That is, a bank might decide not to pay a dividend to stockholders when doing so would place the bank in a new, lower PCA capital category. It also *directly* regulates outflows of dividends by authorizing supervisors to restrict distributions of bank property to stockholders that would result in the bank becoming “undercapitalized.”<sup>100</sup> As discussed in Part V of this Article, PCA expanded the scope of dividend restrictions somewhat, but stopped well short of the conjectural, counterfactual, stress-based dividend regulatory regime that Congress and the FRB introduced in 2011.

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<sup>98</sup> § 1831o(h)(3)(A).

<sup>99</sup> As noted earlier in Part III, supervisors have been statutorily empowered since 1966 to enjoin dividends even in the absence of a mandatory accounting-based or compliance-based trigger. *See supra* note 78 (describing Congressional authorization of supervisory agencies to issue cease and desist orders on any bank engaging in unsafe or unsound practices). That said, the 1966 authority has lied largely dormant in the *ex ante* sense, and is only invoked in an *ex post* enforcement capacity to enjoin a bank from further wrongdoing or to implement a control regime to prevent a repeat of the same. The legislative purpose behind FDICIA, by contrast, was to mandate supervisory corrective action.

<sup>100</sup> *See* § 1831o(d)(1)(A) (“An insured depository institution shall make no capital distribution if, after making the distribution, the institution would be undercapitalized.”).

## V. TWO WAYS OF THINKING ABOUT BANK DIVIDEND REGULATION

Since the Banking Act of 1933 introduced safety and soundness concerns into regulatory practice,<sup>101</sup> bank supervision in the United States has occurred along two dimensions: a *formal-mandatory dimension* and an *informal-discretionary dimension*. By looking at the history of dividend restrictions through this binary lens, the important and novel impact of the new stress testing initiative on dividend regulation stands more starkly in relief. In particular, the new contingency of bank dividends results from the way in which bank regulators have merged these two dimensions for the first time in the CCAR program. Before describing the new program, the following description outlines the characteristics of this bipartite frame of reference. The formal-mandatory dimension is characterized by rigid, formulaic, bright-line rules. It vests little discretion in regulators and prefers to trigger regulatory interventions based on actual, present circumstances. By contrast, the informal-discretionary dimension vests considerable flexibility in regulators, allowing them to intervene based on qualitative, discretionary judgments—even including consideration of hypothetical, conjectural scenarios. When operating in the formal-mandatory dimension, supervisors are usually performing the enforcement function of administrative law. When operating in the informal-discretionary dimension, supervisors are undertaking a more fulsome regulatory project<sup>102</sup> involving risk identification and assessment, decisions as to resource allocation, and discretionary standard-setting.<sup>103</sup>

Figure 1 below maps the dividend restrictions discussed in the previous Part IV along an x-axis reflecting the rigidity of the regulatory program and a y-axis reflecting the extent to which the regulatory program contemplates the use of regulatory discretion to consider hypothetical, future scenarios.

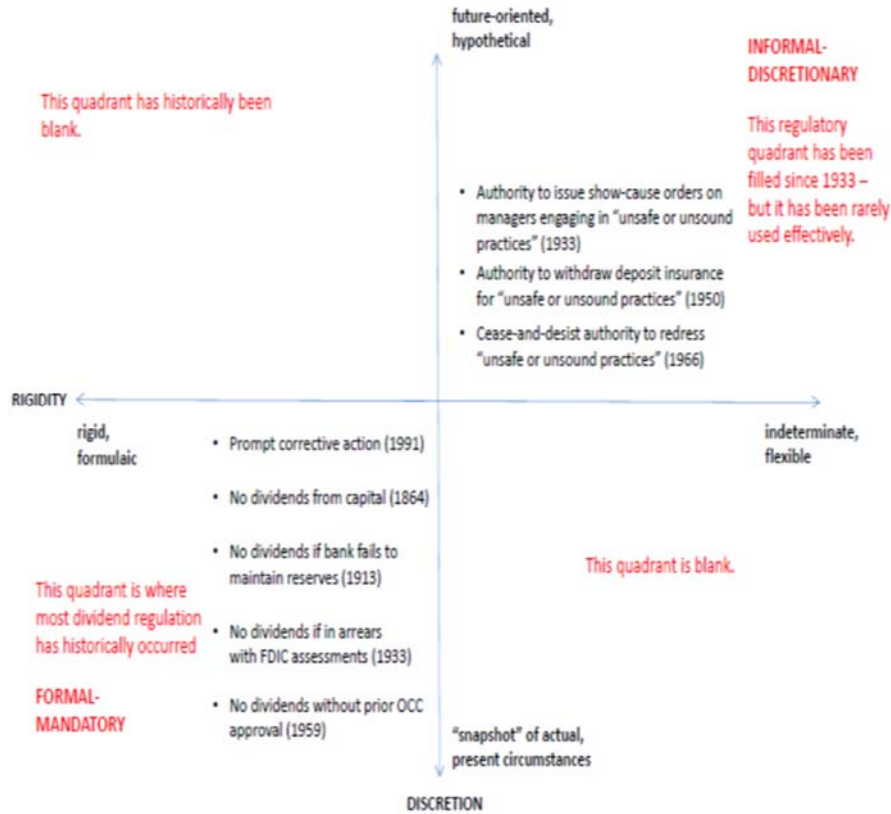
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<sup>101</sup> See *supra* note 73 and accompanying text (discussing introduction of “unsafe and unsound practices” term in the banking law lexicon).

<sup>102</sup> See *Burlington Truck Lines, Inc. v. United States*, 371 U.S. 156, 167 (1962) (“Expert discretion is the lifeblood of the administrative process . . .”).

<sup>103</sup> See John S. Applegate, *Worst Things First: Risk, Information, and Regulatory Structure in Toxic Substances Control*, 9 *YALE J. ON REG.* 277, 305 (1992) (describing the “four phases” of regulatory action as hazard identification, allocation of resources, standard setting, and standard enforcement).

**Figure 1: Regulatory Map of U.S. Bank Dividend Regulations According to Their Rigidity and Use of Regulatory Discretion**



Most of the action is in the lower left quadrant, which spatializes the familiar formal-mandatory dimension of bank dividend regulation. The informal-discretionary dimension is represented by the upper right quadrant. Regulators have been empowered to regulate dividends in this quadrant since 1933, when they acquired the power to monitor “unsafe and unsound practices” of regulated banks and their directors and officers.<sup>104</sup> Nevertheless, regulatory activity—as distinguished from regulatory authority—has been sparse in this quadrant. The empty bottom right quadrant reflects an implicit assumption that where actual, present circumstances justify regulatory intervention, the rigid tools populating the lower left quadrant will

<sup>104</sup> See *supra* notes 76–83 and accompanying text (chronicling how bank supervisors were successively empowered to take certain actions predicated on a finding of an “unsafe or unsound practice,” including issuing show-cause orders on bank executives in 1933, withdrawing deposit insurance in 1950, and issuing cease-and-desist orders in 1966).

best promote regulatory objectives. The blank upper left quadrant is where the CCAR program, to be discussed in Part VI, unites elements of the informal-discretionary quadrant and the formal-mandatory quadrant in a new system of bank dividend regulation. This new system is both rigid and hypothetical. It allows regulators to consider the effects of future scenarios on a bank, but also tethers those scenarios to a system of rigid numerical trigger points that require intervention by regulators. This latter point is important because it is a potential antidote to regulators' historical tendency towards inaction based on what they perceive to be future, conjectural risks of loss.

A. *The Formal-Mandatory Dimension of Bank Supervision*

The formal-mandatory dimension has historically been the province of Congress and consists of bright-line legal rules that require precise applications, often carrying with them coercive sanctions. Prominent examples of the formal-mandatory dimension include prophylactic measures such as asset restrictions and the Glass-Steagall Act's prohibition on affiliations of commercial banks with securities firms and insurance companies.<sup>105</sup> As far as dividends are concerned, we see this dimension in the prohibitions on declaring dividends when a bank is not in compliance with its reserve requirements,<sup>106</sup> when a bank is in arrears with respect to its FDIC assessments,<sup>107</sup> and when a dividend would cut into a bank's "capital surplus"<sup>108</sup> or would be paid in an amount in excess of three-year accumulated profits.<sup>109</sup> With PCA, Congress cemented the formal-mandatory dimension with a series of prescriptive, formulaic statutory rules: a system of mandatory intervention points calibrated to bank capitalization levels.<sup>110</sup> The law restricts the authority of a bank's board of directors to declare dividends based on precise calculations of the bank's capitalization level.<sup>111</sup> There is little room for administrative discretion in PCA and these other formal-mandatory regulatory tools.

Because the regulatory responses contemplated by the formal-mandatory dimension are automatic, they rely on precisely calculated triggering events. These triggering events are calibrated to payments systems (e.g., whether the bank has transferred funds to satisfy its

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<sup>105</sup> See MCCOY, *supra* note 71, § 7.01 (briefly describing the Glass-Steagall Act).

<sup>106</sup> See *supra* note 69 and accompanying text (discussing reserve requirements for member banks of the Federal Reserve System).

<sup>107</sup> See *supra* note 73 and accompanying text (discussing insurance fund assessments for FDIC-insured banks).

<sup>108</sup> See *supra* note 39 and accompanying text (discussing statutory limitations on paying dividends out of surplus).

<sup>109</sup> See *supra* note 75 and accompanying text (discussing OCC approval requirement for such dividends).

<sup>110</sup> 12 U.S.C. § 1831o.

<sup>111</sup> See *supra* Part IV (describing automatic triggering points in PCA regime).

assessment obligations to the FDIC fund) or accounting systems (e.g., whether a bank dividend causes a negative balance in the accounting entries that sum to a bank's "capital surplus"). Moreover, many of the formal-mandatory rules apply in narrow, in extremis contexts. For example, if an institution were unable to pay its modest assessments to the FDIC—its most important creditor in its capacity of guarantor of most of its liabilities—it would almost certainly be defaulting on its other obligations. PCA, on the other hand, was designed to apply not just at an institution's death bed—in the parlance of PCA, when it was "critically undercapitalized"—but also as its health began to decline and restorative action was possible. From 1991 to 2010, PCA constituted the most direct source of coercive power that could be brought to bear on banks, and it also represented the principal means by which regulators could interfere with bank dividend policy.<sup>112</sup> Notwithstanding its novelty as a regulatory technology, its reliance on intervention triggers, calibrated to precise capital accounting entries, places the PCA regime firmly within the formal-mandatory tradition of bank regulation.<sup>113</sup>

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<sup>112</sup> It is also noteworthy that PCA is coercive with respect to the supervisors themselves. See generally George G. Kaufman & George J. Benston, *The Intellectual History of the Federal Deposit Insurance Corporation Improvement Act of 1991*, in ASSESSING BANK REFORM: FDICIA ONE YEAR LATER 19 (George G. Kaufman & Robert E. Litan eds., 1993) (noting that a primary purpose of FDICIA was to restrict regulatory forbearance, which was perceived to have exacerbated the extent of FDIC losses during the savings-and-loan debacle).

<sup>113</sup> FDICIA did more than institute the formal-mandatory PCA regime; it also played an important role to bolster the informal-discretionary dimension of bank regulation, discussed at length below. For example, it required bank managers to attest to the adequacy of internal controls and required bank supervisors to promulgate standards relating to, and review during examinations, bank risk management capabilities and internal controls. See § 1831p-1(d) (setting forth mandate to prescribe safety and soundness standards); Robert F. Weber, *An Alternative Story of the Law and Regulation of Risk Management*, 15 U. PA. J. BUS. L. 1005, 1027–28 (2013). Even more innovatively, the PCA regime itself authorized supervisors to reclassify a bank's PCA capital category (in order to apply PCA restrictions anticipatorily) if the regulator determines that the bank is engaging in an unsafe or unsound practice. § 1831o(g)(1) (codifying § 38(g) of the Federal Deposit Insurance Act). This Section 38(g) reclassification authority in some ways anticipates the CCAR program, inasmuch as it relies on both rigid accounting metrics (in the form of the base PCA categorization) and discretionary actions (in the form of finding an unsafe and unsound practice to exist). Notwithstanding its innovativeness as a regulatory technology, Section 38(g) has rarely been utilized by supervisors. See U.S. GOV'T ACCOUNTABILITY OFFICE, DEPOSIT INSURANCE: ASSESSMENT OF REGULATORS' USE OF PROMPT CORRECTIVE ACTION PROVISIONS AND FDIC'S NEW DEPOSIT INSURANCE SYSTEM 39–40 (2007), available at <http://www.gao.gov/assets/260/256614.pdf> [hereinafter GAO PCA REPORT].



*B. The Informal-Discretionary Dimension of Bank Supervision*

Congress inaugurated the informal-discretionary dimension of bank regulation when it instructed regulators in the Banking Act of 1933 to discipline banks engaging in “unsafe or unsound practices.”<sup>114</sup> Today, the most important application of informal-discretionary bank regulation occurs during the bank examination process, where it exists in shadow form, casting its influence over the discussions between examiners and management. During examinations, supervisors interface regularly with bank management and personnel, especially risk management departments. According to former FRB Chairman Ben Bernanke, the heart of the modern bank examination is reviewing the risk management infrastructure of banks.<sup>115</sup> While conducting examinations, supervisors learn how banks operate and assess how they manage risks. Supervisors also engage in discussions with management about how to improve their risk management practices.

These discussions occur against the background threat of initiating severe supervisory actions—such as cease-and-desist orders and removal orders that impose lifetime bans on executives or directors from serving in the industry—predicated on a finding of an unsafe or unsound practice.<sup>116</sup> Other sanctions also apply in the background, including the ability of supervisors to require prior approval for executive and board member appointments if the supervisor finds that the bank or bank holding company is “in a troubled condition.”<sup>117</sup> Supervisors frequently use informal enforcement mechanisms as well, such as entering into memoranda of understanding with the bank,<sup>118</sup> requiring the bank to execute board

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<sup>114</sup> See *supra* notes 80–83 and accompanying text (describing how the term “unsafe or unsound practices” entered the banking law lexicon).

