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2003

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Recommended Citation
Heidi Mandanis Schooner, Secrets of Bank Regulation: A Reply to Professor Cohen, 6 GREEN BAG 2ND 389 (2003).

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The Secrets of Bank Regulation

A Reply to Professor Cohen

Heidi Mandanis Schooner

Bad news incites bank runs. Before federal deposit insurance, a whiff of trouble at a bank sent depositors running, literally, to withdraw cash from their deposit accounts. This phenomenon is troubling for banks for two reasons. First, banks maintain only fractional reserves, i.e., banks keep on hand only about one dollar for every ten dollars deposited by their customers. Banks lend the remaining nine dollars to other customers. Second, a bank's assets are typically illiquid, meaning that if a creditor (e.g., a depositor) demands payment on a debt owed by the bank, the bank cannot readily turn its assets into cash to satisfy that debt. The result is that a bank run can cause serious financial trouble for a bank, even a solvent one.

Even worse, a run on one bank (caused by bad news regarding that bank) can prompt runs on other banks. Runs on many banks can cause problems for other businesses and result in a systemic crisis. All this creates an incentive for the government to prevent bank runs. In 1933, that is precisely what Congress did by creating a comprehensive scheme of federal deposit insurance. Since that time, and despite periods of significant bad news regarding banks, the United States has avoided contagious bank runs.

The bank insurance fund, however, was not created in a vacuum. It was added to an existing scheme for regulating the solvency, or in banking circles the "safety and soundness," of banks. Because banks are so vital to the overall functioning of any economy (and because they are susceptible to runs), governments typically seek to regulate banks in a way that ensures their solvency. In the U.S., for example, banks and their managers are broadly prohibited from engaging in "unsafe or unsound banking practices."[1] They face stiff administrative sanctions if they do.

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1 *See* 12 U.S.C. § 1818(b); Heidi Mandanis Schooner, *Fiduciary Duties' Demanding Cousin: Bank Director Liability for Unsafe or Unsound Banking Practices*, 63 George Washington Law Review 175 (1995).

Internationally, bank regulators have pushed to regulate the capital maintained by banks to ensure sufficient cushion against losses in a time of crisis.

In a recent article, Professor Stephen Cohen analyzes two cases involving misleading accounting by banks, unchallenged by their bank regulators, which gave rise to taxpayer claims heard by the Supreme Court.[2] Professor Cohen criticizes the Supreme Court for failing to admonish the bank regulators for their role in the deception. He writes: "[I]t is astonishing that the Court did not mention, even in passing, that the tax issues arose only because bank regulators, charged with promoting fair and accurate accounting disclosure, violated their public trust."[3]

No doubt, bank regulators would take issue. Some might contend that the accounting was not deceptive. I will not carry that torch. Professor Cohen makes a very credible argument that the accounting masked the true nature of the underlying transactions in both cases. Still, bank regulators are not defenseless. Bank regulators, unlike securities regulators, are *not*, as Professor Cohen asserts, "charged with promoting fair and accurate accounting disclosure." Accounting disclosure simply is not part of a bank regulator's job description.[4] But there's more. Not only aren't bank regulators responsible for banks' accounting disclosure, bank regulators often have good reason to withhold important information from depositors to prevent systemic crisis. In sharp contrast to the disclosure mandate enshrined in the federal securities laws, the federal banking laws rely on a great deal of secrecy.

The most poignant example lies in the examination process. Federal regulators examine most banks annually.[5] As a result of such examination (which takes place both physically at the bank and also through the filing of reports), the bank regulator assigns the bank a CAMELS rating. "CAMELS" is an acronym for the six components used in the assessment of the safety and soundness of a bank: capital adequacy, asset quality, management capability, earnings quantity and quality, the adequacy of liquidity, and sensitivity to market risk.[6] Regulators assign CAMELS ratings on a scale of one to five; one being the highest. Current and prospective bank depositors, not to mention equity investors, would be very interested in learning the CAMELS rating of the bank – especially if the CAMELS rating is a four or five. Borrowing a concept from the federal securities law, the CAMELS rating of a bank is *material* information.[7] Still, CAMELS ratings are non-public and always have been.[8]

2 Stephen B. Cohen, *Even Before Enron*, 5 GREEN BAG 2D 387 (2002).

3 5 GREEN BAG 2D at 387.

