

**Winter BISM Article
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STARTING OVER

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The thought occurred somewhere between preparing a chart for a client showing a prototype bank holding company structure post-Dodd-Frank Act, and explaining the structure and responsibilities of the new Financial Stability Oversight Council to a law school class on Bank Regulation. The latest in a long line of legislative reactions to financial crisis after financial crisis has left the U.S. banking industry with a structure that would fit better in a Rube Goldberg cartoon, with no assurances that this latest turn of the screw will avert the next crisis. The regulatory regimen for banks and bank holding companies in the U.S. has got to be re-done – completely.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 is but the latest in a long line of banking laws aimed at curing the last thing that went wrong. Recall the Financial Institutions Reform, Recovery and Enforcement Act of 1989, passed in response to the thrift and then commercial bank failures of the 1980s, which armed bank regulators to the teeth with enforcement tools, and exposed third party appraisers, attorneys and accountants to regulatory liability? Or how about the Federal Deposit Insurance Corporation Act of 1991, which introduced capital-based prompt corrective action, risk-based insurance premiums and the least-cost resolution requirement of the FDIC as receiver? FDICIA was actually a comparatively well-thought out reaction to the last crisis, an attempt to combat the perverse incentives for banks and their owners and management, and an attempt to stiffen the back bones of bank regulators

suspected of engaging in forbearance during the period leading up to the crisis. Prompt corrective action was supposed to eliminate “too big to fail” by establishing a system which classified banks into five capital categories, from well-capitalized down to critically undercapitalized, with each step down bringing progressively more stringent regulatory restrictions and requirements. So no more instances of a regulator permitting a bank to “grow out of its problems,” or waiting for a loan portfolio or economy to improve. As capital is depleted, the regulator is required to take a series of steps – ordering restoration of capital, restricting asset growth, and requiring approvals to engage in new activities.

But prompt corrective action was not designed to combat, and was therefore ineffectual in dealing with the sudden asset implosion, contagion and cascades that occurred during the systemic crisis of 2007-2009. In fact, Washington Mutual Bank, F.S.B. met the “well-capitalized” standard through the date of its receivership, as the Offices of Inspector General of the Department of the Treasury and FDIC noted in their Evaluation of Federal Regulatory Oversight of Washington Mutual Bank, “OTS (Office of Thrift Supervision, primary federal regulator for WaMu) did not take, and was not required to take PCA action . . .” In dealing with IndyMac Bank, F.S.B., OTS did not implement its first steps under PCA until July 1, 2008 – the thrift failed on July 11, 2008. Events simply overwhelmed the next-to-latest scheme developed by Congress with the assistance of bank regulators.

But rather than step back and absorb lessons learned from the most recent crisis, or even wait for the report of the Financial Crisis Inquiry Commission which is now expected in January 2011, Congress passed the Dodd-Frank Act, and bank regulators are scurrying to develop

implementing regulations galore. The Bureau of Consumer Financial Protection is leasing property and staffing-up, preparing to assume a huge set of responsibilities from existing bank regulators and to embark on a new “consumer protection first” mission. Meanwhile, yet again, a new slew of laws and regulations arrive, but the existing regulatory scheme remains largely intact – just “improved” or “enhanced” by yet another layer of regulation.

The new bank regulatory structure has regulator after regulator looking over another regulator’s shoulder. The restraints imposed on the Federal Reserve by the Gramm-Leach-Bliley Act have been removed, leaving it free to examine functionally regulated entities. The FDIC now has enforcement authority over bank holding companies when their conduct poses a risk to the deposit insurance fund. And the new Bureau of Consumer Financial Protection has examination and enforcement authority over banks with \$10 billion or more in assets as to consumer financial products and services, and the normal prudential regulators for these banks have back-up authority in that regard. And the FDIC has reinvigorated back-up authority for all non-FDIC supervised banks as a result of a July 2010 inter-agency agreement. And the Financial Stability Oversight Council is to recommend to the Federal Reserve heightened prudential standards for large, interconnected banks.

You get the picture.

Over the decades there have been numerous efforts to step back and re-order what has become a jumbled morass of laws, regulations and guidance applied by regulator upon regulator. The thinking among bank regulators, legal scholars, industry analysts and bankers alike has been that the best time for a fundamental overhaul should be between crises. From the so-called Hunt

Commission appointed by President Nixon in 1971 through the Task Group Report in 1984 and the Financial Services Roundtable Blueprint for U.S. Financial Competitiveness, which was the victim of incredibly poor timing in its November 2007 introduction, thoughtful efforts to identify alternatives for restructuring bank regulation in a non-crisis, non-political atmosphere have gone nowhere.

Let's assume the Financial Crisis Inquiry Commission finishes its work in January 2011. Though it appears likely that the Commission's findings as to the causes of the most recent financial crisis will by no means be unanimous, the acceptance of the report by the President and Congress should not end the venture. A new commission, perhaps with some carryover members, should be appointed and charged with developing a proposal for the comprehensive reform of U.S. bank regulation. The timing for delivery of the report should be after the 2012 election. Though there is political risk that Congress or an administration might attempt to make political hay by once again demonizing the industry, and popular wisdom is that Congress is weary of dealing with banking issues from the Dodd-Frank Act grind, an industry facing years of follow-on regulation and regulatory backstopping should begin to work now to convince anyone who needs convincing that there has got to be a better way.