<sup>115</sup> Ben Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks at the Stonier Graduate School of Banking, Wash., D.C. (June 12, 2006) (referring to such review as “the heart of the modern bank examination”); see also Mishkin, *supra* note 31, at 16 (“In the ‘supervisory approach’ bank examiners focus less on compliance with specific regulatory rules and the risks of the financial instruments currently in the bank’s portfolio and more on the soundness of the bank’s management practices with regard to controlling risk.”).

<sup>116</sup> See *supra* note 78 (introducing supervisors’ authority to issue cease-and-desist orders for banks engaging in unsafe and unsound practices); § 1818(e)(1) (authorizing bank supervisors to initiate removal actions against “institution-affiliated parties” such as executives and directors where such parties engage in unsafe or unsound practices that “involve[] personal dishonesty on the part of such party” or “demonstrate[] willful or continuing disregard by such party for the safety or soundness of such insured depository institution or business institution”).

<sup>117</sup> See § 1831i(a)(1).

<sup>118</sup> See Bd. of Governors of the Fed. Reserve Sys., Commercial Bank Examination Manual § 5020.1 (2012), available at <http://www.federalreserve.gov/boarddocs/supmanual/cbem/cbem.pdf> (defining a memorandum of understanding between bank supervisor and bank as “a good faith understanding between the bank’s directorate and the Reserve Bank concerning the principal problems and the bank’s

resolutions to address problems,<sup>119</sup> and extracting a “commitment letter” from bank management.<sup>120</sup> Against the backdrop of this arsenal of informal and formal enforcement tools, supervisors use their “moral suasion” to influence bank governance.<sup>121</sup> The bank examination process is shrouded with secrecy, and most information about communications between examiners and bank personnel is confidential under applicable agency regulations.<sup>122</sup> Consequently, the mechanics of this process are opaque, and data about bank examinations and informal enforcement of safety-and-soundness is unavailable.

We do know, however, that *formal* enforcement of safety and soundness is largely non-existent for the largest, most significant banks. To the extent it is enforced at all, it is done so in an *ex post* capacity, as a backwards-looking disciplinary device for past behavior. Such a status quo is the regulatory path of least resistance. The supervisory task is complicated because a supervisory intervention might be justified on safety and soundness grounds before a bank has formally seen its capital fall below the statutory PCA thresholds that vest supervisors with mandatory remedial authority.<sup>123</sup> For instance, under applicable judicial precedent, a cease-and-desist order is certainly appropriate<sup>124</sup> where a bank is assuming outsized net positions in derivatives markets that yield impressive profits but expose the bank

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proposed remedies”).

<sup>119</sup> The FRB frequently uses board resolutions as an informal supervisory mechanism. In subsequent examinations, supervisors assess whether the bank has implemented the board resolutions. *See id.* § 6000.1.

<sup>120</sup> *See* OFFICE OF THE COMPTROLLER OF THE CURRENCY, POLICIES AND PROCEDURES MANUAL NO. 5310-3 app. A (2011), *available at* <http://www.occ.gov/static/publications/ppm-5310-3.pdf> (“A Commitment Letter is a document signed by the bank’s board of directors on behalf of the bank and is acknowledged by an authorized OCC official, reflecting specific written commitments to take corrective actions in response to problems or concerns identified by the OCC in its supervision of the bank.”).

<sup>121</sup> *See* GAO PCA REPORT, *supra* note 113, at 40 (defining moral suasion as “reminding the board of directors that it has an obligation to ensure that the institution is competently managed”).

<sup>122</sup> *See, e.g.*, 12 C.F.R. § 4.36(b) (2015) (“It is the OCC’s policy regarding non-public OCC information that such information is confidential and privileged. Accordingly, the OCC will not normally disclose this information to third parties.”); *id.* § 4.32(b) (defining “non-public OCC information” broadly to include, among other things, most communications between supervisory staff and bank personnel).

<sup>123</sup> *See* GAO PCA REPORT, *supra* note 113, at 41 (“The regulators acknowledged that section 38 permits them to reclassify an institution’s capital category to dismiss an officer or director; however, they said that because section 38 only allows them to dismiss individuals from institutions that are undercapitalized or worse by PCA standards, the tool generally is not available to them in these good economic times when all or most of the institutions they regulate are well capitalized.”).

<sup>124</sup> *See infra* notes 179–88 and accompanying text (summarizing judicial interpretation of “unsafe and unsound practices”).

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to risks that might compromise the bank's solvency.<sup>125</sup> But the event triggering the regulatory intervention is a corporate practice and the harm to be avoided is a potential, hypothetical loss—a loss that has not yet occurred, and quite possibly will never occur. For this reason, supervisors have historically avoided making formal findings of unsafe and unsound practices for the largest banks.<sup>126</sup>

In fact, during the period of 2007–2010, which marks the most unstable financial market environment in nearly a century, none of the federal bank supervisors commenced a formal enforcement action against any of the twenty largest banks or bank holding companies on safety and soundness grounds. In retrospect, this observation is staggering. The large banks continued to return capital to stockholders through dividends and share repurchases even after the financial crisis started and the FRB and U.S. Treasury were supporting markets.<sup>127</sup> And supervisors never objected.<sup>128</sup> This pre-crisis track record is unsurprising in light of the minimalist view of supervisors' legal authority held by some supervisory officials. According to this passive interpretation of supervisory authority, supervisors lack the legal authority to object to risky bank lending and business practices.<sup>129</sup> This perspective contrasts with the implicit message underlying

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<sup>125</sup> See, e.g., Justin Baer & Julie Steinberg, *Bank Rule Challenges Wall Street*, WALL ST. J., Dec. 11, 2013, at A1 (reporting how revelations that a single J.P. Morgan trader, nicknamed the "London Whale," caused his employer to incur multibillion dollar losses in connection with ill-advised derivatives trades, bolstered the case for tougher implementation standards of the so-called "Volcker Rule" from the Dodd-Frank Act, which aimed to require depository institutions to divest or otherwise cease most of their proprietary trading businesses and private equity activities); Dan Fitzpatrick et al., *J.P. Morgan Ordered to Fix Lapses*, WALL ST. J., Jan. 15, 2013, at C1 (noting that total losses from the London Whale scandal eventually amounted to six billion dollars).

<sup>126</sup> See Robert F. Weber, *Drug Courts for the Banks* (2014) (unpublished manuscript) (on file with the author) (highlighting historic tendency for supervisors to enforce safety and soundness norms only on small banks); cf. Julie Anderson Hill, *Bank Capital Regulation by Enforcement: An Empirical Study*, 87 IND. L.J. 645 (2012) (registering a similar unwillingness on the part of supervisors to initiate capital enforcement actions against the twenty-five largest banks).

<sup>127</sup> See Hirtle, *supra* note 5, at 3–4.

<sup>128</sup> See Tim P. Clark & Lisa H. Ryu, *CCAR and Stress Testing as Complementary Supervisory Tools*, <http://www.federalreserve.gov/bankinforeg/ccar-and-stress-testing-as-complementary-supervisory-tools.htm> ("[T]he continuation of capital distributions at many large bank holding companies (BHCs) well after it became apparent that there was substantial deterioration in the operating environment highlights the extent to which supervisors . . . underestimated the effect that stressed conditions could have on BHCs' financial soundness.").

<sup>129</sup> See Thomas M. Hoenig, President, Fed. Reserve Bank of Kan. City, Remarks at the 2008 Institute of International Finance Membership Meeting: Perspectives on the Recent Financial Turmoil (Mar. 5, 2008) at 8, *available at* <https://www.kansascityfed.org/~media/files/publicat/speechbio/hoenigpdf/hoenigbrazil3708.pdf> [hereinafter Hoenig Brazil Remarks] ("[I]n many situations, there may be no legal basis for requiring a change in business or lending practices.").

Bernanke's more maximalist position that the heart of the modern bank examination is supervisory review of risk management and other corporate systems.<sup>130</sup> As a description of legal authority, the minimalist view is incorrect; but as a positive description of regulatory praxis, the minimalist view might well be accurate. The lack of publicly available data concerning informal enforcement complicates any effort to assess which of the two views is more prevalent, but a recent whistleblower exposé of the holding company-level examination of Goldman Sachs by the Federal Reserve Bank of New York suggests that the minimalists have the upper hand and that examiners are not shaping risk management practices at the largest banks in any meaningful way.<sup>131</sup> So too does the Federal Reserve Bank of New York's publicly announced more conciliatory enforcement posture. Its examiners do not *examine* anymore; instead, they *manage relationships*.<sup>132</sup>

Instead of prophylactically sanctioning banks engaging in unsafe and unsound practices uncovered during examinations, supervisors have historically shown more willingness to enter into consent cease-and-desist orders predicated on *past* unsafe and unsound practices that have *already* resulted in losses. In that capacity, the regulatory sanction functions more as a remedy for prior failures than a prophylaxis against future failures.

We might label these *ex post findings* of unsafe and unsound practices, as distinguished from the implicit threat of making *ex ante findings* before the practices result in losses. Whereas both types of findings occur along the informal-discretionary dimension, the latter are, from political and institutional perspectives, more difficult to administer.<sup>133</sup> Compared with adjudications of past facts, anticipatory

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<sup>130</sup> See *supra* note 115 and accompanying text (reporting Bernanke's comments that review of risk management function is the "heart" of the modern bank examination).

<sup>131</sup> See Jake Bernstein, *Inside the New York Fed: Secret Recordings and a Culture Clash*, PROPUBLICA (Sept. 26, 2014), <http://www.propublica.org/article/carmen-segarras-secret-recordings-from-inside-new-york-fed>; *Improving Financial Supervision: Examining and Addressing Regulatory Capture: Hearing Before the Subcomm. on Fin. Insts. and Consumer Prot. of the S. Comm. on Banking, Hous. and Urban Affairs*, 113th Cong. 52 (2014) (testimony of David O. Beim, Professor, Prof'l Practice, Columbia Bus. Sch. regarding a report he wrote, commissioned in 2009 by the Federal Reserve Bank of New York, which identified a "weak form of regulatory capture," predicated on revolving doors and information asymmetries, as an institutional shortcoming of bank supervisors), available at <http://www.gpo.gov/fdsys/pkg/CHRG-113shrg93411/pdf/CHRG-113shrg93411.pdf>.

<sup>132</sup> See Caroline Salas & Bradley Keoun, *New York Fed's Dahlgren Overhauls Bank Supervision to Beef Up Oversight*, BLOOMBERG (Mar. 21, 2011), <http://www.bloomberg.com/news/articles/2011-03-21/new-york-fed-s-dahlgren-overhauls-bank-supervision-to-beef-up-oversight>.

<sup>133</sup> Another example of the *ex ante* application of informal-discretionary regulation results from the Dodd-Frank Act's requirement that large banks prepare "living wills" that detail how they could be resolved in an orderly manner. Specifically,

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evasions of future hypothetical harms face higher justificatory hurdles—and the largest banks can employ a cadre of expensive lawyers to make their case. For example, the OCC made no ex ante unsafe and unsound practice findings for JPMorgan Chase & Co. over the past decade, but entered consent cease-and-desist orders predicated on ex post findings concerning the following unsafe and unsound practices: the “robo-signing” scandal,<sup>134</sup> the “London Whale” trading losses,<sup>135</sup> custodial service failures in connection with the Madoff fraud,<sup>136</sup> and anti-money laundering control failures.<sup>137</sup> In each of these cases, supervisors disciplined the bank *in the aftermath* of highly salient reports of corporate failures.

This informal-discretionary examination process is a dialogic, negotiated governance setting.<sup>138</sup> It has the potential to influence

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the Act authorizes the FRB to order asset divestitures in the event that the FRB finds a bank’s resolution plans are not “credible”—a determination committed to the FRB’s discretion. Dodd-Frank Act § 165(d), 12 U.S.C. § 5365(d) (2011) (providing that FRB can require resubmission of initial proposed living will and authorizing divestiture powers where the resubmitted plan constitutes a “failure to submit [a] credible plan”).

<sup>134</sup> JPMorgan Chase Bank, No. 2011-050 (Dep’t of Treasury Apr. 13, 2011), *available at* <http://www.occ.gov/static/enforcement-actions/ea2011-050.pdf> (consent cease-and-desist order arising out of findings of unsafe or unsound practices in residential mortgage servicing and initiation and handling of foreclosure proceedings).

<sup>135</sup> JPMorgan Chase Bank, No. 2013-001 (Dep’t of Treasury Jan. 14, 2013), *available at* <http://www.occ.gov/static/enforcement-actions/ea2013-001.pdf> (consent cease-and-desist order arising out of findings of unsafe or unsound practices in the credit derivatives trading strategy implemented by the bank’s “chief investment office” that resulted in six billion dollars in losses to the bank); *see also supra* note 125 and accompanying text (providing more details of the “London Whale” episode).

<sup>136</sup> JPMorgan Chase Bank, No. 2014-001 (Dep’t of Treasury Jan. 7, 2014), *available at* <http://www.occ.gov/topics/laws-regulations/enforcement-actions/bank-enforcement-actions/civil-money-penalties/ea-2014-001.pdf> (consent cease-and-desist order arising out of findings of unsafe and unsound practices in, among other things, custodial services for Madoff investment funds).

<sup>137</sup> JPMorgan Chase Bank, No. 2013-002 (Dep’t of Treasury Jan. 14, 2013), *available at* <http://www.occ.gov/news-issuances/news-releases/2013/nr-occ-2013-8a.pdf> (consent cease-and-desist order arising out of findings of unsafe or unsound practices in deficient anti-money laundering compliance program).