4 It is, however, part of the Securities and Exchange Commission's (SEC) job description. In fact, because the SEC and the bank regulators have such different statutory mandates, the agencies have differed from time to time on the banks' accounting practices. *See* Testimony of Governor Laurence H. Meyer Before the Subcommittee on Financial Institutions and Consumer Credit, Committee on Banking and Financial Services, U.S. House of Representative (June 16, 1999) (discussing accounting for loan-loss).

5 The federal bank regulators are the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the Board of Governors of the Federal Reserve System.

6 *See* 61 Fed. Reg. 67021 (Dec. 19, 1996).

7 Under federal securities law, information is material "if there is a substantial likelihood that a reasonable shareholder would consider it important ... ." TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976).

8 The CAMELS rating is, however, disclosed to the board of directors of the bank under examination. *See* 61 Fed. Reg. 67021 (Dec. 19, 1996).

Why deny depositors access to such vital information? Contagious runs and systemic crisis provide one answer. If the public learns that a bank has been assigned a CAMELS rating of four or five, depositors might rush to withdraw their deposits from the bank. This might cause runs at other banks and lead to system-wide financial crisis. Moreover, today, extensive deposit insurance leaves depositors with little need to monitor the solvency of their banks. The Federal Deposit Insurance Corporation absorbs most of the risk of loss to depositors. For the most part, the cost of bank insolvency is borne by the other banks,[9] the government, and sometimes, the taxpayer.[10]

Consistent with their safety and soundness mandate, bank regulators require that banks utilize sound accounting practices. Bank regulators, quite obviously, need an accurate picture of the financial condition of a bank in order to assess its solvency. Why then, wouldn't bank regulators always insist on accurate accounting? Consider this: if the transaction in question benefits the solvency of the bank itself, the failure of a bank regulator to ensure accurate accounting of the transaction may be extrinsic to the bank regulator's role, i.e., not relevant to solvency. Even stranger, if the questionable accounting serves to protect the solvency of the institution (by preventing runs), allowing misleading accounting may be consistent with the role of the bank regulators! This jaded hypothesis can be tested through consideration of the two cases Professor Cohen analyzes.

In *Frank Lyon v. U.S.*,[11] Worthen Bank sought to build a new headquarters building. Federal regulations required that Worthen obtain prior approval of its federal regulator, the Board of Governors of the Federal Reserve System (Federal Reserve), if the investment in bank premises exceeded the bank's capital stock.[12] Congress placed restrictions on banks' ability to own real estate to protect banks from the risks of such investments.[13] Federal law, however, allows banks to own their own premises and gives the regulatory agencies the discretion to approve an investment in bank premises even if such investment exceeds the bank's capital stock. In *Lyon*, the Federal Reserve refused to approve the transaction until Worthen proposed a sale and leaseback arrangement. Professor Cohen asserts convincingly that the sale and leaseback arrangement masked the fact that the Worthen was the effective owner of the premises. Still, given Congress' grant of discretion to the agencies, it is not clear that the Federal Reserve's approval of the transaction violated its obligations to the public. If the sale and leaseback transaction actually benefited the competitiveness of Worthen, and thereby its safety and soundness, then the Federal Reserve's actions furthered, rather than opposed, its regulatory charge. Moreover, as long as the accounting of the transaction did not deceive the bank regulators (there is nothing to indicate that it did), I am not convinced that the Federal Reserve violated a public trust by failing to insist on proper accounting.