<sup>138</sup> Notwithstanding the lack of formal enforcement efforts against large banks along the informal-discretionary dimension of bank regulation, the principle that corporate practices, rather than outputs, are proper subjects of regulatory control is hardly novel or controversial. Michael Power has observed that such regulatory directives “turn organizations inside out”—that is, they divert the gaze of internal and external governance systems from externally verifiable performance outputs (such as the PCA’s capitalization levels) to the internal and auditable organizational processes on which the performance outputs depend. Michael Power, *The Risk Management of Everything: Rethinking the politics of uncertainty*, DEMOS (2004), <http://www.demos.co.uk/files/riskmanagementofeverything.pdf>. They eschew reliance on precise calculations in favor of a focus on how institutions process, respond to, and prepare for contingencies. Cary Coglianese and David Lazer have referred to this method of regulatory governance as “management-based regulation.” *See* Cary Coglianese & David Lazer, *Management-Based Regulation: Prescribing Private Management*

dividend policy if bank regulators consider and discuss with bank management whether declaring dividends under certain circumstances could constitute an unsafe and unsound practice. The designation of a past or proposed dividend as an unsafe and unsound practice, like the violation of a formal-mandatory prescription, triggers a suite of coercive sanctions. The determination itself, however, is highly context-specific and idiosyncratic, and requires a high degree of discretionary judgment on the part of the regulator. In that respect, it differs dramatically from the triggering event in the formal-mandatory dimension, which is usually an accounting shortfall or payment. In this context, the exercise of administrative discretion is not, on account of the indeterminacy of the triggering event, susceptible to a lawmaking approach characterized by general applicability and precise accounting metrics. When bank regulators consider whether declaring or paying a dividend constitutes an unsafe and unsound practice, they engage in a *forward-looking* analytic exercise that requires them to take into account how a dividend might affect the bank under future, hypothetical states of the world. This exercise contrasts sharply with the formal-mandatory dimension, which relies on processing precise and current calculations (of, e.g., “capital surplus”) through a binary decision matrix—that is, either the dividend is illegal because it would deplete the surplus or it is legal because it would not. Professor Mehrsa Baradaran has coined the apt term “regulation by hypothetical” to capture the idea that governmental power is deployed based on indeterminate and hypothetical informational inputs.<sup>139</sup> Moreover, the discretionary quality of the agency’s determination invites all relevant actors to deliberate on the risks facing the business and to reconsider their perspectives as the future unfolds.<sup>140</sup>

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*to Achieve Public Goals*, 37 LAW & SOC’Y REV. 691 (2003). They look at corporate and managerial practices rather than accounting metrics, and as such are more amenable to informal discussions and discretionary judgment.

<sup>139</sup> See Mehrsa Baradaran, *Regulation by Hypothetical*, 67 VAND. L. REV. 1247, 1249 (2014) (“Regulation by hypothetical refers to rules duly promulgated under appropriate statutory and regulatory mechanisms that require banks and their regulators today to make predictions about sources of crisis and weakness tomorrow. Those predictions—which, by their very definition, are conjectural and speculative, even hypothetical—then become the basis of the use of the state’s regulatory power.”).

<sup>140</sup> See Sidney Shapiro et al., *The Enlightenment of Administrative Law: Looking Inside the Agency for Legitimacy*, 47 WAKE FOREST L. REV. 470 (2012).

C. *Integrating the Informal-Discretionary Dimension into the Broader Literature on “Risk Regulation”*

When acting pursuant to the informal-discretionary dimension, bank supervisors exercise their regulatory discretion to intervene in activity based on the risk of future, uncertain, hypothetical adverse outcomes—in other words, on outcomes that might occur, but have not yet occurred. These interventions can be situated in a broader literature on “risk regulation” in the environmental, health, and safety regulatory contexts. In particular, they share with these risk regulatory regimes a statutory trigger mechanism predicated on a necessarily uncertain harm. In other words, the legality of the regulatory intervention depends on a determination that is subject to some amount of uncertainty. This marriage of uncertainty and law is unavoidably fraught with weighty concerns—about accountability, legitimacy, science, and even democracy—that are outside the scope of this Article, but the parallels drawn here demonstrate that the informal-discretionary dimension is quite active in other areas of administrative law.

Risk regulation is a slippery moniker with a range of related, but rarely identical, connotations.<sup>141</sup> To some extent, the varied uses of the term reflect theoretical and disciplinary differences in the ways risk is conceived.<sup>142</sup> Any attempt to define risk regulation, however, must start with the burst of environmental, health, and safety regulation that emerged in the 1960s and 1970s. This legislative activity was the political expression of increased societal concerns over latent and uncertain dangers to health and the environment resulting from new technologies in the latter part of the twentieth century.<sup>143</sup> David

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<sup>141</sup> See Elizabeth Fisher, *Framing Risk Regulation: A Critical Reflection*, 2 *EURO. J. RISK REG.* 125, 126 (2013).

<sup>142</sup> See Tom Baker & Jonathan Simon, *Embracing Risk*, in *EMBRACING RISK: THE CHANGING CULTURE OF INSURANCE AND RESPONSIBILITY* 1, 20–21 (Tom Baker & Jonathan Simon eds., 2002) [hereinafter *EMBRACING RISK*] (registering transatlantic divide in conceptions of the idea of risk regulation); NIKLAS LUHMANN, *RISK: A SOCIOLOGICAL THEORY* 1–4 (1993) (registering disciplinary divides in the conception of risk more generally).

<sup>143</sup> Sheila Jasanoff, *Risk in Hindsight—Towards a Politics of Reflection*, in *RISK SOCIETY AND THE CULTURE OF PRECAUTION* 28, 30 (Ingo K. Richter et al. eds., 2006) (“In the latter half of the terrifying twentieth century, risk became a major concern of governments.”); NAT’L RES. COUNCIL, *RISK ASSESSMENT IN THE FEDERAL GOVERNMENT: MANAGING THE PROCESS I* (1983) [hereinafter *NRC RED BOOK*] (“The decade of the 1970s was a period of heightened public concern about the effects of technology on the environment.”); CASS R. SUNSTEIN, *RISK AND REASON: SAFETY, LAW, AND THE ENVIRONMENT* 11 (2002) (arguing that “commitments [embodied in 1970s environmentalism] helped to spur national risk regulation in [the] United States (and elsewhere)”); William Boyd, *Genealogies of Risk: Searching for Safety, 1930s–1970s*, 39 *ECOLOGY L.Q.* 895, 897 (2012).

Garland describes this process as an adjunct to that of development: “[h]istory has caught up with modern societies, causing them to focus less and less upon technical and economic development, and more and more upon the problem of managing the hazards that this development entails.”<sup>144</sup> Whether we are living in a new age of higher statistical probabilities of catastrophic risks occurring—in something akin to what Ulrich Beck famously labeled a “risk society”—is a contestable proposition.<sup>145</sup> But it is not contestable that much of regulatory praxis today, in the United States and abroad, consists of initiatives aiming to reduce exposures to future uncertain hazards.

Ulrich Beck argues that this increased risk consciousness impacts the way people and organizations, including regulatory agencies, act: “the actual social impetus of risks lies in the *projected dangers of the future*.”<sup>146</sup> “We become active today,” Beck continues, “in order to prevent, alleviate or take precautions against the problems and crises of tomorrow and the day after tomorrow—or not to do so.”<sup>147</sup> Whatever the underlying societal causes of this increased governmental attention to risk, it is plausible to refer to a new “risk state” or “risk regulatory state” in which the predicate for current action is the prospect of future harm.<sup>148</sup> As a result, risk has become an organizing principle of

<sup>144</sup> David Garland, *The Rise of Risk*, in RISK AND MORALITY 48, 74 (Richard V. Ericson & Aaron Doyle eds., 2003).

<sup>145</sup> See, e.g., ORTWIN RENN, RISK GOVERNANCE: COPING WITH UNCERTAINTY IN A COMPLEX WORLD 30 (2008) (observing that “[t]he novel character of risk does not seem as novel as Beck claims”); IAIN WILKINSON, ANXIETY IN A RISK SOCIETY 108 (2001) (“For Beck, actuarial guarantees of safety are irrelevant in light of the knowledge that there are still rare occasions where the statistically improbable event of disaster takes place.”); IAIN WILKINSON, RISK, VULNERABILITY AND EVERYDAY LIFE 45 (2010) (“Beck’s representation of the reality of the risks we face is open to a great deal of critical debate and he readily admits to this.”); Sophie Day, *The Politics of Risk Among London Prostitutes*, in RISK REVISITED 29, 51 (Pat Caplan ed., 2000) (“Much of what Beck describes . . . has long been standard for those without much money or control over their lives.”); Mary Douglas, *Risk as a Forensic Resource*, 119 DAEDALUS 1, 8 (1990) (claiming that while modern technological risks are “only too horribly real,” the distinguishing feature of contemporary risk discourse is that it, like sin and taboo in former times, posits a causal relationship between behaviors and decisions and real-world danger in an effort to protect a valued institution—in our case, individual liberty); Peter Huber, *Safety and the Second Best: The Hazards of Public Risk Management in the Courts*, 85 COLUM. L. REV. 277, 277 (1985) (arguing that the legal system is unduly preoccupied with and biased against “public risks,” defined as “threats to human health and safety that are centrally or mass-produced, broadly distributed, and largely outside the individual risk bearer’s direct understanding and control”); Nikolas Rose, *The Death of the Social?*, 25 ECON. & SOC’Y 327, 341–43 (1996) (arguing that heightened attention to risk results from a “strategic shift . . . in the politics of security” whereby individuals are urged by politicians to “re-responsibiliz[e]” themselves for the management of their own risks).

<sup>146</sup> ULRICH BECK, THE RISK SOCIETY: TOWARD A NEW MODERNITY 34 (1992).

<sup>147</sup> *Id.*

<sup>148</sup> See Julia Black, *The Role of Risk in Regulatory Processes*, in THE OXFORD HANDBOOK OF REGULATION 302, 302 (Robert Baldwin et al. eds., 2010).



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governments,<sup>149</sup> and regulation increasingly reflects, and also nourishes, a new moral climate of risk politics that conceives of and expects regulatory initiatives to affect the future by identifying risks and allocating risk burdens.<sup>150</sup>

The newness of state intervention into risk should not be overstated. To that end, two caveats are in order. The first caveat is dealt with more straightforwardly. The judiciary (itself an organ of the state) has long concerned itself with risk allocation, albeit in an ex post capacity. The risk regulation era sees the role of law transformed from the guarantor of ex post compensation for harms through court systems to ex ante risk mitigator of harms through regulatory initiatives.<sup>151</sup>

The second caveat is that, to some extent, *all* regulatory systems aim to control some form of risk, broadly defined.<sup>152</sup> Traditional economic regulation was concerned with managing the effects of monopoly or state-granted privileges.<sup>153</sup> Later on, legislators envisioned a role for regulation in correcting information asymmetries. It is possible to say, for example, that utility rate regulation was designed to prevent the “risk” that monopolistic pricing practices would afflict the electricity market, or that securities registration requirements aim to reduce the “risk” that retail investors are bilked by investor promoters. Some authors categorize regulatory programs to correct for negative externalities within the risk regulatory

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<sup>149</sup> See Applegate, *supra* note 103, at 305.

<sup>150</sup> See ANTHONY GIDDENS, *RUNAWAY WORLD: HOW GLOBALIZATION IS RESHAPING OUR LIVES* 47–48 (2000); DAVID A. MOSS, *WHEN ALL ELSE FAILS: GOVERNMENT AS THE ULTIMATE RISK MANAGER* (2002); Anthony Giddens, *Risk and Responsibility*, 62 *MODERN L. REV.* 1, 5 (1999) (referring to the “new moral climate of politics” that characterizes risk policy).

<sup>151</sup> See NIKLAS LUHMANN, *LAW AS A SOCIAL SYSTEM* 417 (Fatima Kastner et al. eds., Klaus A. Ziegert trans., Oxford Univ. Press 2004) (contrasting liability regimes with regimes that prevent an “injury has not yet materialized or is not immediately threatening”); SIDNEY A. SHAPIRO & ROBERT L. GLICKSMAN, *RISK REGULATION AT RISK: RESTORING A PRAGMATIC APPROACH* 3 (2003) (“By the late 1960s, Congress had determined that the tort system, augmented by minimal federal regulation, was incapable of providing an effective response to the increasing threats to the public health and safety and the environment attributable to new technologies and development.”); Jonathan B. Wiener, *Risk Regulation and Governance Institutions*, in *RISK AND REGULATORY POLICY: IMPROVING THE GOVERNANCE OF RISK* 133, 141 (2010).

<sup>152</sup> See Saule T. Omarova, *License to Deal: Mandatory Approval of Complex Financial Products*, 90 *WASH. U. L. REV.* 63, 79 n.72 (2012).

<sup>153</sup> See R. SHEP MELNICK, *REGULATION AND THE COURTS: THE CASE OF THE CLEAN AIR ACT* 5–6 (1983) (contrasting economic regulation and risk regulation (which the author refers to as “social regulation,” a designation that underscores the broad sweep of risk regulatory regimes)).

family;<sup>154</sup> others place them outside.<sup>155</sup> The demarcation lines between traditional economic regulation and modern risk regulation are anything but bright. Contributing to the muddle, some authors simply use “risk regulation” as shorthand for the environmental, health, and safety regulatory regimes that gave rise to the term, with no attempt made to distinguish between regulatory systems’ normative precepts or design-related mechanics.<sup>156</sup> Bearing this caveat in mind, the essential attribute of a new and distinct model of *risk regulation* emerges more clearly: risk regulation requires regulators to exercise their discretion in settings where scientific uncertainty is unavoidable.<sup>157</sup>

In order to appreciate the distinctive attributes of this new risk state and how it deals with the scientific uncertainty problem, it is necessary to examine its legal-institutional structure in more concrete detail. Shapiro and Glicksman identify two essential features of risk regulatory programs.<sup>158</sup> First, the legislature designs a *statutory trigger* that permits an agency to act on the basis of anticipated harm. Second, the legislature assigns the agency a *statutory standard* specifying the level or stringency with which it should regulate the harm and the factors it may consider in doing so. Fisher expresses the same idea in slightly different terms: debates about risk regulation are about how to *evaluate risk*, a task that requires *risk appraisal* and *standard setting*.<sup>159</sup> Thus, for instance, a statutory trigger might, as in the Clean Air Act, require that the regulator demonstrate that the public or environment is exposed to a risk factor (e.g., airborne pollution) at a level that is potentially dangerous before a regulatory intervention is legally permissible.<sup>160</sup> As

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<sup>154</sup> See, e.g., STEPHEN BREYER, REGULATION AND ITS REFORM 23–26 (1982) (including in a general discussion of regulation objectives the mitigation of “spillover” effects of otherwise private activity); MELNICK, *supra* note 153, at 5–6 (stating that the “purpose of recent [risk] regulation” is to reduce risks created by, among other things, “externalities”).

<sup>155</sup> See, e.g., Omarova, *supra* note 152, at 81–82 (distinguishing on normative grounds “the familiar objective of eliminating specific inefficiencies that distort market dynamics” (which the author calls “economic regulation”) and “the more fundamental problems posed by the increasing complexity and interconnectedness in the financial system” (which the author analogizes to risk regulation)).

<sup>156</sup> See Black, *supra* note 148, at 305 (making this point, not contributing to the muddle).

<sup>157</sup> See SHEILA JASANOFF, THE FIFTH BRANCH: SCIENCE ADVISERS AS POLICYMAKERS 50 (1990); Sidney A. Shapiro, *OMB and the Politicization of Risk Assessment*, 37 ENVTL L. 1083, 1087 (2007) (noting that Congress intended for risk regulators to “make regulatory decisions on the basis of imperfect scientific knowledge”) (citations omitted).

<sup>158</sup> See SHAPIRO & GLICKSMAN, *supra* note 151, at 31–45.

<sup>159</sup> ELIZABETH FISHER, RISK REGULATION AND ADMINISTRATIVE CONSTITUTIONALISM 6–7 (2007).

<sup>160</sup> See 42 U.S.C. § 7411(b)(1)(A) (2012) (“The Administrator shall . . . publish . . . a list of categories of stationary sources [of pollution]. He shall include a category of sources in such list if in his judgment it causes, or contributes significantly to, air

for the statutory standard, a legislature might instruct the regulator to require firms to use the “best available technology” or adopt a particular corporate best practice “to the extent feasible.”<sup>161</sup> Alternatively, the legislature might adopt a more restrictive standard, requiring a risk regulator to demonstrate that the expected benefits of a regulation exceed its costs.<sup>162</sup> Inevitably, the regulatory process requires some recourse to science and statistical data, and a wide range of opinions exist with respect to how this information is best integrated into the regulatory process.<sup>163</sup> A full exploration of these issues is outside the scope of this Article, but it suffices to say for now that these intramural conflicts are nowhere close to being resolved.<sup>164</sup>

The relevance of the risk regulation literature to the informal-discretionary dimension of bank supervision should be apparent. In both settings, the regulatory task requires the regulator to determine whether a statutory trigger test has been met by referring to an assessment of the risk that a future, uncertain outcome will transpire. Moreover, both settings also necessitate a trade-off, guided by the statutory standard, between protection against risks and the costs of providing that protection.<sup>165</sup>

So what explains the historical disinclination on the part of legal scholars studying financial regulation to appreciate the relevance of the rich risk regulation literature—especially when the robust debate is occurring just down the hallway in the offices of their environmental law and administrative law colleagues? Some care should be taken not to paint with too broad a brush; some commentators have perceptively flagged the similarities between risk regulation and financial regulation. Perhaps in recognition of the trenchant association of risk regulation with environmental, health, and safety regulation,<sup>166</sup> they have done so cautiously, pointing out that to date financial regulation has not yet been admitted to the club.<sup>167</sup> In any event, so far the idea

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pollution which *may reasonably be anticipated to endanger public health or welfare.*”) (emphasis added).

<sup>161</sup> See SHAPIRO & GLICKSMAN, *supra* note 151, at 38.

<sup>162</sup> See *id.* at 39–40.

<sup>163</sup> See Martin Kusch, *Toward a Political Philosophy of Risk: Experts and Publics in Deliberative Democracy*, in *RISK: PHILOSOPHICAL PERSPECTIVES* 131, 133–39 (Tim Lewens ed., 2007) (contrasting Cass Sunstein’s enthusiasm for quantitative, technocratic cost-benefit analysis with Sheila Jasanoff’s skepticism of technical scientific experts in the regulatory process).

<sup>164</sup> *But cf.* Fisher, *supra* note 141, at 128 (lamenting that “the risk assessment/risk management framework,” which relies heavily on technocratic cost-benefit analysis in the assessment stage, “has become the dominant account of risk regulation”).

<sup>165</sup> See SHAPIRO & GLICKSMAN, *supra* note 151, at 21; Clayton P. Gillette & James E. Krier, *Risk, Courts, and Agencies*, 138 U. PA. L. REV. 1027, 1028 n.2 (1990) (“The objective . . . is to minimize the *sum* of the costs of risk and the costs of avoiding risk.”).

<sup>166</sup> See *supra* note 156 and accompanying text.

<sup>167</sup> See Robert B. Ahdieh, *Reanalyzing Cost-Benefit Analysis: Toward a Framework of*

that risk regulation is really about protecting health, safety, and the environment—and, by implication, not about financial regulation—has proven sticky.

In a sense, this phenomenon is counterintuitive. After all, financial regulators have been regulating risk and supervising risk-creating, risk-taking, risk-profiting institutions since well before the 1960s and 1970s.<sup>168</sup> There are lexical and institutional explanations for the lack of communication between the financial regulation and risk regulation camps that still require significant exploration from both risk regulation and financial regulation scholars. Future research will undoubtedly advance our understanding of how the informal-discretionary mode of banking supervision fits into risk regulatory theory more broadly, but for present purposes the important point is to register how this particular corner of financial regulation resonates in perhaps unexpected ways with well-established traditions in other administrative law settings.

*D. A Hypothetical Example: Hipobank's Ukrainian Operations*

To better understand the advantages of the forward-looking orientation of the informal-discretionary mode of banking supervision, consider how the rigid PCA regime is ill equipped to address the following hypothetical scenario. Imagine that a large, federally chartered bank named HipoBank, in response to retrenchment from its competitors, significantly ramps up its syndicated loan operations (through its Moscow, London, and Kiev branches) for large and mid-sized Russian and Ukrainian corporate clients, despite the unrest in those nations. HipoBank has historically had strong relationships with Russian clients, due to it being one of the most active Western banks to underwrite, through its London branch office, initial public offerings of privatized assets following the collapse of the Soviet Union. Furthermore, HipoBank's risk managers are under the impression that its competitors are overestimating the political risk and war risk of lending operations in Russia and the Ukraine, and they believe that the conflict will resolve itself shortly and without further violence.<sup>169</sup>

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*Function(s) and Form(s)*, 88 N.Y.U. L. REV. 1983, 2048 (2013) (“At least in the conventional sense, meanwhile, the SEC is not a risk regulator. Agencies such as the EPA, OSHA, NHTSA, and the like—with their focus on human health and safety—have traditionally been thought to represent the universe of risk regulators.”); Omarova, *supra* note 152, at 80 n.75 (“U.S. banking law has strong elements of risk regulation, insofar as it seeks to prevent systemic effects of bank failure and to safeguard the federal deposit insurance fund.”). *See also* FISHER, *supra* note 159, at 6 (expressly mentioning financial regulation as an arena where risk regulatory principles could apply).

<sup>168</sup> *See supra* note 143 and accompanying text.

<sup>169</sup> The hypothetical will consider the effects of managerial judgment of political

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Initially, the increased portfolio of Russian and Ukrainian loans—forming part of HipoBank’s “Central and Eastern European Corporate,” or “CEEC,” unit—performs well, and lower competition results in higher interest rates. The decision to take on more CEEC business, in short, results in handsome profits for the unit and the bank at large.

What are bank supervisors<sup>170</sup> to do if they believe the risk from Ukrainian and Russian corporate loans is much higher than the bank believes—so much so that the solvency of the bank and the stability of the holding company might be threatened? What if regulators determine that payment of the normal dividend to bank stockholders would deprive the bank of the added capital cushion that the supervisor believes the bank should maintain to protect itself against unexpected CEEC losses?<sup>171</sup> The problem is that until the risk—here, a political risk or war risk associated with the conflict in the Ukraine—has materialized and resulted in losses, it will not affect the accounting and payments systems to which the PCA regime and other dividend regulations are calibrated. In other words, it will not raise any red flags along the formal-mandatory dimension of bank supervision. In fact, if anything, the build-up of Ukraine risk will result in lowered supervisory surveillance, inasmuch as the enhanced profits, in the short term, will boost CEEC results and make the bank appear on more solid footing than before the decision to expand that portfolio.<sup>172</sup> Turning to the initial question, what is a supervisor to do in such circumstances? Can the supervisor order the bank to suspend or reduce its normal dividend or otherwise reduce its distributions to stockholders in order to preserve capital to hold against what the supervisor anticipates to be an impending rash of CEEC loan losses?

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and war risk, but not of sanctions-related liabilities or risks.

<sup>170</sup> In this fictional case of HipoBank, the relevant supervisors would be the OCC (as the primary supervisor of HipoBank itself) and the FRB (as the supervisor of HipoBank’s holding company).

<sup>171</sup> The supervisor obviously expects the CEEC business will result in losses, so in a colloquial sense it might seem incongruous to describe such losses as unexpected. But in financial accounting parlance, expected losses result in loan loss provisions (also known as “valuation reserves”), which reduce earnings on the income statement and assets on the balance sheet, in turn resulting in reduced capital (which, after all, represents the difference between the now-reduced assets and the static liabilities). See JOHN DOWNS & JORDAN ELLIOT GOODMAN, *DICTIONARY OF FINANCE AND INVESTMENT TERMS* 775 (7th ed. 2006) [hereinafter *FINANCE DICTIONARY*]. If the bank has not established a loan loss provision, the loss is not described as “expected.”

<sup>172</sup> In particular, the increased profitability of the CEEC unit will result in increased earnings or income, which in turn will increase retained earnings and, eventually, capital. See *infra* note 184 (discussing tendency of some commentators to view safety and soundness through the lens of profitability). This analysis assumes that the CEEC profits are not distributed to stockholders as dividends or used to repurchase outstanding shares of stock of HipoBank or its holding company.

The preliminary answer is deceptively simple: remember that the supervisors wield the power to issue a cease-and-desist order on regulated banks engaging in practices the supervisor has determined to be “unsafe or unsound.”<sup>173</sup> By designating aspects of the CEEC business, as presently conducted, as unsafe and unsound practices, supervisors could take any number of actions, including ordering Hipobank to hedge its Ukraine and Russia exposures, cease origination of new loans, or even divest its CEEC business altogether.<sup>174</sup> Of course, they could also issue a cease-and-desist order mandating that it suspend any dividend payments. And their arsenal is not limited to cease-and-desist orders. Supervisors could also order the removal of (and lifetime industry bans for) bank management or directors under Section 8(e) of the Federal Deposit Insurance Act.<sup>175</sup> They could even withdraw federal deposit insurance,<sup>176</sup> which would likely precipitate a run on the bank that would result in the bank’s conservatorship.<sup>177</sup>

When deliberating on whether a practice is unsafe or unsound, supervisors must take into account how *current* business practices might result in losses in a contingent *future* world state. The inquiry is conjectural and counterfactual, and radically different than the mechanical inquiries of the formal-mandatory dimension, which rely on accounting metrics. In this example, the supervisor must ask itself “what *might* go wrong here, and how severe *might* the consequences be

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<sup>173</sup> See *supra* note 78 and accompanying text (introducing authority to issue cease and desist orders).

<sup>174</sup> The cease-and-desist order could take the form of a temporary restraining order issued before a hearing takes place. See 12 U.S.C. § 1818(c) (2012).

<sup>175</sup> See § 1818(e). The Section 8(e) action would impose a higher burden of proof on the supervisors, who must prove that the institution-affiliated party engaged in personal dishonesty or acted with willful disregard for the safety and soundness of the bank. See *supra* note 116 (introducing Section 8(e) actions).

<sup>176</sup> See § 1818(a) (empowering the FDIC to initiate process for withdrawal of its deposit insurance where agency finds that “an insured depository institution or the directors or trustees of an insured depository institution have engaged or are engaging in unsafe or unsound practices in conducting the business of the depository institution”). In practice, withdrawal of deposit insurance would only be deployed as a sanction for small and mid-sized banks. While the FDIC is keen to avoid recourse to its deposit insurance fund, a run on a large bank could lead to a crisis in confidence, further bank failures, and far greater depletion of the insurance fund. Cf. GARTEN, *supra* note 20, at 41 (“Although the regulators could commence a proceeding to terminate a bank’s deposit insurance, this power was not likely to be used.”).

<sup>177</sup> See Douglas W. Diamond & Philip H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. POL. ECON. 401 (1983) (demonstrating importance of deposit insurance to prevention of runs on compromised banks). Such a run would follow Gresham’s Law, which states that when there are two forms of money (in this case, insured deposits and uninsured deposits), the overvalued bad money drives out the good money. See FINANCE DICTIONARY, *supra* note 171, at 297. Legally fixed parity does not convince money users that the value of two different instruments is the same. Savers hoard the good money (in this case, the insured deposits), and rush to circulate, or otherwise convert, the bad money (in this case, the newly uninsured deposits).

if such outcomes were to materialize?” Given the potential severity of the sanction—e.g., a government agency ordering a bank not to pay dividends to its stockholders<sup>178</sup>—the power to designate a business practice as unsafe or unsound might be thought to raise due process concerns. But courts have consistently rejected due process challenges to bank supervisory safety and soundness actions, reasoning that Congress put in place a scheme for aggrieved parties to seek redress both within the agency and, if necessary, the courts.<sup>179</sup>

Indeed, the courts have approved broad and indeterminate agency interpretations of the scope of unsafe and unsound practices. As mentioned earlier, they have largely ratified the open-ended interpretation of “unsafe and unsound practices” proffered by Chairman Horne in his 1966 Congressional testimony—that is, a bank action or inaction is unsafe or unsound if “it is contrary to generally accepted standards of prudent operation” and if its “possible consequences . . . if continued” would include “abnormal risk or loss or damage to an institution, its shareholders, or the agenc[y] administering the [FDIC] insurance fund.”<sup>180</sup> The D.C. Circuit has held that an “unsafe or unsound practice” is one that poses a “reasonably foreseeable [and] undue risk to the institution.”<sup>181</sup> The Third Circuit, again picking up on Horne’s language, ruled that an “imprudent act . . . posing an abnormal risk to the financial stability of the banking institution would qualify” as an unsafe or unsound practice.<sup>182</sup> The Ninth Circuit has stated explicitly what is implicit from Horne’s definition: namely, that a bank need not even be insolvent for its supervisor to initiate proceedings on safety and soundness grounds.<sup>183</sup>

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<sup>178</sup> See *supra* note 78 and accompanying text (discussing supervisory authority to issue cease and desist orders).