The conflict between Professor Cohen's hypothesis and the traditional role of bank regulators is presented more plainly in *Cottage Savings Association v. Commissioner of Internal*

9 The bank insurance fund is funded by premiums paid by banks.

10 In the 1980s, the insurance fund for savings institutions was rendered insolvent. Taxpayers bore the brunt of those losses.

11 435 U.S. 561 (1977).

12 For the current law with regard to national banks, *see* 12 U.S.C. § 371d; 12 C.F.R. 5.37.

13 *See generally* Patricia A. McCoy, Banking Law Manual (2d ed. 2000) at § 5.02[5] (discussing banks' ownership and leasing of real estate).

Revenue.[14] In *Cottage Savings*, the Federal Home Loan Bank Board (FHLBB) allowed Cottage Savings to swap its existing mortgages for substantially identical mortgages held by other lenders. The swap enabled Cottage Savings to realize a loss, for tax purposes, on its mortgages. The FHLBB, however, did not require Cottage Savings to report the same losses to the FHLBB because the swap "would not substantially affect the economic position of" Cottage Savings.[15] Professor Cohen deems this a grave dereliction of responsibility by the FHLBB. He writes: "Given the public's stake in knowing if a bank faces insolvency, the large losses of the S&Ls, *whether realized or not*, should have been disclosed for financial accounting purposes."[16] It may be true that the FHLBB should have required Cottage Savings and other S&Ls to report losses on their non-performing mortgages. Still, the FHLBB may have had good reason to (1) encourage Cottage Savings and other S&Ls to seek a tax benefit, and (2) hide this information from the public. The FHLBB's responsibility was to protect the safety and soundness of its regulated institutions. Therefore, it appropriately encouraged a transaction that generated a tax savings. Moreover, disclosure of the poor financial condition of the S&Ls might have made the situation worse by sparking a run on deposits. Of course, this does not address the concerns of Cottage Savings' shareholders. But bank regulators are not charged with the protection of shareholder interests. They protect the solvency of the institution. Hindsight facilitates criticism of the FHLBB for its handling of the S&L crisis.[17] *Cottage Savings* may be evidence of the FHLBB's miscalculation or even negligence in the handling of the S&L crisis. But it does not prove a violation of public trust.

The accounting in *Lyon* and *Cottage Savings* was slippery. Professor Cohen sees the Enron debacle as a slide further down the same slope. Professor Cohen may be right that the Supreme Court should have had sharp words for such practices; but, as he acknowledges, it merely would have been dicta. Moreover, any such words should have been aimed primarily at Congress, not the banking regulators.

In neither case were the bank regulators' motives necessarily inconsistent with their statutory obligations. Bank regulators generally insist on sound accounting practices. However, as illustrated by *Cottage Savings*, in particular, it is not always clear that bank regulators should so insist when disclosure of a loss might threaten the solvency of a bank, or worse, the financial system.

Professor Cohen raises an important public policy question: Should bank regulation rely more on a system of disclosure, in which banks are allowed to fail through the exercise of normal market forces?[18] Such transparency is appealing, but the secrets of traditional bank regulation remain inextricably linked with the public's expectation that the government will

14 499 U.S. 554 (1991).

15 499 U.S. at 557.

16 5 Green Bag 2d at 391 (emphasis in original).

17 Criticism is especially easy now since the FHLBB no longer exists.

18 Critics of traditional bank regulation and its focus on the protection of the solvency of institutions note that a market-based approach to regulation is more effective and efficient. Such critics would prefer a system of regulation that relies more heavily on market discipline – one in which underperforming banks are allowed to fail and deposit insurance is provided by the private sector. Any remaining government regulation under such a market-based approach would likely rely on mandatory disclosures, much like that provided under the federal securities laws. Despite support for this deregulatory approach, the system remains one in which the government is expected to protect depositors and not one which depends on depositors' access to material information which would enable them to protect themselves.

bailout insolvent institutions. Someday, the public may instead demand that the owners of failed institutions be held accountable. But, hey, that's dicta.