<sup>179</sup> See *Seidman v. Office of Thrift Supervision*, 37 F.3d 911 (3d Cir. 1993) (rejecting due process challenge to OTS Section 8(e) removal order alleging that the same agency—indeed, the same individual—was acting as investigator, prosecutor, and adjudicator of charges based on unsafe and unsound practices); *Nw. Nat’l Bank v. United States*, 917 F.2d 1111, 1119 (8th Cir. 1990) (rejecting due process challenge of OCC decision to pursue cease and desist order to discipline bank management for unsafe and unsound practices instead of Section 8(e) removal order, which required a higher standard of proof); *Hoffman v. Fed. Dep. Ins. Corp.*, 912 F.2d 1172, 1175 (9th Cir. 1990) (rejecting bank’s argument that due process required FDIC to demonstrate the bank was insolvent before entering order withdrawing deposit insurance on account of an unsafe and unsound practice).

<sup>180</sup> Horne Testimony, *supra* note 80; see also *supra* note 81 (citing cases ratifying Horne’s interpretation).

<sup>181</sup> *Kaplan v. Office of the Comptroller of the Currency*, 104 F.3d 417, 421 (D.C. Cir. 1997).

<sup>182</sup> See *Seidman*, 37 F.3d at 928.

<sup>183</sup> *Hoffman*, 912 F.2d at 1175.

Furthermore, the D.C. Circuit clarified in *Landry v. FDIC* in 2000 that it is no defense that the imprudent actions did not ultimately result in losses to the bank.<sup>184</sup> In that case, the FDIC brought a Section 8(e) removal order against a bank executive for self-dealing activities that exposed a bank<sup>185</sup>—and, in the process, the FDIC in its capacity as guarantor of most of the bank’s liabilities—to “abnormal risks,” including “at least one large loan to an uncreditworthy out-of-territory borrower, long-term contracts with consultants whose fees were proportionately greater than the services rendered, and the use of [b]ank funds for travel and related expenses in pursuit of breathtakingly irresponsible schemes.”<sup>186</sup> The defendant argued that the FDIC erred in finding that the practices were unsafe or unsound because, whatever the risks might have been, the bank was profitable throughout the period in question.<sup>187</sup> The court retorted that its inquiry was risk-focused, not outcome-focused; where a bank takes an imprudent action that results in reasonably foreseeable abnormal risks to the institution, a supervisor is authorized to make an unsafe and unsound practice finding.<sup>188</sup> Again, the question is what *might happen* (or what *might have happened* had things turned out otherwise), not what *did happen*. The contrast with dividend regulation and the PCA regime, as traditionally conceived, could not be starker.

Viewing dividend regulation through these formal-mandatory and informal-discretionary lenses reveals a troubling state of affairs. On the one hand, the formal-mandatory tools have become largely obsolete. On the other hand, regulators exhibit hesitancy, even unwillingness, to use informal-discretionary tools to limit bank dividends. More troublingly, these patterns are generalizable beyond dividend regulation. But dividend regulation is where the FRB has created a possible solution to the problem. Its new CCAR program is both rigid and forward-looking. It allows regulators to consider the effects of future hypothetical scenarios on a bank, but also tethers

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<sup>184</sup> *Landry v. FDIC*, 204 F.3d 1125, 1128 (D.C. Cir. 2000). This is an important clarification, as many commentators view safety and soundness through the lens of profit and loss. Cf. Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 101, 190 (2008) (“[Federal bank supervisory] agencies are designed with a primary mission to protect the safety and soundness of the banking system. This means protecting banks’ profitability.”). According to this view, practices are safe and sound if they increase a bank’s earnings, which can only increase, and never decrease, a bank’s capital. The *Landry* court ratifies the bank supervisory agencies’ view that the nature of risk requires that accounting profits alone cannot be the touchstone of safety and soundness.

<sup>185</sup> See *supra* note 175 and accompanying text (explaining supervisory power to issue Section 8(e) removal orders).

<sup>186</sup> *Landry*, 204 F.3d at 1138.

<sup>187</sup> *Id.*

<sup>188</sup> See *id.* (“Just as a loss, without more, does not prove that an act posed an abnormal risk, a profit does not establish its absence.”) (citations omitted).



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those scenarios to a system of rigid numerical trigger points that require intervention by regulators. This latter point is important because it is a potential antidote to regulators' historical tendency towards inaction based on what they perceive to be future, conjectural risks of loss.

## VI. INTRODUCING THE COMPREHENSIVE CAPITAL ANALYSIS AND REVIEW

The new CCAR regulatory initiative represents the most sweeping governmental intervention into bank dividend and distribution policy to date. It is also noteworthy because it unites, for the first time, the forward-looking, counterfactual analysis of the informal-discretionary dimension of bank supervision with the precise, outcome-focused orientation of the formal-mandatory dimension. In the process, it has supplanted the PCA regime as the primary lever of governmental power over U.S. banks and their holding companies. FRB Governor Daniel Tarullo has stated that the combination of the CCAR program and the mandatory stress testing program constitutes a "building out" of a "more dynamic, more macroprudential, and more data-driven" bank regulatory framework.<sup>189</sup> He might also have added that supervisors have performed a volte-face and turned their gaze from the past towards the future, without jettisoning the precise accounting metrics on which regimes like the PCA depend.

With this new regulatory program, the FRB now (1) requires banks to consider the effects of hypothetical stress test scenarios on their balance sheets and (2) makes banks' ability to distribute corporate property to their stockholders (including, most obviously, by paying dividends) contingent on banks having in place a sufficient capital cushion to withstand the stress scenarios. As a result, the ability of banks to make capital distributions—the most basic method by which equity investors obtain returns on their investment—has been made contingent and contestable to an unprecedented degree.

### A. *Mechanics of the CCAR Program*

For all its importance and novelty, the CCAR program is really an add-on to the FRB's stress testing initiatives. Since 2011, the Dodd-Frank Act has required the FRB to conduct annual stress tests of bank holding companies with total consolidated assets greater than fifty billion dollars and of financial institutions designated by the Financial

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<sup>189</sup> Daniel K. Tarullo, Member, Bd. of Governors of the Fed. Reserve Sys., Remarks at the Federal Reserve Third Annual Stress Test Modeling Symposium, Boston, Massachusetts: Stress Testing after Five Years 1 (June 25, 2014) [hereinafter Tarullo Remarks] (transcript available at <http://www.federalreserve.gov/newsevents/speech/tarullo20140625a.pdf>).

Stability Oversight Council (FSOC) as systemically important.<sup>190</sup> The FRB implemented this DFAST<sup>191</sup> stress testing mandate as part of its new Regulation YY, which consists of a suite of enhanced prudential requirements applicable to such large financial organizations. Subpart E of Regulation YY sets forth the administrative details of the DFAST tests and labels companies subject to the testing requirements as “covered companies.”<sup>192</sup> The DFAST program projects revenues, expenses, losses, and the resulting post-stress capital ratios based on three hypothetical scenarios of increasing degrees of stress severity: a baseline scenario, an adverse scenario, and a severely adverse scenario.<sup>193</sup> By measuring the capital ratios, it functions as a sort of hypothetical PCA regime, but in a purely diagnostic capacity; the DFAST stress tests themselves have no coercive or prescriptive consequences.

Congress elected to commit matters of stress scenario design entirely to the supervisors’ discretion.<sup>194</sup> In implementing the DFAST program, the FRB has announced that its severely adverse scenarios will contain macroeconomic (i.e., economy-wide) and microeconomic (i.e., institution-specific) assumptions. As a macroeconomic matter, the severely adverse scenario is designed to reflect, at a minimum, the economic and financial conditions typical of a severe recession.<sup>195</sup> A microeconomic scenario might involve a default by the covered company’s most significant counterparty.<sup>196</sup> The FRB has also announced that its severely adverse scenario will include a “market shock” to the portfolios of covered companies with large trading exposures.<sup>197</sup> The FRB then applies the scenarios in a rigid and uniform manner to all covered companies to see how they would

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<sup>190</sup> 12 U.S.C. § 5365(a) & (i)(1) (2012). The institutions subject to these tests are also required to conduct their own internal stress tests based on (i) the FRB-designed scenarios and (ii) an additional internally-designed scenario. *See Weber, supra* note 12, at 2292–93.

<sup>191</sup> The DFAST designation refers to Dodd-Frank Act Stress Tests. *See supra* note 12 and accompanying text.

<sup>192</sup> 12 C.F.R. § 252.42(f) (2015).

<sup>193</sup> *Id.*; Bd. of Governors of the Fed. Reserve Sys., DODD-FRANK ACT STRESS TEST 2013: SUPERVISORY STRESS TEST METHODOLOGY AND RESULTS 2 (2013), available at [http://www.federalreserve.gov/newsevents/press/bcreg/dfast\\_2013\\_results\\_20130314.pdf](http://www.federalreserve.gov/newsevents/press/bcreg/dfast_2013_results_20130314.pdf) [hereinafter 2013 DFAST RESULTS].

<sup>194</sup> *See* 12 U.S.C. § 5365(i) (requiring the FRB to conduct supervisory stress tests but not setting forth any guidance or requirements with respect to scenario design).

<sup>195</sup> Policy Statement on the Scenario Design Framework for Stress Testing, 78 Fed. Reg. 71,435, 71,443 (Nov. 29, 2013), available at [www.gpo.gov/fdsys/pkg/FR-2013-11-29/pdf/2013-27009.pdf](http://www.gpo.gov/fdsys/pkg/FR-2013-11-29/pdf/2013-27009.pdf).

<sup>196</sup> *See id.* at 71,442.

<sup>197</sup> *See id.* at 71,442–43.

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respond in the event the scenarios in fact materialized.<sup>198</sup> Specifically, the FRB requests specific data sets from the covered companies. The FRB then projects revenues, expenses, losses, and capital ratios by inputting the requested data into the FRB's own mathematical models.<sup>199</sup>

The DFAST results grow teeth when they are combined with the subsequent CCAR program, pursuant to which the FRB requires each covered company to submit an annual capital plan to the FRB.<sup>200</sup> Recognizing that the DFAST and CCAR programs together constitute the most significant supervisory reform at least since the 1991 PCA reform, the FRB has been careful to legitimate these programs by pointing to the sources of authority pursuant to which they were undertaken. In its final rule for the CCAR program, the FRB invoked its longstanding expectation—occasionally emphasized but rarely enforced—that bank holding companies operate with capital positions well in excess of those set forth in the PCA rules.<sup>201</sup> The FRB also cited a Dodd-Frank Act mandate that the FRB identify, measure, and monitor risks to financial stability, and impose heightened prudential standards on large bank holding companies.<sup>202</sup> Furthermore, Section 166 of the Dodd-Frank Act provided an important statutory authorization for the CCAR program.<sup>203</sup> That section instructs the FRB to “prescribe regulations establishing requirements to provide for the early remediation of financial distress” at a covered company.<sup>204</sup> Like PCA, Section 166 contemplated ratcheted supervisory measures that “increase in stringency as the financial condition of the [covered] company declines”—including, most importantly for present purposes, “limits on capital distributions.”<sup>205</sup> But unlike PCA, Section 166 authorizes the FRB to calibrate its supervisory measures not only

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<sup>198</sup> 2013 DFAST RESULTS, *supra* note 193, at 3.

<sup>199</sup> *See id.* at 1.

<sup>200</sup> Capital Plans, 76 Fed. Reg. 74,631, 74,633–34 (Dec. 1, 2011) (codified at 12 C.F.R. § 225.8 (2015)) [hereinafter Capital Plans].

<sup>201</sup> *Id.* at 74,632.

<sup>202</sup> *Id.*

<sup>203</sup> *See id.*

<sup>204</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act § 166, 12 U.S.C. § 5366 (2012).

<sup>205</sup> § 166(c)(2)(A). In a report to Congress mandated by Section 202(g)(4) of the Dodd-Frank Act, the Treasury Department noted the similarities between the FRB's new Section 166 responsibilities and the PCA regime. DEP'T OF THE TREASURY, REPORT TO THE CONGRESS ON PROMPT CORRECTIVE ACTION 6 (2012), available at <http://www.treasury.gov/initiatives/fsoc/studies-reports/Documents/FSOC%20PCA%20Report%20FINAL.pdf> (“Importantly, section 166 requires the FRB to include liquidity measures, and other forward-looking indicators in addition to regulatory capital in the early remediation framework. While section 166 and the PCA framework are separate, implementation of new rules under section 166 could provide regulators with additional experience to inform potential modifications to the PCA framework.”).

to actual and current regulatory capital ratios, but also to “other forward-looking indicators.”<sup>206</sup> Here, Congress seems to invite bank supervisors, with express statutory language, to experiment with informal-discretionary initiatives styled after risk regulation programs.

Whatever its *statutory* authorization, the *historical* genesis of the CCAR program can be traced to the FRB’s 2009 Supervisory Capital Assessment Program (SCAP), an ad hoc program consisting of a series of publicly disclosed stress tests to assess capital adequacy of large banking organizations.<sup>207</sup> The SCAP did not require banks to describe their dividend plans (in part because nearly all banks had significantly cut back dividends in response to the financial crisis), although it did require banks to accept capital directly from the U.S. Treasury if they failed to demonstrate that they had sufficient capital to support lending in the stress scenarios.<sup>208</sup> In 2011, the FRB conducted its first *review of planned capital distributions* in light of stress scenarios, in a program that, for the first time, bore the CCAR name.<sup>209</sup> With this ad hoc 2011 exercise, the FRB assessed, on a *prospective* basis, the capital adequacy and the internal capital planning processes of the nineteen largest bank holding companies. The nineteen banks subject to this exercise were the same banks subject to the 2009 SCAP program.<sup>210</sup>

Shortly thereafter, in December of 2011, the FRB promulgated a final rule, entitled “Capital Plans” (the Capital Plans rule, or the Capital Plans program), requiring all covered companies to submit an annual capital plan to the FRB.<sup>211</sup> This new rule transformed these initially ad hoc assessments of capital adequacy and capital planning practices into a regular feature of the supervisory regime for this new class of covered companies—that is, *all* large bank holding companies (not just those who had participated in the 2009 SCAP exercise) and

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<sup>206</sup> § 166(c)(1).

<sup>207</sup> See BD. OF GOVERNORS OF THE FED. RESERVE SYS., COMPREHENSIVE CAPITAL ANALYSIS AND REVIEW 2012: METHODOLOGY AND RESULTS FOR STRESS SCENARIO PROJECTIONS 4 (2012), *available at* <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20120313a1.pdf> [hereinafter 2012 CCAR RESULTS] (noting that the bank holding companies subject to the first CCAR were “the same institutions that participated in the 2009 [SCAP] [p]rogram”); Timothy Geithner, *How We Tested the Big Banks*, N.Y. TIMES, May 6, 2009, at A33 (explaining the SCAP stress test exercise).

<sup>208</sup> See BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE SUPERVISORY CAPITAL ASSESSMENT PROGRAM: DESIGN AND IMPLEMENTATION 2 (2009), *available at* <http://www.federalreserve.gov/bankinforeg/bcreg20090424a1.pdf>.

<sup>209</sup> See BD. OF GOVERNORS OF THE FED. RESERVE SYS., COMPREHENSIVE CAPITAL ANALYSIS AND REVIEW: OBJECTIVES AND OVERVIEW (2011), *available at* <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20110318a1.pdf> [hereinafter 2011 CCAR RESULTS].

<sup>210</sup> See *supra* note 207 and accompanying text (introducing the 2009 SCAP program).

<sup>211</sup> See *supra* note 200 and accompanying text.

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companies the FSOC designates as their equivalents.<sup>212</sup> In 2014, the FRB combined the ad hoc CCAR program and the new, regular Capital Plans program into a single program bearing the CCAR name, but now backed by the express authority of a full-blown notice-and-comment rulemaking.<sup>213</sup> Consequently, today there is no difference between the

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<sup>212</sup> See *supra* notes 190 & 192 and accompanying text (discussing (1) the FSOC's authority to designate companies as systemically important and to subject those companies to heightened FRB supervision, including the DFAST and CCAR programs and (2) the new designation "covered company" that the FRB uses to refer to companies subject to those programs).

<sup>213</sup> For such young programs, the history of the SCAP program, the CCAR program, the DFAST program, and the Capital Plans program is nothing short of byzantine. For example, one might reasonably wonder why the FRB continued to conduct the CCAR program at all in 2012 and 2013—i.e., after the Capital Plans program, which applied to all the institutions subject to the CCAR, had already become law in December of 2011. On that score, it bears reminding that the FRB had been operating the CCAR program since before the Capital Plans rule came into existence. See 2011 CCAR RESULTS, *supra* note 209 (dated March 2011, several months before the FRB promulgated the final Capital Plans rule in December of 2011). In 2012, the first year in which the Capital Plans rule applied, the CCAR and the Capital Plans program were largely identical in their mechanical details. The innovative aspects of the latter program were twofold: on the one hand, its scope was wider; and on the other hand, it formalized the 2011 CCAR process via rulemaking. As for the new scope, the class of "covered companies" subject to the Capital Plans program was wider than the class of companies subject to the CCAR, the terms of which applied only to those companies subject to the initial 2009 SCAP program. See 2012 CCAR RESULTS, *supra* note 207, at 4. This discrepancy arose because the CCAR program incorporated the DFAST supervisory stress tests, which the FRB did not apply to non-SCAP institutions until the stress test cycle commencing on October 1, 2013—i.e., in connection with the 2014 CCAR program. See 12 C.F.R. § 252.133(a) (2013). Accordingly, the FRB conducted the 2012 and 2013 Capital Plans programs for only the eleven covered companies that had not been subject to the SCAP program and, by implication, were not subject to the CCAR program. See Bd. of Governors of the Fed. Reserve Sys., *COMPREHENSIVE CAPITAL ANALYSIS AND REVIEW 2013: ASSESSMENT FRAMEWORK AND RESULTS 10* (2013), available at <http://www.federalreserve.gov/bankinforeg/ccar-2013-results-20130314.pdf> [hereinafter 2013 CCAR RESULTS]; 2012 CCAR RESULTS, *supra* note 207, at 7. The 2011, 2012, and 2013 CCAR programs applied to the initial SCAP covered companies (nineteen in 2012, but only eighteen in 2013 because MetLife, Inc. de-registered as a bank holding company). In each of the CCAR programs that the FRB conducted after it had finalized the Capital Plans rule, it expressly invoked the Capital Plans rule as authority for the CCAR program. See, e.g., 2014 CCAR RESULTS, *supra* note 13, at 1 ("Pursuant to the capital plan rule, each [covered company] with total consolidated assets of fifty billion dollars or more is required to submit a capital plan approved by the [covered company's] board of directors, or a committee thereof, for the Federal Reserve's annual CCAR."). By that point, the Capital Plans rule had, unlike the CCAR program, become a final rule following a full notice-and-comment rulemaking. The only technical difference between the CCAR program (which incorporated the DFAST stress tests) and the pre-2014 Capital Plans program is that with the latter, the FRB did not conduct a supervisory stress test on its own, as it was required to do in connection with the DFAST stress test program that was incorporated into the CCAR program; instead, these covered companies conducted their own stress tests, based on the same DFAST scenarios, and reported the results, which, unlike the DFAST results, were not required

Capital Plans program and the CCAR program; this Article will refer to the rule from here on as the CCAR rule, in recognition of the FRB's decision to do the same.

In evaluating the capital plan, the FRB assesses whether the covered company has robust, forward-looking capital planning processes and sufficient capital to continue operations throughout times of economic and financial stress.<sup>214</sup> Mandatory elements of a capital plan include: (1) an assessment of the expected uses and sources of capital over the planning horizon (at least nine quarters, beginning with the quarter preceding the quarter in which the covered company submits its capital plan) that reflects the covered company's size, complexity, risk profile, and scope of operations, assuming both expected and stressful conditions; (2) a detailed description of the covered company's process for assessing capital adequacy; (3) the covered company's capital policy; and (4) a discussion of any expected changes to the covered company's business plan that are likely to have a material impact on its capital adequacy or liquidity.<sup>215</sup>

A linchpin of the CCAR program is the stress test component that requires each covered company to estimate projected revenues, losses, reserves, and pro forma capital levels under a range of stress scenarios.<sup>216</sup> In its rule, the FRB has announced its intention that the CCAR stress scenarios will "be consistent with" the DFAST stress test scenarios.<sup>217</sup> In practice, the FRB has utilized the exact DFAST stress test scenarios when conducting each of the CCAR exercises it has administered to date.<sup>218</sup> The rule requires the capital plan to consider the effects of, in addition to the FRB-formulated stress scenarios, at least one stress scenario developed by the covered company itself.<sup>219</sup>

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to be publicly disclosed. See 2013 CCAR RESULTS, *supra*, at 10; 2012 CCAR RESULTS, *supra* note 207, at 7. As noted in the text, in 2014, the FRB merged the CCAR program and the Capital Plans program into a single, unitary CCAR program that applies in an identical manner to all covered companies—of which there were thirty in 2014. See BD. OF GOVERNORS OF THE FED. RESERVE SYS., COMPREHENSIVE CAPITAL ANALYSIS AND REVIEW 2014: SUMMARY INSTRUCTIONS AND GUIDANCE 1–2 (2013), available at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131101a2.pdf> [hereinafter 2014 CCAR INSTRUCTIONS]; 2014 CCAR RESULTS, *supra* note 13, at 2 ("This year's CCAR covered 30 large BHCs, including 12 BHCs that did not participate in previous CCAR exercises.").

<sup>214</sup> See Capital Plans, *supra* note 200, at 74,633.

<sup>215</sup> *Id.* at 74,634.

<sup>216</sup> *Id.* at 74,635.

<sup>217</sup> *Id.*

<sup>218</sup> In the 2013 and 2014 CCAR programs, the FRB adopted the DFAST stress scenarios in their entirety. See BD. OF GOVERNORS OF THE FED. RESERVE SYS., COMPREHENSIVE CAPITAL ANALYSIS AND REVIEW 2013: SUMMARY INSTRUCTIONS AND GUIDANCE 5 (2012), available at <http://www.federalreserve.gov/bankinforeg/bcreg20121109b1.pdf> [hereinafter 2013 CCAR INSTRUCTIONS]; 2014 CCAR INSTRUCTIONS, *supra* note 213, at 7–8.

<sup>219</sup> 2014 CCAR INSTRUCTIONS, *supra* note 213, at 5.

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After reviewing the capital plan, the FRB may approve the plan, reject the plan, or require re-submission of the plan.<sup>220</sup> In coming to its decision, the FRB takes into account quantitative and qualitative considerations.<sup>221</sup> FRB Governor Daniel Tarullo has described the *qualitative* inquiry as “cover[ing] a range of topics, including the extent to which the design of a firm’s internal scenario captures the specific risks from the firm’s activities, the firm’s methods for projecting losses under stress scenarios, and how the firm identifies appropriate capital levels and plans for distributions.”<sup>222</sup> The principal *quantitative* grounds for disapproval of a capital plan are that a covered company fails to demonstrate its ability to maintain a minimum five-percent Tier 1 common ratio<sup>223</sup> or other mandatory levels of minimum regulatory capital<sup>224</sup> under the stress test scenarios.<sup>225</sup>

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<sup>220</sup> Capital Plans, *supra* note 200, at 74,638–41; *see also* Policy Framework on the Scenario Design Framework for Stress Testing, 77 Fed. Reg. 70,124, 70,125 (2012) (noting that the CCAR program “ties the review of a bank holding company’s performance under stress scenarios to its ability to make capital distributions”). The new CCAR rule makes a process analogous to the PCA regime’s “capital restoration plan” for “undercapitalized” banks an ongoing feature of banking supervision for *all* large banks. *See supra* note 96 and accompanying text. In this respect, it is also similar to the new requirement set forth in the Dodd-Frank Act that large banks present “living wills” for approval by bank supervisors. In each of these cases, lawmakers have instituted periodic discursive events and settings in which regulatory processes can engage in continuous learning and adjust dynamically to changing circumstances and learned experience. *See* JULIA BLACK, RULES AND REGULATORS 37–44 (1997) (touting virtues of a “conversational model of regulation”); William H. Simon, *Optimization and Its Discontents in Regulatory Design: Bank Regulation as an Example*, 4 REG. & GOVERNANCE 3 (2010).

<sup>221</sup> *See* 12 C.F.R. § 225.8(e)(2)(ii) (2013).

<sup>222</sup> Tarullo Remarks, *supra* note 189, at 10–11.

<sup>223</sup> The CCAR was the first bank regulatory initiative to use the concept of a Tier 1 common capital ratio. Tier 1 common capital is defined as Tier 1 capital less non-common elements in Tier 1 capital, including perpetual preferred stock and related surplus, minority interest in subsidiaries, trust preferred securities and mandatory convertible preferred securities. *See* Capital Plans, *supra* note 200, at 74,636. In substance, this amounts to common stock plus retained earnings. Since the FRB promulgated its CCAR rule, it has adopted the so-called “Basel III” capital adequacy framework, which introduced a new common equity Tier 1 definition. *See* Regulations Y and YY: Application of the Revised Capital Framework to the Capital Plan and Stress Test Rules, 78 Fed. Reg. 59,779, 59,779 (Sept. 13, 2013), *available at* <http://www.gpo.gov/fdsys/pkg/FR-2013-09-30/pdf/2013-23618/pdf>. The FRB anticipates that this new common equity Tier 1 will be even more stringent than the Tier 1 common ratio established by the CCAR. *See id.* at 59,781.

<sup>224</sup> The other minimum regulatory ratios required by the CCAR rule are the “common equity tier 1 capital ratio,” the “tier 1 risk-based capital ratio,” the “total risk-based capital ratio,” and the “tier 1 leverage ratio.” 2014 CCAR INSTRUCTIONS, *supra* note 213, at 2.

<sup>225</sup> 2013 CCAR RESULTS, *supra* note 213, at 11. On the DFAST stress test scenarios, *see supra* note 193 and accompanying text. Although the focus of the review is the projected capital levels under the DFAST stress test scenarios, the FRB in its rule reserves the right to object to the plan even where the covered company is projected

If the FRB rejects the capital plan, the covered company is prohibited from engaging in any “capital distribution,” a category of transactions defined to include, most obviously, making dividend payments to stockholders or repurchasing stock.<sup>226</sup> In such a case, the FRB requires the holding company to retain that capital, rather than distribute it to holding company stockholders.<sup>227</sup> The prohibition stays in effect for four quarters.<sup>228</sup> Consequently, the covered company becomes more resilient to perturbations in the financial markets, and the FRB might even require it to contribute capital downstream to its bank subsidiaries under the source-of-strength principle.<sup>229</sup>

Since 2013, the FRB has given covered companies the opportunity to revise their proposed capital plans before receiving a final FRB objection, but such revisions may only include reductions in proposed dividends or other distributions.<sup>230</sup> In any event, however, disapproval of a capital plan halts dividend payments. If a covered company that is subject to a capital plan objection wishes to pay higher dividends in the future, it must wait until the following year, at which point it must be in a position to demonstrate, either by raising additional capital or otherwise, its ability to meet the quantitative and qualitative criteria of the review.<sup>231</sup> The remedial actions available to the FRB are narrower than the remedial actions provided for by the PCA regime,<sup>232</sup> but the

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to have stressed capital ratios that remain above regulatory minimum levels. *See* 2012 CCAR RESULTS, *supra* note 207, at 6.

<sup>226</sup> For purposes of its CCAR rule, the FRB defines “capital distribution” as: [A] redemption or repurchase of any debt or equity capital instrument, a payment of common or preferred stock dividends, a payment that may be temporarily or permanently suspended by the issuer on any instrument that is eligible for inclusion in the numerator of any minimum regulatory capital ratio, and any similar transaction that the [FRB] determines to be in substance a distribution of capital.

Capital Plans, *supra* note 200, at 74,637; *see also* 12 C.F.R. § 225.8(e)(2)(iv) (2015).

<sup>227</sup> In the case of the covered companies subject to the CCAR program, the relevant stockholders are widely dispersed owners of publicly traded stock.

<sup>228</sup> *See* 2013 CCAR RESULTS, *supra* note 213, at 4.

<sup>229</sup> *See supra* notes 86 & 87 and accompanying text (summarizing the FRB’s source-of-strength principle and its statutory authorization).

<sup>230</sup> *See* 2013 CCAR RESULTS, *supra* note 213, at 4; 2013 CCAR INSTRUCTIONS, *supra* note 218, at 27.

<sup>231</sup> A covered company failing in year one might be able to make such a demonstration in year two based on internal or external developments (or, more likely, some mixture of the two). For instance, it could raise additional equity capital (raising additional debt capital would likely exacerbate any failure to satisfy the quantitative criteria) or it could reduce its balance sheet or offload assets with high risk weights. On the other hand, market developments entirely external to the firm might result in increased reported values for covered company assets (or decreased loss provisions), such that the company would report higher capital ratios.

<sup>232</sup> *See supra* note 94 (describing remedial actions available to bank supervisors as bank capital and leverage ratios fall).



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power to restrict capital distributions is particularly meaningful, as it strikes at the basic value proposition of holding equity securities.<sup>233</sup>

The critical point here is that whereas the PCA regime triggers intervention powers based on *actual* capitalization levels, the CCAR program triggers intervention powers based on consideration of *hypothetical* capitalization levels in the event the stress scenarios come to pass.<sup>234</sup> In the words of the FRB, the new program “incorporates a forward-looking, post-stress evaluation of a [covered company’s] capital adequacy.”<sup>235</sup>

Before these programs, bank regulators lacked a systematized way of tying dividend regulation to the informal-discretionary dimension of bank regulation. Prior to the Dodd-Frank Act, bank supervisors examined banks’ risk models and stress tests, but they consistently failed to require banks to change business practices or maintain additional capital to ensure reliable performance in contingent stress scenarios, despite their statutory authorities to do so.<sup>236</sup> The director of the now-defunct Office of Thrift Supervision (OTS) addressed this issue in Congressional testimony: “[a]ll of our institutions, all of our risk management practices, all of our examination approaches work well, but it is difficult to look at all the risk models and stress them to unprecedented degrees and then require institutions to operate within those stress models.”<sup>237</sup>

Of course, supervisors could always designate any bank action or inaction uncovered during the examination process an “unsafe or unsound practice,” but prior to the CCAR program these determinations would have to be made on an ad hoc basis. Now, the FRB has instituted a regular procedural mechanism to deliberate on, formulate, and take into account the effects of hypothetical stress scenarios on bank capital levels. Moreover, the OTS director’s testimony alludes to another difficulty: with the largest banks, supervisors are hesitant to deploy their enforcement arsenal based on

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<sup>233</sup> See *supra* note 18 and accompanying text (explaining how all returns on equity depend, even if indirectly, on the prospect of payment of dividends to equity owners).

<sup>234</sup> The impetus for this shift toward linking minimum capital standards to stress scenarios came from the Basel Committee’s so-called “Basel 2.5” enhancements in 2009. See BASEL COMM. ON BANKING SUPERVISION, ENHANCEMENTS TO THE BASEL II FRAMEWORK 25 (2009), available at <http://www.bis.org/publ/bcbs157.pdf> (“Supervisors should challenge banks on how stress testing is used and the way it affects decision-making. *Where this assessment reveals material shortcomings, supervisors should require a bank to detail a plan of corrective action.*”) (emphasis added).

<sup>235</sup> 2013 CCAR RESULTS, *supra* note 213, at 1.

<sup>236</sup> See *supra* notes 116, 173 & 174 and accompanying text.

<sup>237</sup> *Lessons Learned in Risk Management Oversight at Federal Financial Regulators: Hearing Before the Subcomm. on Sec., Ins., and Inv. of the S. Comm. on Banking, Hous. and Urban Affairs*, 111th Cong. 25 (2009) (statement of Scott M. Polakoff, Acting Director, Office of Thrift Supervision), available at <http://www.gpo.gov/fdsys/pkg/CHRG-111shrg52966/pdf/CHRG-111shrg52966.pdf>.

hypothetical scenarios. As an illustration of this hesitancy, consider that none of the largest banks were the subject of any enforcement proceedings predicated on an unsafe or unsound practice finding in the five years leading up to the September 2008 financial crisis.<sup>238</sup>

The novelty of the CCAR regime is not limited to its innovative combination of two formerly distinct modes of regulation, which is really an innovation in regulatory theory more than practice. It will also have significant practical implications. As a practical matter, it will eclipse the PCA regime as the first regulatory intervention point based on capital adequacy grounds for large banks.<sup>239</sup> This prediction is straightforward because the stress scenario will *necessarily* result in a bank becoming insolvent earlier than it would in actual market conditions. Unsurprisingly, bank holding companies have taken notice of the regulatory shift. After all, it is a direct impediment to returning capital to their stockholders. For all the controversy over whether managers and boards are responsive to stockholders, the pressure to pay dividends and engage in share repurchases is an incontrovertible fact of life for today's public company.<sup>240</sup>

Figure 2 below updates the earlier regulatory map by including the qualitative and quantitative elements of the CCAR program.

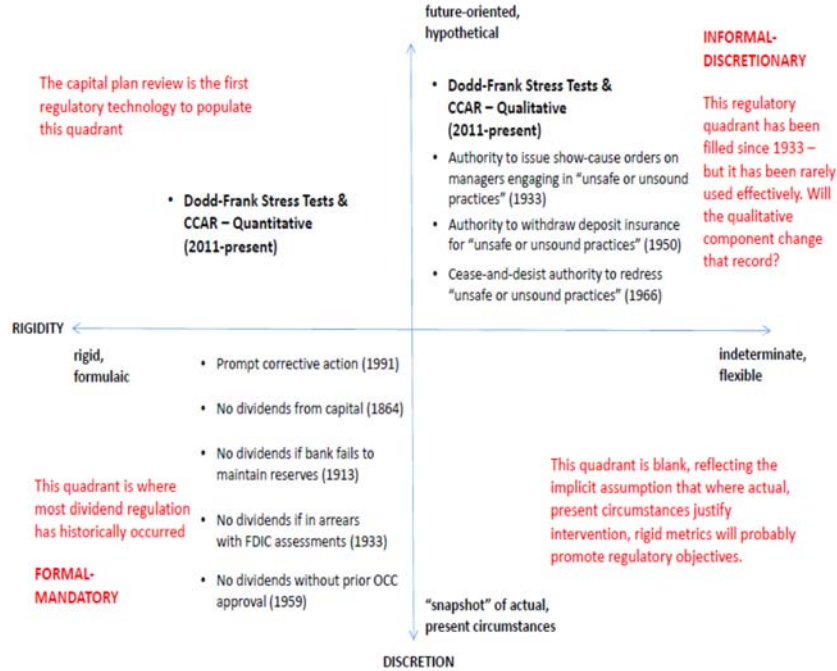
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<sup>238</sup> See *supra* note 126 and accompanying text (describing tendency for supervisors to avoid finding unsafe and unsound practices at the largest banks).

<sup>239</sup> The "based on capital adequacy grounds" qualification is required to take account of the supervisors' powers to issue cease-and-desist orders when a bank or bank holding company engages in an unsafe or unsound practice. See *supra* note 114 and accompanying text (describing supervisors' authority to discipline banks and their executives and boards of directors on safety and soundness grounds even when the firm is adequately capitalized under the capital adequacy rules).

<sup>240</sup> Compare Lucian Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 901 (2005) ("At present, all decisions concerning distributions are in management's hands."), and Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 323 (1986) ("Conflicts of interest between shareholders and managers over payout policies are especially severe when the organization generates substantial free cash flow."), with LYNN STOUT, *THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC* 15–23 (2012) (chronicling the "rise of shareholder value thinking"), William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1415 (2007) (noting that "hedge funds also intervene on the financial side, pressuring firms to disgorge cash—either by substantially increasing a regular dividend, paying a special dividend, or repurchasing stock"), and William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 685 (2010) ("Whether or not cash retention remains a serious governance problem, the cash-disgorgement agenda registered in boardrooms with unprecedented success during the later stages of the most recent bull market.").

**Figure 2: Regulatory Map of U.S. Bank Dividend Regulations (including the CCAR program)**



This map reflects visually the point made throughout this Part VI: that the CCAR program combines elements of the informal-discretionary quadrant with elements from the formal-mandatory quadrant in a new way. The map also shows the qualitative component of the CCAR as an additional informal-discretionary tool. It differs, however, from the other informal-discretionary regulatory initiatives appearing in that quadrant because it has been formalized as a periodic, recurring feature of bank supervision. As such, it might be hypothesized that the FRB should utilize it more frequently than its historically underutilized safety-and-soundness authority. The early returns on the qualitative component, discussed below, support this hypothesis.

*B. Early Experience of the CCAR Program*

The CCAR program has become one of the key pillars of the U.S. bank supervisory system. Regulators and industry both acknowledge its novel importance, and boards of directors manage their companies' affairs in its shadow.<sup>241</sup> JPMorgan Chase & Co., the largest U.S. bank holding company, describes the new regulatory CCAR regime as the "primary measure [that it] use[s] to assess capital adequacy."<sup>242</sup> It further attributes the primacy of regulatory capital to the regulators' powers to restrict capital distributions: "regulatory capital measures are the basis upon which the Federal Reserve objects or does not object to the Firm's planned capital actions as set forth in the Firm's CCAR submission."<sup>243</sup>

JPMorgan Chase's concerns are not merely theoretic. For the 2012 CCAR,<sup>244</sup> the FRB objected to the capital plans of four of nineteen covered companies subject to CCAR<sup>245</sup>: Ally Financial Inc., Citigroup Inc., SunTrust Banks, Inc., and MetLife, Inc. Under the severely adverse stress scenario, the Tier 1 common capital levels<sup>246</sup> for three companies would fall below the new 5.0% threshold if they effectuated the dividends and other capital distributions as proposed in their capital plans. For Ally Financial, they would fall from actual levels of 8.0% to 2.5%; for Citigroup, they would decline from 11.7% to 4.9%; and for SunTrust, they would decline from 9.3% to 4.8%.<sup>247</sup> MetLife, Inc. would maintain Tier 1 common capital levels above 5.0%, but its Tier 1 leverage ratio would fall to 3.4%, below the regulatory minimum of 4.0%.<sup>248</sup> In each of these cases, the FRB enjoined planned distributions of corporate funds to stockholders.<sup>249</sup>

In 2013, the FRB enjoined proposed distributions for two of the eighteen covered companies subject to the CCAR program: Ally Financial Inc. and BB&T Corporation. The FRB objected to the

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<sup>241</sup> See *supra* note 9 and accompanying text (reporting how Goldman Sachs cut back its repo lending program because of its preliminary 2014 CCAR results).

<sup>242</sup> JPMorgan 10-K, *supra* note 8, at 117.

<sup>243</sup> *Id.*

<sup>244</sup> See *supra* note 213 and accompanying text (explaining that the CCAR program was the programmatic vehicle through which the FRB conducted the Capital Plans program for the largest bank holding companies, but that the Capital Plans program has since 2014 been subsumed into a now unitary CCAR program).

<sup>245</sup> For an explanation for why only nineteen covered companies were subject to the CCAR program, see *supra* note 213.

<sup>246</sup> See *supra* note 224 and accompanying text (listing minimum capital adequacy ratio requirements that must be met under the stress scenarios pursuant to the CCAR program).

<sup>247</sup> 2012 CCAR RESULTS, *supra* note 207, at 24.

<sup>248</sup> *Id.* (noting MetLife, Inc.'s 3.4% leverage ratio); see also *id.* at 26 n.24.

<sup>249</sup> See Peter Eavis & J.B. Silver-Greenberg, *15 of 19 Big Banks Pass Fed's Latest Stress Test*, N.Y. TIMES, Mar. 13, 2012, at B1; 2012 CCAR RESULTS, *supra* note 207, at 24 tbl.2.

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former's plan on quantitative and qualitative grounds.<sup>250</sup> In particular, in the severely adverse stress scenario, Ally Financial's Tier 1 common equity ratio decreased from 7.33% to 1.78% after giving effect to its proposed distributions.<sup>251</sup> In BB&T's case, the FRB objected to the plan on qualitative reasons alone.<sup>252</sup> These qualitative reasons related to BB&T's public disclosure that it was reevaluating the process by which it calculated its risk-weighted assets—a key input for one of the regulatory capital levels tested in the CCAR program—to comply with applicable regulatory guidance concerning its treatment of unfunded lending commitments.<sup>253</sup>

In each of these cases, the FRB objected to and enjoined dividends or other distributions of capital where the covered company was “well capitalized” according to each of the PCA regulatory capital requirements to which it was subject.<sup>254</sup> The objection was premised on the covered company's predicted inability to *maintain* its “well capitalized” status if a stress scenario were to occur. With the CCAR program (and the DFAST stress tests it incorporates), the regulatory lens has shifted from snapshot assessments of actual capital levels to forward-looking assessments based on contingent, conjectural, and hypothetical future world states. By limiting the ability to declare dividends or otherwise distribute corporate property—which, again, is the essential characteristic of a privately funded banking system<sup>255</sup>—the FRB has rendered bank dividends more contingent and contestable than ever before.

The 2014 CCAR Results ushered in a new era for two reasons. First, the scope of the program expanded; thirty covered companies met the statutory threshold for participation,<sup>256</sup> up from eighteen the year before.<sup>257</sup> Second, the FRB significantly ramped up its enforcement efforts to discipline banks on qualitative grounds. The FRB rejected the capital plans of four banks due to what the FRB determined were deficient corporate governance systems with respect to capital planning. As for the quantitative component of the

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<sup>250</sup> On the FRB's authority to object to a capital plan for qualitative or quantitative grounds, see *supra* note 221 and accompanying text.

<sup>251</sup> 2013 CCAR RESULTS, *supra* note 213, at 16.

<sup>252</sup> *Id.* at 6.

<sup>253</sup> *Id.* at 20.

<sup>254</sup> For a discussion of the importance of the “well capitalized” definition to the prompt corrective action regime, see *supra* note 93 and accompanying text.

<sup>255</sup> See *supra* Part II (explaining importance of dividends to a privatized financial system).

<sup>256</sup> All bank holding companies with assets in excess of fifty billion dollars, as well as all entities designated by the FSOC as systemically important, must participate in the CCAR program. See *supra* notes 190 & 200 and accompanying text.

<sup>257</sup> See 2014 CCAR RESULTS, *supra* note 13, at 2. For a full discussion of the scope of application of the CCAR program, see *supra* note 213 and accompanying text.

program, the FRB continued to restrict dividend payments for banks failing to maintain requisite capital ratios over the severely adverse scenario.

The FRB objected to four banks' capital plans on qualitative grounds. The FRB's most significant objection was that of Citigroup, which once again found itself the subject of an FRB objection.<sup>258</sup> In objecting to Citigroup's planned increase of its annual dividend from four cents to twenty cents,<sup>259</sup> the FRB noted that, consistent with a 2012 policy statement, it had heightened expectations of "financial resiliency"<sup>260</sup> of the largest, most important financial institutions.<sup>261</sup> The FRB highlighted "deficiencies" in the bank's abilities "to project revenue and losses under a stressful scenario for material parts of the firm's global operations" and "to develop scenarios for its internal stress testing that adequately reflect and stress its full range of business activities and exposures."<sup>262</sup> The FRB noted that it had previously brought these deficiencies to Citigroup managers' attention during its supervisory examinations of the holding company system.<sup>263</sup>

The three other covered companies that received objections to their capital plans—Santander Holdings USA, Inc., RBS Citizens Financial Group, Inc., and HSBC North America Holdings Inc.—are the U.S. holding companies for banks headquartered outside of the United States.<sup>264</sup> For RBS Citizens and HSBC, the FRB echoed its concerns with Citigroup. These banks had deficient practices for estimating revenues and losses under a stress scenario; in the process, they failed to demonstrate their ability to plan for a recession.<sup>265</sup> The FRB found that Santander's problems ran deeper, describing the bank's capital planning deficiencies as "widespread and significant."<sup>266</sup> In fact, the FRB's results for Santander lamented nearly every important aspect of its stress scenario planning: "governance, internal controls, risk identification and management, management

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<sup>258</sup> See *supra* note 247 and accompanying text (discussing the FRB's rejection of Citigroup's 2012 capital plan on quantitative grounds).

<sup>259</sup> See Stephanie Armour et al., *Fed Kills Citi Plan to Pay Investors*, WALL ST. J., Mar. 27, 2014, at A1 (reporting that Citigroup executives were surprised by the objection, and had believed the proposed dividend increase was "modest").

<sup>260</sup> BD. OF GOVERNORS OF THE FED. RESERVE SYS., SR NO. 12-17, CONSOLIDATED SUPERVISION FRAMEWORK FOR LARGE FINANCIAL INSTITUTIONS 4 (2012), available at <http://www.federalreserve.gov/bankinforeg/srletters/sr1217.pdf>.

<sup>261</sup> 2014 CCAR RESULTS, *supra* note 13, at 7.

<sup>262</sup> *Id.*

<sup>263</sup> *Id.*

<sup>264</sup> See *id.* at 6.

<sup>265</sup> *Id.* at 7.

<sup>266</sup> *Id.*

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information system[s], and assumptions and analysis that support [its] capital planning processes.”<sup>267</sup>

Zions Bancorporation was the only bank to receive an objection on quantitative grounds in 2014. Its Tier 1 common ratio for the severely adverse scenario was 4.4%, short of the 5.0% standard. Consistent with past practice, the FRB provided preliminary results of its CCAR exercise to the covered companies. The Goldman Sachs Group Inc. and Bank of America Inc., two of the five largest U.S.-based bank holding companies,<sup>268</sup> received preliminary word from the FRB that it would reject their capital plans on quantitative grounds if they were left unchanged.<sup>269</sup> If those banks were to pay out dividends as proposed in their initial capital plan submissions, their leverage ratios would have fallen below the required minimum levels in the severely adverse scenario. In response to the preliminary objection, Bank of America and Goldman pared back their planned distribution of dividends.<sup>270</sup> In light of the close call, Goldman Sachs also elected to preserve its future flexibility and reduce its likelihood of receiving a future objection by shrinking its total assets.<sup>271</sup> Here, the FRB demonstrated its ability to conceive of dividend regulation in less formal terms—as a dialogic and conversational regulatory model that occurs in the shadow of the FRB’s more prescriptive powers.<sup>272</sup>

The conduct of the CCAR program over the past three years has reinvigorated dividend regulation—a largely forgotten feature of U.S. banking regulation, at least for the largest banks—and made it a salient component of the bank supervisory apparatus. In administering the program, the FRB has restricted the ability of ten of the largest bank holding companies in the world to pay dividends to their

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<sup>267</sup> *Id.*

<sup>268</sup> See *Holding Companies with Assets Greater Than \$10 Billion*, NAT’L INFO. CTR., <http://www.ffiec.gov/nicpubweb/nicweb/HCSGreaterThan10B.aspx> (last visited Oct. 2, 2015) (providing list of largest financial holding companies as of March 31, 2014).

<sup>269</sup> 2014 CCAR RESULTS, *supra* note 13, at 9, 13 tbl.6.A, 32 tbl.A.4.A (noting in particular that under the severely adverse stress scenario, Goldman Sachs would see its Tier 1 leverage ratio drop to 3.9% (below the 4.0% standard) and Bank of America would see its Tier 1 leverage ratio fall to 3.9% and its Tier 1 capital ratio fall below the 6.0% standard).

<sup>270</sup> See Michael J. Moore & Elizabeth Dexheimer, *Citigroup Fails Fed Stress Test as BofA Gets Dividend Boost*, BLOOMBERG BUS. (Mar. 27, 2014, 12:55 PM), <http://www.bloomberg.com/news/2014-03-26/citigroup-fails-fed-stress-test-as-goldman-bofa-modify-plans.html> (“[Bank of America and Goldman Sachs] asked for too much in buybacks and dividends after their own internal stress tests showed better performance than in the central bank’s exam.”).

<sup>271</sup> See *supra* note 9 and accompanying text (reporting how Goldman Sachs cut back its repo lending program because of its preliminary 2014 CCAR results). See *infra* notes 277–79 and accompanying text for a fuller discussion of how Bank of America and Goldman Sachs responded to the FRB’s 2014 preliminary objection.

<sup>272</sup> See BLACK, *supra* note 220, at 37–44.

stockholders.<sup>273</sup> Moreover, by instituting the CCAR program as an ongoing feature of bank supervision, the FRB has formally made all large bank holding company dividends contingent on regulatory approval. Although the FRB has possessed the authority—since 1966, at any rate<sup>274</sup>—to restrict dividends and other distributions where a bank or bank holding company is engaging in unsafe or unsound practices, this new program systematizes and formalizes this intrusion into the corporate governance of the banking sector. Moreover, it does so without requiring the supervisor to demonstrate that the bank is engaging in an unsafe or unsound practice. Instead, the regulatory intervention is predicated on a bank's failure to demonstrate that its practices, however facially safe and sound, are sufficient to secure stable, continued, and resilient operation in the event that a stress scenario, formulated by the supervisors, were to transpire.

The CCAR program affects the decisional landscape for covered companies in ways that extend well beyond dividend policy. It also alters the *ex ante* incentive structure for covered company management. Because boards and executives manage their firms in light of their expectations of the future, the CCAR program can force management into choosing between two strategy types. These strategy types involve incremental trade-offs; that is, they are not mutually exclusive and can be contemporaneously adopted in combination to varying degrees. The first strategy type is simple: management can adjust its planned dividends and distributions in recognition of the possible, or likely, rejection of its capital plan. Under the second alternative, management can adjust its existing strategy by re-allocating asset portfolios or raising new capital, so as to maximize its chances of avoiding a rejection and preserving its ability to distribute capital to stockholders. Any informal model of these decisional incentives must also take into consideration whether the FRB continues its practice of notifying covered companies preliminarily of its intent to object to a submitted plan, or whether management learns of an FRB objection only when it is publicly, and definitively, disclosed. Under either of these scenarios, however, management will be confronted with two possible strategy types in the shadow of the threat of the FRB objection.

To appreciate how this process unfolds, consider the choices facing management of a covered company that suspects the FRB might object to its plans (1) to pay a quarterly dividend of \$0.75 to its stockholders and (2) to spin out (that is, distribute) an insurance division to its stockholders. First, the company could simply reduce its

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<sup>273</sup> In the cases of Bank of America and Goldman Sachs, the mandates were provisional; once these banks revised their capital plan submissions, the FRB authorized their proposed distributions to stockholders. *See supra* note 270 and accompanying text.

<sup>274</sup> *See supra* notes 78–83 and accompanying text.



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planned dividend or scupper the planned spin out. Although on the surface this course of action solves a procedural problem with the regulator, in practice it formally *cements* a more fundamental, economically substantive problem the company was trying to avoid: regulatory intervention with planned corporate actions and policies. Alternatively, the company could adjust its strategies with respect to non-dividend policies. For example, the company might change its investment strategy by substituting low-risk loans for a portion of highly risky assets.<sup>275</sup> Technically, this course of action would produce two computational effects, each of which would increase the company's likelihood of passing the CCAR test. First, it would lower the company's "risk-weighted assets," in the process decreasing the denominator of its capital adequacy ratio.<sup>276</sup> In other words, it would be easier for the company to demonstrate higher capital ratios, thereby complying with regulatory minimum, because the equation's denominator would have decreased. Second, it would attenuate the adverse effects of the stress scenarios on the bank's reconstructed, hypothetical balance sheet. While this example imagines de-risking by asset substitution, the company would achieve similar alchemy by simply reducing total assets by borrowing less. Therefore, a covered company can avoid an FRB objection of its planned distributions by decreasing the risk-weighted assets denominator through de-risking its asset portfolio.

It is not possible to know exactly how the program, in practice, impacts managerial decision outcomes because covered companies are not required to disclose, and understandably choose not to volunteer, internal deliberations of this sort. The experience of Goldman Sachs and Bank of America in 2014 is, however, instructive. As noted earlier, the FRB preliminarily notified Goldman Sachs and Bank of America that the 2014 CCAR results would disclose their failure to maintain leverage ratios and (in Bank of America's case) Tier 1 capital ratios above applicable regulatory minimums under the severely adverse scenario.<sup>277</sup> The FRB permitted the two companies to submit adjusted capital plans. The resubmitted plans were confidential, but the salience of the event resulted in significant media attention, and some

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<sup>275</sup> The following description explicates how the CCAR program carries forward the "risk tax" effect of capital requirements into the hypothetical, future-oriented realm of the informal-discretionary dimension. See, e.g., Sun Bae Kim & Ramon Moreno, *Stock Prices and Bank Lending Behavior in Japan*, *ECON. REV. FED. RESERVE BANK S.F.* 31, 33–34 (1994) (noting that where the supply of equity finance is imperfectly elastic and temporal limitations for accumulating retained earnings as equity exist, an institution will likely be required to reduce its risk-weighted assets to maintain acceptable capital ratios).

<sup>276</sup> See RICHARD S. CARNELL ET AL., *THE LAW OF FINANCIAL INSTITUTIONS* 226–32 (2013) for a description of capital adequacy regulation that is both technical and concise.

<sup>277</sup> See *supra* note 269 and accompanying text.

details emerged about the companies' responses. In its adjusted capital plan, Bank of America reduced its planned dividends, leaving it with more capital and a higher leverage ratio.<sup>278</sup> Goldman Sachs, on the other hand, not only reduced its planned distributions, it also shed assets to boost its leverage ratio and reduce the risk of running into the same situation the following CCAR cycle.<sup>279</sup> From the perspective of the FRB, the end results were similar: Bank of America became more resilient by retaining rather than distributing capital, and Goldman Sachs became more resilient by taking the further step of de-leveraging its balance sheet. One of the more interesting trends to track in banking supervision is whether the FRB will continue this dialogic practice of providing preliminary results to banks whose capital plans come close, but not do not meet, the regulatory capital minimums under the severely adverse scenario. No matter what the FRB does with respect to preliminary results, the threat of a CCAR capital plan rejection can be expected to alter the ex ante incentive structure for covered company management, thereby impacting beyond dividend policies to core matters of strategy and economic capital allocation.

#### VII. CONCLUSION

Dividend restrictions have been a part of bank regulation in the United States since the Civil War when Congress enacted the National Bank Act, the first initial general incorporation statute for banks. In today's financial markets, these rigid, formulaic, accounting-based dividend restrictions (and their progeny) are anachronisms. The endemic instability of today's banking environment requires a different regulatory approach that considers how regulatory objectives can be promoted in an uncertain and volatile future. But the regulation of dividends, if it can be implemented in an effective manner, remains a useful tool on account of its simplicity: by restricting the ability of banks and their holding companies to transfer capital to stockholders, they ensure that there is greater loss absorbing capital within the enterprise.

With the DFAST stress tests and the CCAR program, the FRB and Congress should be applauded for having taken steps to do just that. These initiatives are noteworthy for two reasons. The first reason is a matter of rationalist, regulatory technique. Regulators have opted to update the anachronistic system in an effort to rehabilitate the logical connection between the regulatory means (dividend regulation) and the regulatory ends (a more resilient and stable banking system). The

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<sup>278</sup> See Andrew Dunn, *Bank of America to Increase its Dividend for First Time Since Financial Crisis*, CHARLOTTE OBS., Mar. 26, 2014 (reporting that Bank of America "had to revise down the level of capital it would return to shareholders" in response to the FRB's preliminary objection to its capital plan).

<sup>279</sup> See *supra* note 9 and accompanying text.

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second reason matters from a regulatory theory perspective. With its new CCAR program, the FRB unites the informal-discretionary and formal-mandatory dimensions of bank supervision. Specifically, it has adopted the informal-discretionary element of imaginative and counterfactual thinking. But by retaining a binary pass-fail mechanism calibrated to regulatory capital ratios, the CCAR program remains tethered to traditional formal-mandatory modes of regulation. Consequently, U.S. bank capital regulation has become a “risk regulatory” regime, a type of regulatory system that has prevailed for decades in other contexts such as environmental, health, and safety regulation. This observation should prompt future research to inquire into how the traditional risk regulation literature sheds light on bank supervisory tasks, as well as how risk regulation in the financial supervision context might differ from the traditional contexts in which the risk regulatory model has taken hold. Bearing in mind that one of the central purposes of financial institutions is to produce information about, purchase, and trade risk, this latter consideration opens a discussion about a new risk regulation of risk-taking, a theme that has not been examined.